www.pwc.com

Internal Audit. Expect More.

2019 Internal Audit planning: Insurance and asset and wealth management

September 2018

pwc

Executive summary

The insurance and asset and wealth management industries continue to operate in a challenging environment with further changes in regulation, customer behaviours and distribution channels as well as significant transformation on the horizon from emerging technology.

As a result, Internal Audit functions are having to consider a broad range of topics in their risk assessment process in a landscape that is continuously evolving.

This paper seeks to provide you with PwC's view on the market issues impacting the insurance and asset and wealth management sectors in 2019, collated through our own experiences and the insights of our subject matter experts.

We have seen a shift in the approach to audit planning with Internal Audit functions performing targeted risk focused reviews, which when reflected upon collectively at the end of the year, can give wider insights into key themes. Whilst this document is structured into specific sections there are some clear themes that cut across a number of topics including governance and conduct, customer focus, technology and transformation.

We would encourage Head of Audits to use this pack in their risk assessment process to identify relevant topics for incorporation into their audit plan, as well as wider themes that can be reported to stakeholders at the end of the year.

Contents

Applicability of section

- AM Asset and wealth management
- Ins Insurance
- Br Insurance Broker

The current market

The UK economic outlook

The world economy remains relatively strong, but the UK will lag behind in 2018-19 due to the drag on domestic demand from higher inflation and Brexit-related uncertainty. Government investment has picked up recently, but business investment will remain constrained by uncertainties related to Brexit despite the stronger global economy. The latter could also be put at risk in 2019 and beyond if there is further escalation of the recent US-led trade war.

We expect UK growth to become more balanced across regions in 2018-19, with London no longer growing significantly faster than the UK average and all regions growing at 1% or above. The Bank of England is expected to continue with very gradual interest rates rises over the next few years, but the timing of these will depend on the evolution of both the economic data and the Brexit negotiations.

The UK economy held up well in the six months after the EU referendum, but growth slowed from early 2017. This slowdown continued into early 2018, although early signs are that GDP growth was somewhat stronger in the second quarter of this year as the weather improved. Higher inflation has squeezed real household incomes and this has taken the edge off consumer-led growth, together with a slowdown in the housing market. Brexit-related uncertainty has also dampened business investment growth.

On the positive side, UK exports have been boosted by the upturn in global growth over the past two years. The weaker pound, although bad for UK consumers, has been helpful to exporters and inbound tourism. Jobs growth has remained strong, with the employment rate at record levels. Fiscal policy has also been relaxed somewhat since the Brexit vote, particularly as regards public investment. Given continued uncertainties around Brexit and the UK economy, we expect the Monetary Policy Committee to remain cautious about the pace of future interest rate rises

AI and related technologies such as robots, drones and driverless vehicles could displace many jobs formerly done by humans over the coming decades. This will also create many additional jobs as productivity and real incomes rise and new and better products are developed. We estimate that these countervailing displacement and income effects on employment are likely to broadly balance each other out over the next 20 years in the UK, with the share of existing jobs displaced by Artificial Intelligence (c.20%) likely to be approximately equal to the additional jobs that are created. However, there will inevitably be 'winners' and 'losers' by industry sector.

Key projections

	2018 (%)	2019 (%)
Real GDP growth	1.3	1.6
Consumer spending growth	1.1	1.3
Inflation (CPI)	2.5	2.3
House prices	2.9	2.8

Source: *PwC main scenario projections.*

Financial services update

The insurance and asset management industries remain some of the most disrupted industries through continued changes in the **regulatory** environment, accelerating **technological change** and more demanding **customers**.

The FCA and PRA published their annual business plan on 9 April 2018 covering their key regulatory priorities. Following a number of years of big 'implementation' exercises - from **MiFID II** to PRIIPs - the FCA is evolving its approach to assess how these topics have been implemented.

We are beginning to see the FCA engaging with firms on **culture and governance** to assess the drivers of behaviour and their potential to cause harm. It is also continuing with a number of existing initiatives – from the extension of **SM&CR**, to reporting on the mortgage market study, to concluding its initial work on general insurance **distribution chains**. But there are also new items. The FCA has announced new market studies, confirmed its intention to undertake further work on **fund liquidity** and may extend the role of Independent Governance Committees.

The PRA highlights **operational resilience** as a top priority whilst also focusing on the impact of Brexit on the PRA and firms, areas of **Solvency II** improvement, and on investment risk and quality.

Brexit is having a major impact on firms, the regulatory environment and the PRA and FCA themselves. Both regulators acknowledge that Brexit represents a significant challenge and requires substantial resources, leading the FCA to reprioritise its agenda and limit the number of new initiatives.

Meanwhile on the EU front, EIOPA reviewed its strategy for **conduct** supervision, and published its supervisory convergence plan for 2018-19 for the insurance sector. Following the implementation of the **IDD** and the **PRIIPs** Regulation, EIOPA is increasing its focus on driving supervisory convergence in conduct supervision, and on enhancing market monitoring and conduct risk assessments.

However CEOs remain concerned about having the necessary **technological capabilities** to remain competitive. Firms need a clear innovation strategy, one that is predicated on integrated, end-to-end business and operating models that enable companies to take full advantage of advanced automation.

Firms are beginning to explore **RegTech** to explore cost effective solutions to strip out costs in labour-intensive areas such as 'know your customer', but also to strengthen risk management and improve compliance.

Even bigger opportunities are on the horizon as a new generation of **predictive analytics and AI** transforms firms' ability to detect, anticipate, and avert regulatory risks and improve the **customer experience**. The possibilities include scanning for early warning signs of financial crime or miss-selling and identifying the scenarios that could give rise to regulatory missteps.

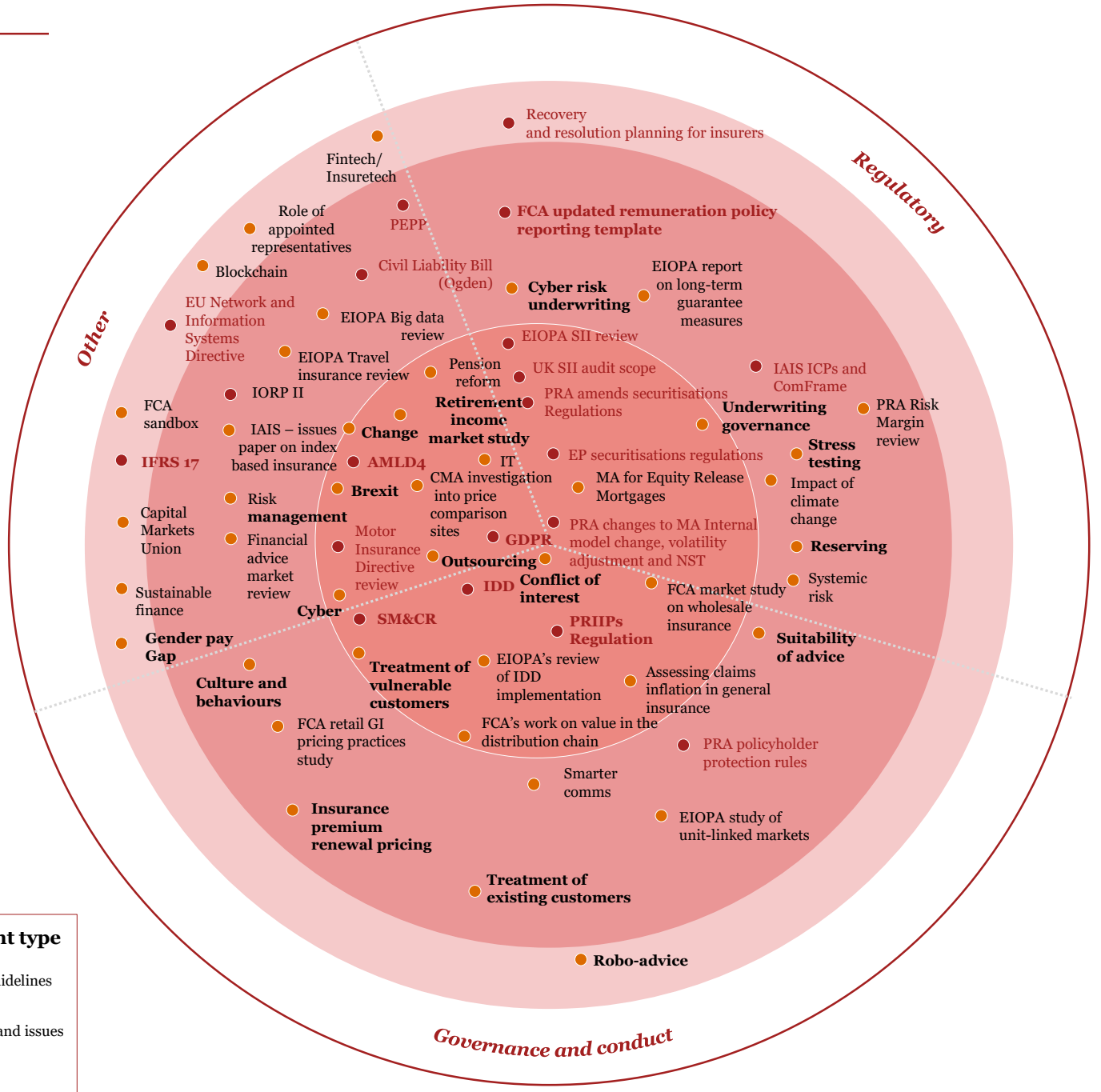
This level of change requires **digital talent** combined with creativity and emotional intelligence to innovate and reconnect with customers. There is a significant shortage of digital skills within the industry with firms competing for the top talent.

The risk landscape
Insurance

We present our view of the risk landscape for Insurance groups, which can be used by Internal Audit functions as part of annual planning.

Like banks, large insurers in particular are seeing greater scrutiny from the PRA and FCA on operational and cyber resilience, including oversight of outsourced arrangements. Aside from those areas where it is joined up with the PRA, the FCA has its own plans for insurance firms. Among these are publishing the interim findings of its wholesale insurance brokers market study, and assessing claims inflation in general insurance – a newly –announced initiative. The FCA 's emphasis is on fairness, access and value for retail customers, while ensuring an effective wholesale market.

The FCA 's insurance - specific Brexit agenda focuses on the potential complexity of firm structures due to the loss of passporting. Insurers should also be aware of the FCA's plans to monitor compliance with the IDD, ensuring the rules reduce conflicts of interests and ensure firms act in consumers' best interests, as intended. Pricing practices and the use of big data, echoing a cross-sector priority, will also be an area of focus as the FCA looks to understand the impact on consumers. Its work on pricing practices links to the treatment of existing customers, another cross-sector priority.



Timing and relevance

- Rules currently in force or coming into force in the next 12 months – key issues
- Rules coming into force in 12 to 24 months, and potential issues firms need to address
- Rules coming into force after 24 months, and issues on the horizon for firms to consider

Development type

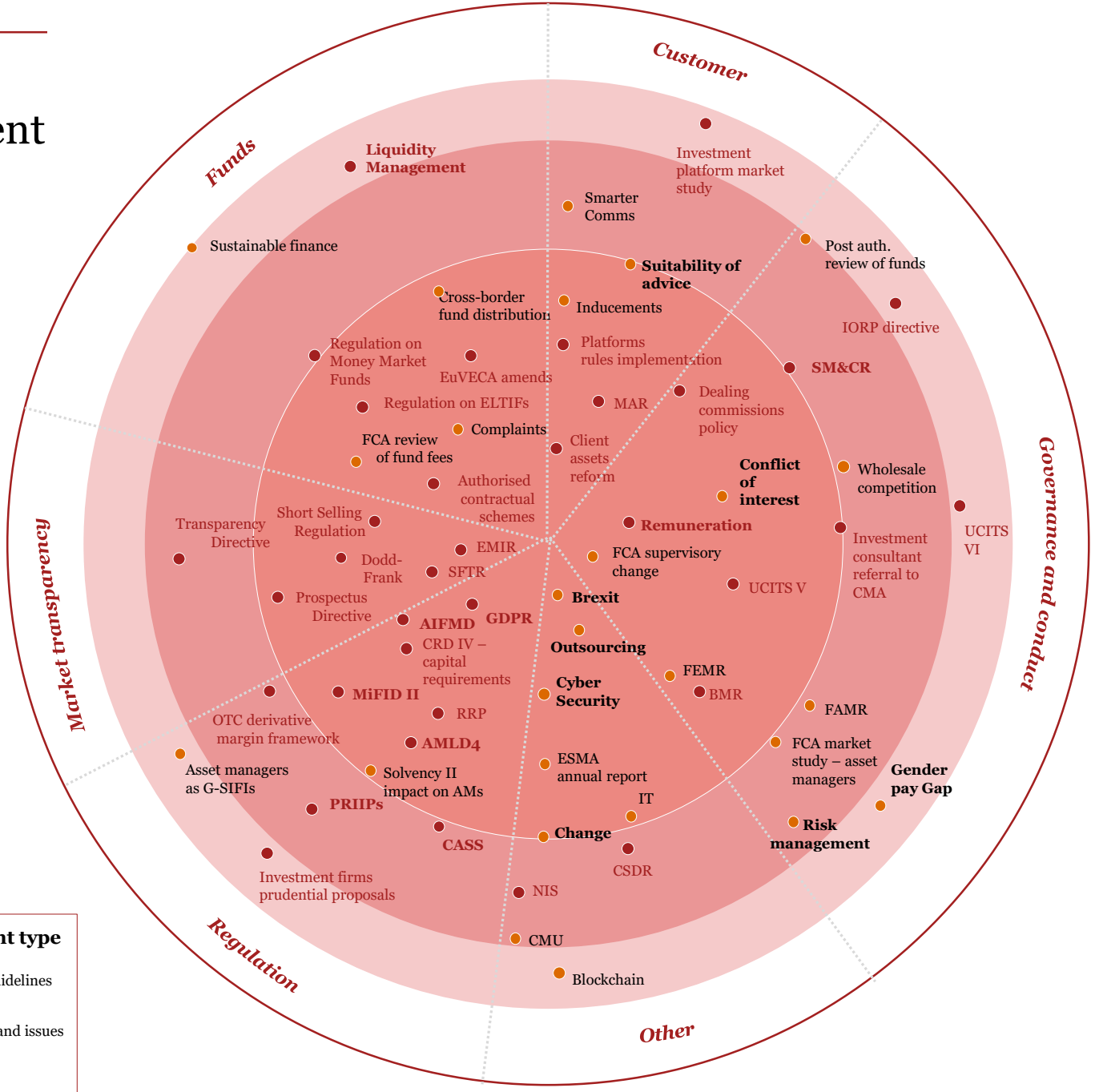
- Rules and guidelines
- Key themes and issues

The risk landscape
Asset and wealth management

We present our view of the risk landscape for Asset and Wealth managers, which can be used by Internal Audit functions as part of annual planning.

The investment management sector has been subject to significant regulatory focus over the past year, with the implementation of MiFID II and PRIIPs, and the FCA's asset management market study. Embedding these changes will require a lot of attention but firms should not expect the FCA to take its foot off the accelerator with new initiatives. These include a planned consultation on rules for liquidity management in open-ended funds. Firms may be particularly interested in the FCA's review of passive management, set to be published by Q1 2019.

The FCA also highlights its focus on financial crime, cyber and technological risks in the asset management sector. The FCA wants to ensure that asset managers using new technologies such as distributed ledger technology and artificial intelligence have sufficient expertise and resources to prevent consumer harm and avoid disruption to critical services. Smaller investment management firms not usually subject to inspections may face reviews if the FCA believes they present high money laundering or cyber risks.



Timing and relevance

- Rules currently in force or coming into force in the next 12 months – key issues
- Rules coming into force in 12 to 24 months, and potential issues firms need to address
- Rules coming into force after 24 months, and issues on the horizon for firms to consider

Development type

- Rules and guidelines
- Key themes and issues

Cross sector themes

Governance and conduct

We continue to see the regulators focused on governance and culture with the topic highlighted as a priority in both the FCA and PRA business plans. The FCA released a discussion paper on culture in March 2018 which covered many of the topics considered in the Senior Manager & Certification regime demonstrating its commitment to explore this topic further.

The Financial Reporting Council (FRC) released the new UK Corporate Governance Code (CGC) on the 16 July 2018 which sets the standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. Although only applicable to companies with a premium listing of equity shares in the UK, the PRA has indicated it considers this Code as best practice for all firms it supervises. They have also indicated they will continue to review firms' governance arrangements, particularly in areas such as remuneration practices, dividend distributions and corporate governance at board level.

In March 2018 the FCA released a discussion paper on culture, its' first tangible output on this topic for some time. The paper considered the role of leaders, incentives and capabilities and the governance of decision making, all of which are considered in the Senior Manager & Certification Regime (SM&CR).

In line with this increased focus, we have observed an increase in regulatory investigations and enforcement relating to conduct and culture.

We present in this section particular topics Internal Audit functions may wish to include in their annual plan however governance and conduct is a theme that should be incorporated and considered across all reviews. The implementation of the SM&CR regime over the next couple of years further highlights individual accountability for firms' ways of working.

Governance and conduct

Senior manager and certification regime (SM&CR)

AM Ins Br

The PRA and FCA are extending the SM&CR regime to all supervised firms and correspondingly amending the existing insurance and banking regimes.

The rules will come into effect for Insurers from the 10 December 2018. The regime will replace the existing Senior Insurance Managers Regime (SIMR) within the Insurance industry, and seek to drive individual accountability in senior staff across organisations.

This will be further extended to cover all FCA solo regulated firms including asset and wealth managers by the 9 December 2019.

Key risks

- Incomplete identification of those employees performing Certification Functions, especially with differing definitions for the PRA and FCA.
- Insufficient internal governance processes to allow demonstration and evidence that suitable duty of care and oversight has been exercised.
- Quality of documentation of governance processes and controls is insufficient.
- Failure to complete initial certification process within 12 month deadline.

Internal audit focus

- Allocation of Senior Manager Function holders (H2 2018) and certified individuals.
- Appropriateness of HR systems to record the information required for certification.
- Appropriateness of systems and procedures in place to record Senior Managers' responsibilities.
- Staff training.
- Appropriateness of conduct risk register design and monitoring.

Conflicts of interest

AM Ins Br

The FCA has been ramping up its activity across all sectors on effective management of conflicts of interest. This includes aspects of conflicts, such as inducements, that feature heavily in recent European directives such as MiFID II and the IDD.

The regulator's concerns extend beyond 'gifts and hospitality', with the FCA showing a willingness to challenge conflicts within firms' core strategy and business model, such as vertically integrated business.

Key risks

- Firms unable to demonstrate how they manage or mitigate conflicts risk facing major regulatory interventions, including restrictions on permissions to wholesale restructuring of the business and governance structure.

Internal audit focus

- Review of the Conflicts of Interest Framework. A clearly defined framework should be in place, including governance and monitoring.
- The Framework should demonstrate firms have considered all forms of conflicts of interest within their business, including inherent conflicts.
- Detailed testing in vulnerable areas relating to conflicts.

Remuneration code

AM Ins Br

Remuneration rules have been issued by regulators across financial services sectors. Solvency II, for instance, has introduced remuneration rules to align the insurance sector regulations with those across other financial services sectors.

We are seeing an increase in the supervision of the appropriate implementation of remuneration rules.

Under SM&CR an independent individual must be appointed with personal responsibility for ensuring that the firm is compliant with its own pay rules. In the banking sector we are seeing the FCA directly challenging this individual and therefore firms need to ensure that in implementing SM&CR, this individual has suitable information and oversight to perform this role effectively.

Key risks

- Employees who are Material Risk Takers ('MRTs') are not correctly identified and there is insufficient documentation, process and framework to support the identification.
- Variable pay pool decisions do not reflect all risks the firm is exposed to.
- Employee performance is not assessed using financial and non-financial metrics.
- Inadequate governance and oversight processes are in place relating to the operation of remuneration policies.

Internal audit focus

- Interpretation and application of relevant criteria to identify MRTs and how this is documented.
- Whether all financial and non-financial risks have been taken into account in variable pay pool decisions, and how these have been taken into account.
- Adequacy of governance and oversight processes in place relating to the operation of remuneration policies.
- Adequacy of MI used to assess individual performance against non-financial metrics including conduct risk.

Governance and conduct

AM Ins Br

Board effectiveness

The Financial Reporting Council (FRC) released the new UK Corporate Governance Code (CGC) on 16 July 2018 following a consultation process initiated towards the end of 2017.

The new CGC comes into force on 1 January 2019 and as well as amendments to the existing CGC, a substantial guidance document regarding Board Effectiveness was also published which will have an impact on the performance of these reviews in future.

Key risks

- Insufficient succession planning processes to support the new recommended tenure and prior experience principles for Board members.
- No clear articulation of responsibilities for chair, chief executive, senior independent director, board and committees.
- Remuneration policy and processes not sufficiently articulated and implemented.
- Lack of process for documenting governance activities.

Internal audit focus

- Increased documentation requirements of committee activity and responsibilities of key individuals and committees.
- Plan for assessment of Board Effectiveness on a multi-year basis.
- Sufficiency of focus on wider stakeholders and the increased reporting requirements.
- Internal Board effectiveness reviews performed by Internal Audit.

AM Ins Br

Risk management in a cost cutting environment

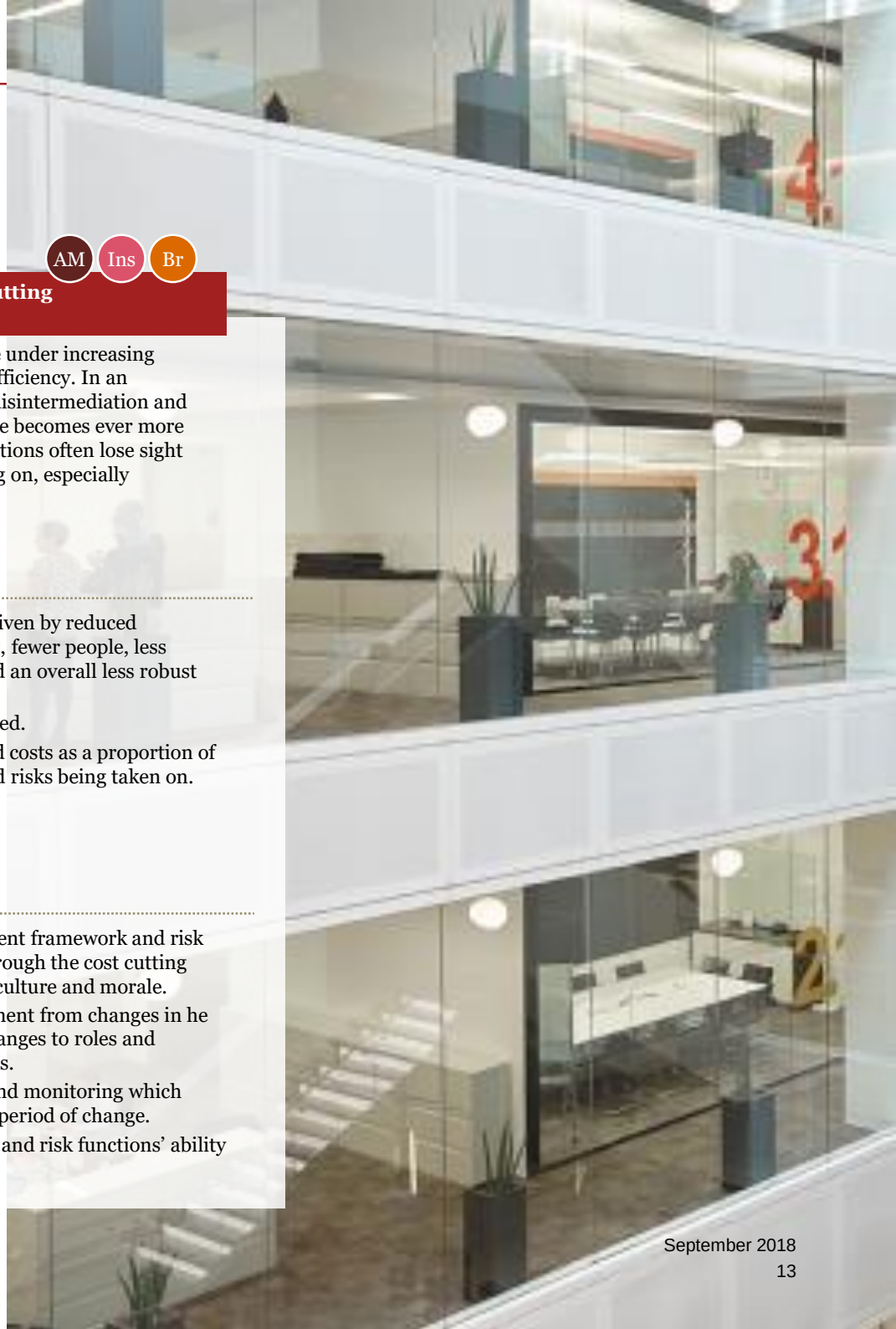
Financial services organisations are under increasing pressure to cut costs and increase efficiency. In an environment of low interest rates, disintermediation and increasing automation, this pressure becomes ever more acute. But in cutting costs, organisations often lose sight of the additional risk they are taking on, especially operational risk.

Key risks

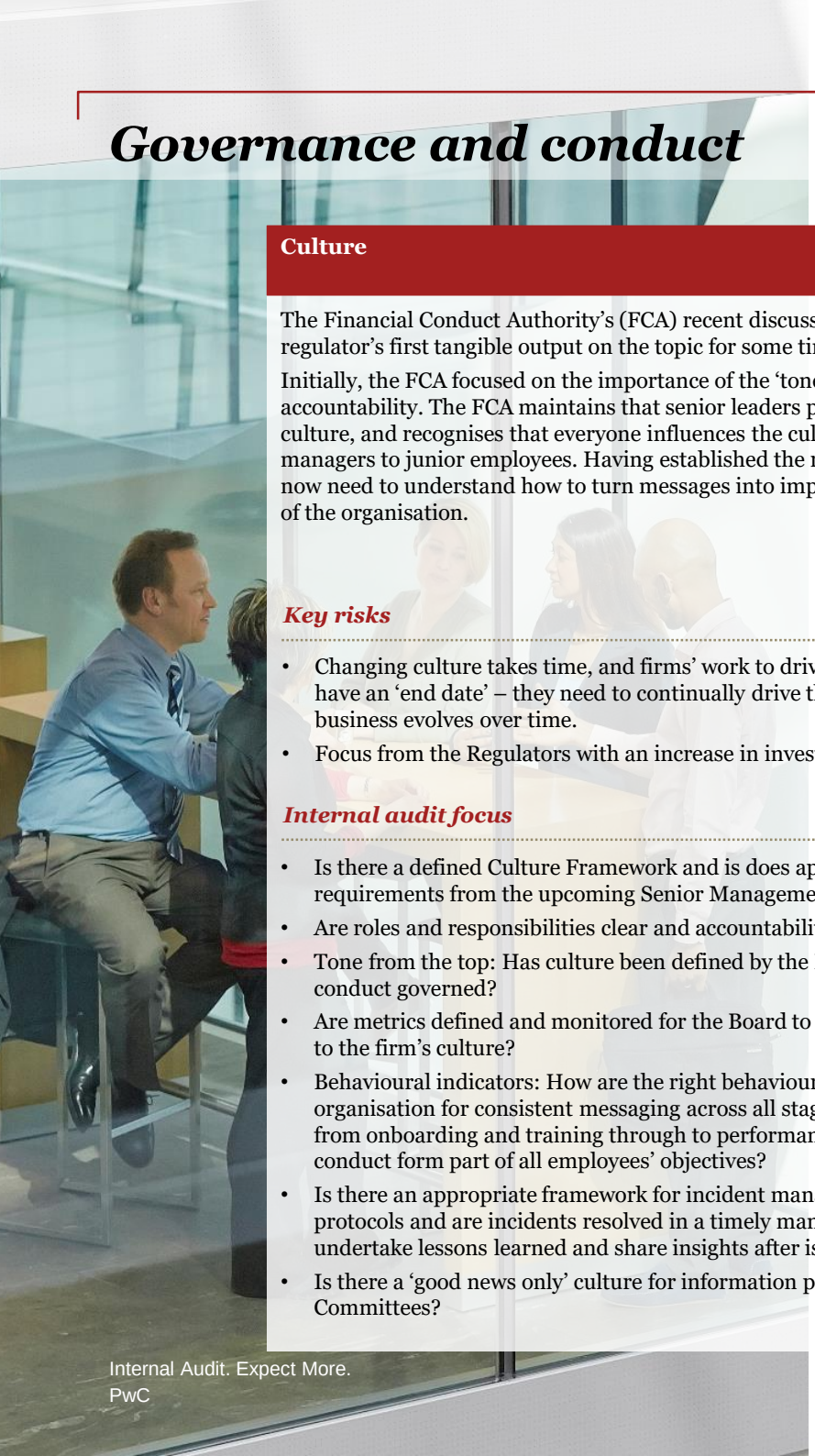
- Increased likelihood of error, driven by reduced resilience in the IT environment, fewer people, less onerous checks and reviews, and an overall less robust controls environment.
- Assurance activity may be reduced.
- Pressure to grow, to reduce fixed costs as a proportion of revenue, may lead to unintended risks being taken on.

Internal audit focus

- Adherence to the risk management framework and risk appetite as the business goes through the cost cutting exercise considering impact on culture and morale.
- Changes to the control environment from changes in he operating model considering changes to roles and responsibilities and staff changes.
- Additional controls, reporting and monitoring which maybe required throughout the period of change.
- Effectiveness of lines of defence and risk functions' ability to challenge the business.



Governance and conduct



Culture

AM Ins Br

The Financial Conduct Authority's (FCA) recent discussion paper on culture is the regulator's first tangible output on the topic for some time.

Initially, the FCA focused on the importance of the 'tone from the top' and individual accountability. The FCA maintains that senior leaders play a key role in influencing culture, and recognises that everyone influences the culture of a firm, from middle managers to junior employees. Having established the right tone from the top, firms now need to understand how to turn messages into improved behaviours at all levels of the organisation.

Key risks

- Changing culture takes time, and firms' work to drive the right culture will not have an 'end date' – they need to continually drive this as the market and their business evolves over time.
- Focus from the Regulators with an increase in investigations and enforcements.

Internal audit focus

- Is there a defined Culture Framework and is does appropriately reflect requirements from the upcoming Senior Management & Certification Regime.
- Are roles and responsibilities clear and accountability understood?
- Tone from the top: Has culture been defined by the Board and how is culture and conduct governed?
- Are metrics defined and monitored for the Board to effectively oversee adherence to the firm's culture?
- Behavioural indicators: How are the right behaviours cascaded through the organisation for consistent messaging across all stages of an employee's lifecycle from onboarding and training through to performance and remuneration. Does conduct form part of all employees' objectives?
- Is there an appropriate framework for incident management including escalation protocols and are incidents resolved in a timely manner? Is there a willingness to undertake lessons learned and share insights after issues are raised?
- Is there a 'good news only' culture for information presented to Boards and Committees?

Diversity and inclusion

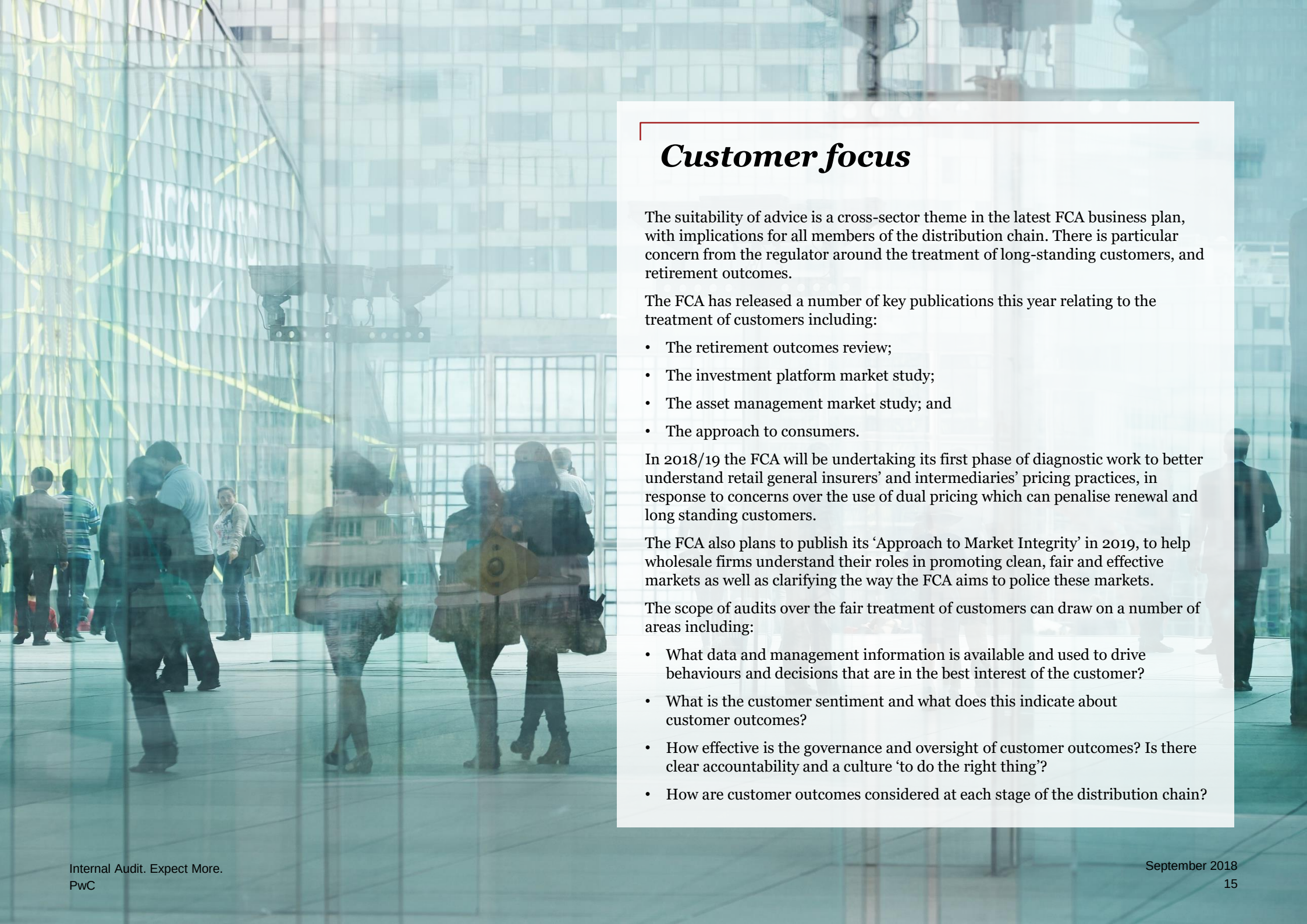
AM Ins Br

The Equality Act Gender Pay Gap (Information) Regulations 2017 require all companies with 250 or more employees in England, Scotland and Wales to disclose multiple gender pay gap indicators. The figures are published on your own website (signed off by a senior executive to validate the accuracy of the information) in addition to the government website.

In June 2018, the Treasury Committee published the Women in Finance report specifically focusing on barriers to the progression of women in finance. The report made a number of recommendations on which firms should act. In August 2018, the Business, Energy and Industrial Strategy Committee (BEIS) also released a report on their latest enquiry into pay fairness. It is likely that gender pay reporting requirements will broaden to include ethnicity and disability pay by 2020.

- There is increased public and government scrutiny of the progression of women in financial services. It is likely that the exemption of partners and subsidiaries from reporting will be removed.
- There are reputational risks to companies who do not demonstrate that they are taking action to resolve their gender pay gap.

- How has your approach to investigating and resolving your gender pay gap been defined? Does it have appropriate investment and senior buy-in to drive change?
- Do you have appropriate and sufficient data to better understand the reasons behind your gender pay gap? What analysis of this is being performed?
- Have your recruitment and promotion policies been examined to eliminate unconscious bias?
- Are performance bonuses and promotions based on clear criteria?
- Is the public reporting of your plans to resolve your firm's gender pay gap accurate, sufficient and supported by activity being undertaken within the firm?
- Have you reflected on the implications on your gender pay gap from culture audits?



Customer focus

The suitability of advice is a cross-sector theme in the latest FCA business plan, with implications for all members of the distribution chain. There is particular concern from the regulator around the treatment of long-standing customers, and retirement outcomes.

The FCA has released a number of key publications this year relating to the treatment of customers including:

- The retirement outcomes review;
- The investment platform market study;
- The asset management market study; and
- The approach to consumers.

In 2018/19 the FCA will be undertaking its first phase of diagnostic work to better understand retail general insurers' and intermediaries' pricing practices, in response to concerns over the use of dual pricing which can penalise renewal and long standing customers.

The FCA also plans to publish its 'Approach to Market Integrity' in 2019, to help wholesale firms understand their roles in promoting clean, fair and effective markets as well as clarifying the way the FCA aims to police these markets.

The scope of audits over the fair treatment of customers can draw on a number of areas including:

- What data and management information is available and used to drive behaviours and decisions that are in the best interest of the customer?
- What is the customer sentiment and what does this indicate about customer outcomes?
- How effective is the governance and oversight of customer outcomes? Is there clear accountability and a culture 'to do the right thing'?
- How are customer outcomes considered at each stage of the distribution chain?

Customer focus

AM Ins Br

Vulnerable customers

The FCA recently announced it will continue to define vulnerable customers as 'those who are especially susceptible to harm because of their circumstances'.

The final *Approach to Consumers* document reiterates the FCA's commitment to prioritising the most vulnerable and least resilient consumers in its work, as promised in its April 2017 Mission. It expanded the risk factors for vulnerability that it identified in its Occasional Paper No. 8. That paper focused on risk factors associated with health, capability and life events, whereas the FCA has now added resilience to this list.

Key risks

- There is a risk that as a result of the FCAs decision to return to the original definition, firms could deprioritise further development work around identifying and treating vulnerable customers as a result of the regulator deciding to keep its original definition.

Internal audit focus

- How effective is the firm at identifying signs of vulnerability (spanning health, resilience, capability and life events)?
- How well they support those consumers they identify as being at risk?
- Has the business reviewed their vulnerable customer policy in light of the FCA's definition?
- Is available data being used sufficiently to identify indications of vulnerability and monitor the customer journey and outcomes for vulnerable customers?
- Are vulnerable customer policies well-established in the business and is there adequate training for all relevant individuals?

Ins Br

General insurer fairness of renewal pricing (cross subsidisation)

In May 2018 the ABI (Association of British Insurers) and BIBA (British Insurance Brokers' Association) launched a set of Guiding Principles and Action Points to address some of the issues in the current market that can lead to unfair differences between new customer premiums and renewal premiums. These guidelines still only apply to certain personal line insurance products such as home, motor and travel and do not cover pet or health insurance.

The FCA will be undertaking it's first phase of diagnostic work this year to better understand retail general insurers' and intermediaries' pricing practices and how these affect specifically household insurance customers.

- Firms are unable to demonstrate how they adequately meet the needs of long-standing customers.
- Firms do not adequately identify and mitigate the conflicts of interest in serving the needs of long-standing customers, thereby facing major regulatory interventions. These could include restrictions on permissions to wholesale restructuring of the business and governance structure.

- What systems and data are used by firms to establish the final price to the consumers?
- What is the governance and oversight of pricing practices? SM&CR establishes clear lines of responsibility for customer outcomes therefore individuals need to be able to answer critical questions on their firm's pricing principles.

Ins Br

Treatment of long-standing customers: Life insurers'

In 2016, the FCA published the findings of its thematic review into the treatment of long-standing customers in the life assurance market. The findings raised a number of areas of poor practice, in customer disclosure, investment performance, exit charges, and governance and oversight.

Of the eleven firms reviewed, six were referred to the FCA's enforcement division for further investigation, with five of these still ongoing. The regulator has said it expects all life insurance firms with closed books to consider the implications of the review findings.

- Firms are unable to demonstrate how they adequately meet the needs of long-standing customers.
- Firms do not adequately identify and mitigate the conflicts of interest in serving the needs of long-standing customers, thereby facing major regulatory interventions. These could include restrictions on permissions to wholesale restructuring of the business and governance structure.

- Is there a clearly defined and adequate framework around the treatment of long-standing customers including governance and monitoring?
- Does the Framework demonstrate that the firm has considered all forms of conflicts of interest?
- Is there a clear gone-away process?
- Is there a product review process in place with controls to ensure that heritage products continue to meet the needs of long-standing customers?
- Is there an effective strategy and governance in place for managing back-book business?
- Has detailed review work been undertaken on specific areas where there are conflicts of interest?

Customer focus

AM Ins

Suitability of advice: Pensions and retirement income

Following the publication of the Retirement Outcomes Review in July 2018, the FCA expects firms to take action to ensure that pensioners are receiving suitable advice. Specifically, firms will be expected to issue communications to relevant customers at 50. We expect specific guidance to follow.

The regulator has concerns that customers may be exploited due to a lack of knowledge of pension products and may be inappropriately advised to transfer out of defined benefit schemes. There is also concern surrounding the high number of individuals using pension freedoms to access cash without advice, and the number of individuals who have drawdown contracts that remain in cash.

Firms will need to review whether the default for drawdown contracts is for funds to be held as cash or whether funds should be reinvested.

Key risks

- The requirement for new and earlier communications to customers may have system implications in order to ensure these communications are delivered at the correct time.
- Drawdown contracts often default to cash and can remain uninvested. Firms must monitor timely and appropriate investment to demonstrate positive customer outcomes.
- Providers will need to engage with customers during the lifecycle of a drawdown. The FCA considers that firms have an obligation to intervene to improve retirement outcomes and the suitability of advice.

Internal audit focus

- Are there operational implications for the business as a result of the requirement to formally communicate with pension customers at 50, and are there plans in place to respond to this?
- Do your drawdown contracts go into cash as the default option?
- Are you monitoring the level of non-advised pension drawdowns?
- Have you reviewed the process for the sale of non-advised drawdowns? Specifically the quality and appropriate quantity of customer communications.

AM

Platforms

The FCA published MS17/1.2: Investment Platforms Market Study Interim Report on 16 July 2018. It found the market is working well in many respects, but identified the following concerns:

- Switching between platforms and shopping around can be difficult.
- The risks and expected returns of model portfolios are unclear.
- Consumers with large cash balances on direct-to-consumer platforms may not know they are missing out on investment returns
- 'Orphan clients' who no longer have an adviser face higher charges, lower service and challenges to switch.

The FCA sets out a number of areas where it expects firms to make improvements between now and its final report in Q1 2019.

Key risks

- There is a suggestion that the FCA will implement more intrusive remedies if firms do not make urgent improvements.
- Firms must implement changes on switching platforms, and progress existing industry initiatives to introduce standardised times for transfers and improve customer communications, including potentially publishing data on transfer times.
- The FCA also wants to see more innovation in the way platforms present their MiFID II costs and charges data.

Internal audit focus

- Internal Audit functions need to be ready to respond to assess how the business responds to these findings.
- How are the risks and returns of model portfolios explained?
- How is price revealed to customers when they consider changing platforms?
- What is the business doing to identify consumers with large cash balances on direct-to-customer platforms?
- What monitoring is there of 'orphan clients' and what steps are taken to ensure they receive an appropriate service?
- Are customers switching platforms on an advised basis and how much is it costing them to do so?

Customer focus

AM

Assessing value for money in investment funds

On the 5 April 2018 the FCA published a policy statement in response to its 2016 Asset Management Market Study.

Within this statement the FCA highlighted it had amended its previously consulted on 'value for money' assessment, now requiring firms to report annually on a wider range of 'value' factors, rather than the previous focus on costs and charges. Authorised Fund Managers (AFM) must assess the value of each fund, take corrective action if required and explain the assessment annually.

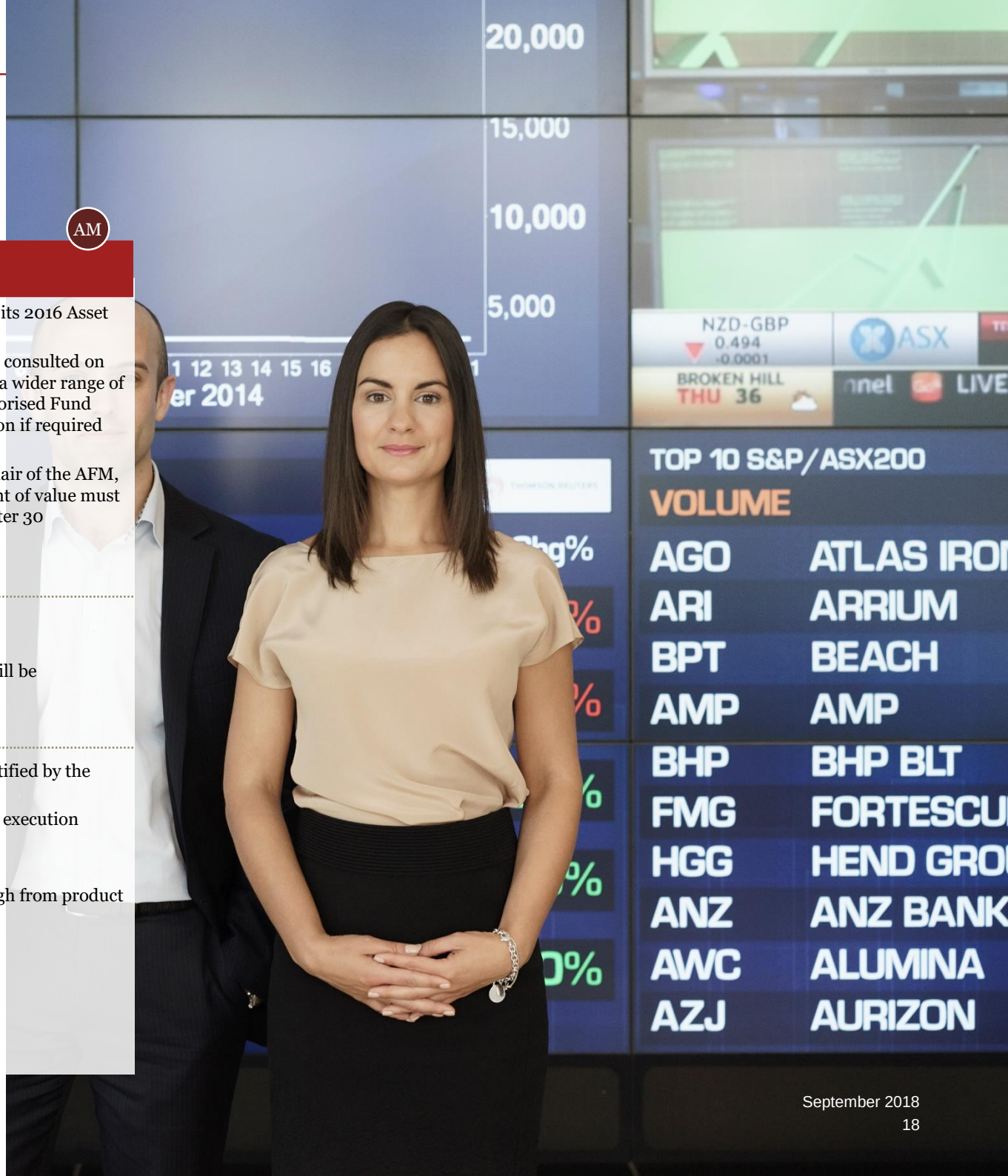
The underlying Prescribed Responsibility for this will still sit with the Chair of the AFM, when the SM&CR comes into effect in 2019. The report on the assessment of value must be published within four months of the first accounting period ending after 30 September 2019, and annually thereafter.

Key risks

- Demonstrating effective oversight under SM&CR.
- The subjective nature of how to assess value for money.
- How to communicate assessments to the customer in a format that will be understood.

Internal audit focus

- How is value for money being assessed against the seven factors identified by the FCA for consideration?
- Does the assessment consider all areas such as management charges, execution costs, research fees and other charges.
- How will value for money assessments be reported?
- What is the governance framework for these assessments right through from product launch to ongoing monitoring.



Technology

Technology is pervasive across all aspects of the value chain within the Financial Services sector. Consequently there is a convergence of focus from regulators, stakeholders and customers in seeking assurances that risks associated with technology are understood and managed.

Technology has moved from being an enabler of business processes to becoming a key factor in long-term business strategy. Technology choices and investments now define how fast a business moves, how agile it becomes, and how effective it is in gaining – and maintaining – competitive advantage.

Financial Services organisations need to take an integrated view of business strategy, customer experience, and technology if they are to deal with the fast paced change that is facing the industry:

- The digital revolution is forcing the industry to evolve at speed, with customers demanding faster, more personalised, anytime anywhere services, and organisations looking to harness the potential of emerging technologies and automation to transform internally.
- Simultaneously, high cost/income ratios and competition from new market entrants are increasing the urgency of addressing technology debt, driving the move from legacy systems to agile processes, digital services, and cloud-based application infrastructure and platforms.
- And as a result of technological change, increased risk and regulation require constant attention in order to ensure – and prove – compliance, whilst dealing with cyber-attacks, fraud, money laundering, data misuse, and the complexity of the evolving technology infrastructure in a cost effective manner.

Technology

Sustained under-investment in the technology estates of major firms has left a 'Technology Debt' which is exacerbated by ambitious digitally enabled growth plans.

The lack of ability of firms to pivot from a legacy estate to 'modern' platforms creates significant risk.

AM Ins Br

Technology operations

Consistent execution of technology controls, underpinned by pragmatic and relevant policy are essential in the delivery of technology services. Internal Audit has an important role to play in ensuring compliance with policy while supporting the evolution of technology control environments.

Each technology function will deliver services to the businesses through a series of formal, or informal processes. While it is easy to be distracted by change or new platforms firms need to maintain a focus on the basics within their ITIA plans.

Whether an organisation has adopted the IT Infrastructure Library (ITIL) framework or not, the basic principles form the ideal foundations from which to base an ITIA plan.

Key risks

- User provisioning is adequately controlled.
- Changes are not tested and approved.
- Staff are not appropriately skilled or trained.
- Documentation is not in place or current.
- Technology risks are not understood or managed.
- Demand on technology services are not controlled or resources allocated appropriately.

Internal audit focus

- Core operational technology processes including; change management, incident management, problem management and security management.
- Approach to technology risk management
- Technology strategy
- Resource development and succession planning

AM Ins Br

Technology resilience

Technology resilience is an area that is still of interest to the regulator, following banking IT issues several years ago. Whilst their attention was on the banks, it is moving toward other FS firms.

The Insurance and Asset management sectors often have serious issues in this space, with management unaware of the technical risk they are facing. It can range from poor operational processes and technical approach that result in unstable IT services, to resilience solutions that can only be used in a very small number of situations. In a small but significant number of cases, firms have developed IT Disaster Recovery ('ITDR') capability at great expense, that do not always work, with management still unaware of the residual risk.

Key risks

- Regulatory and contractual non-compliance.
- Unstable IT services impacting overall business performance.
- ITDR and resilience technical capability that does not protect the business from outages.
- Increased capital requirements for firms unable to demonstrate their ability to understand, manage and mitigate technology risk exposures.

Internal audit focus

- Full IT resilience review (includes IT Service Management, ITDR, New Service Introduction and Technology strategy).
- ITDR review (including controls and technical).
- Specific Incident review.

AM Ins Br

Legacy systems

Sustained under investment in the technology estates of major firms has left a 'Technology Debt'. Legacy systems can result in increasing operating costs to maintain the outdated architecture, are more susceptible to cyber attacks and can prohibit required technology innovation.

The risks associated with this debt are exacerbated by a shortage of skills to maintain legacy systems.

Key risks

- Core operational systems are no longer supported.
- Key skills required to maintain legacy environment are no longer available.
- Cost to maintain legacy estate.
- Legacy estate is not resilient.
- Unable to develop new products as constrained by legacy technology.

Internal audit focus

- Long term plan for legacy systems: maintain, upgrade or replace?
- Skillsets available within the organisation to maintain operation.
- Controls and processes in place to maintain resilience given the heightened cyber risk.

Emerging technology

Technological advances are changing business and operating models.

RPA and AI are the next big technologies on the horizon and it will therefore be important for Internal Audit functions to understand these new technologies so they can effectively support the business as they implement new solutions.

With new technology comes new regulatory implications and it is therefore unsurprising that innovation, big data, technology and competition were a cross sector priority in the FCA business plan.

We have already seen signs of this increased focus. In May 2018 the FCA released findings from a review of the automated online discretionary investment management, which was highly critical of firms' suitability. The report found that robo-advice firms were not properly getting to know their clients' investment objectives or capacity for loss in their suitability assessments.

Robotics (RPA)

AM Ins Br

Robotic Process Automation (RPA) involves software that interacts with legacy software to capture and interpret information from the applications/system. Therefore, processes that are delivered by the current workforce are performed at greater speed, more accurately, and at significantly lower cost.

The 1st line will fundamentally change. New technologies will result in new processes and systems and therefore new risks and controls. As new risks emerge, functions in the 2nd line will need to evolve to address this, for example Robotics Governance and Monitoring, Analytics Governance etc. Functions addressing the new Compliance and Governance requirements will be required.

Key risks

- As RPA becomes an integral part of organisations' processes, new risks and controls in existing domains will emerge that will need to be considered by Internal Audit.
- Testing the inputs, rules and outputs will create new challenges, particularly where rulesets are dynamic and Artificial Intelligence is being used.
- New rights of audit will be required as well as potential remote auditing solutions.
- This has a significant security implication and data security and cyber security audits will become even more prevalent.

Internal audit focus

- Assist the 2nd line while it evolves.
- Assess whether the organisation has the correct skillsets.
- Review the change programme used to govern the identification of technology, assess the appropriateness and monitor implementation.
- Assess the adequacy of ongoing monitoring of any new technology implemented.

Artificial Intelligence (AI)

AM Ins Br

Artificial intelligence is being used by financial services organisations such as chatbots for customer engagement, fraud and error detection, automated loan approval and automated wealth management.

Machine learning is one of the branches of Artificial Intelligence that is being increasingly applied to real time probems and systems.

Key risks

- Regulation determining the acceptable use and level of functional validation needed for a given AI application.
- How the AI application interacts with the business, stakeholders and society and the extent the use case could impact business reputation.
- The robustness of the application, its accuracy and its ability to generalise well to unseen data.
- The potential harm due to an adverse outcome resulting from the use of the algorithm that goes beyond unseen consequences.

Internal audit focus

- Use case criticality : Conduct a risk assessment and consider whether AI should be part of the Audit Plan.
- Responsible AI: Be actively involved in AI projects from inception and assess whether they are governed effectively from strategic assessment, implementation (business readiness and deployment) through to operation and monitoring (resilience, compliance, outcomes, refine and improve).
- Explainable AI: Provide assurance over AI in operation to confirm algorithms and data continue to be reliable.

Operational resilience

Regulators expect firms to be operationally resilient, fundamentally shifting the paradigm to a 'WAR' (Withstand, Absorb and Recovery) footing. This is a material step change from the days of basis business continuity planning with supporting IT disaster recovery.

Both the FCA's and PRA's latest business plans continue to list operational and cyber resilience as key focus areas indicating that regulatory action will continue to increase in this space with an indication of increased supervisory focus on the insurance and asset and wealth management sectors.

Regulators are using data to benchmark firms against their peers with 'SpotCheck' and resilience questionnaires sent to a range of firms. In some cases, the responses to these has resulted in follow-up supervisory action and the statistics arising from these exercises are likely to play an increasingly important role in firms' end of year reviews.

The PRA acknowledges that there is currently no overarching prudential standard for operational resilience. In a joint report with the FCA later this year, it intends to set out the level of operational resilience it expects of firms and how it will make sure this is delivered. This should provide firms with more specific guidelines on the regulators' expectations, and will require work to ensure they are meeting these standards.

Firms also need to ensure they are taking a joined-up approach to operational resilience across conduct and prudential matters, particularly when it comes to governance and accountability.

Operational resilience

Through our experiences of working with firms in their journey to Operational Resilience we have articulated the relevant domains in the diagram below. Internal audit functions should consider where they can add the most value in providing assurance over the steps taken by management to mitigate risks across these domains, with the identified critical business services.

Cyber resilience mechanisms to prevent, detect, respond and recover from cyber-related threats are in place and aligned to the wider response and recovery capabilities.

An operational resilience framework is in place across the organisation, with clear definition and accountability for the different aspects of resilience. The framework is current, communicated, and understood by the organisation.

To ensure that an organisation has the appropriate controls in place to manage physical access to business premises and that environmental quality factors are appropriately reviewed and within risk tolerance.

The operational resilience strategy is aligned and embedded with the Business and IT strategies. Operational resilience drives investment and risk decisions. The Board and Executive management have accurate and adequate oversight of resilience activity, trends and remediation to assist them in making decisions.

Incident response processes are in place to identify, classify and to help ensure appropriate, measured responses. Incident related MI helps drive strategic operational resilience decisions and investments.

Technology services and processes have been designed in such a way that they ensure continuity and there is appropriate investment in these services and processes.

Appropriate continuity plans are in place for all critical services which are well understood by the organisation. These plans are reviewed and assessed regularly to help ensure successful implementation in a continuity scenario.

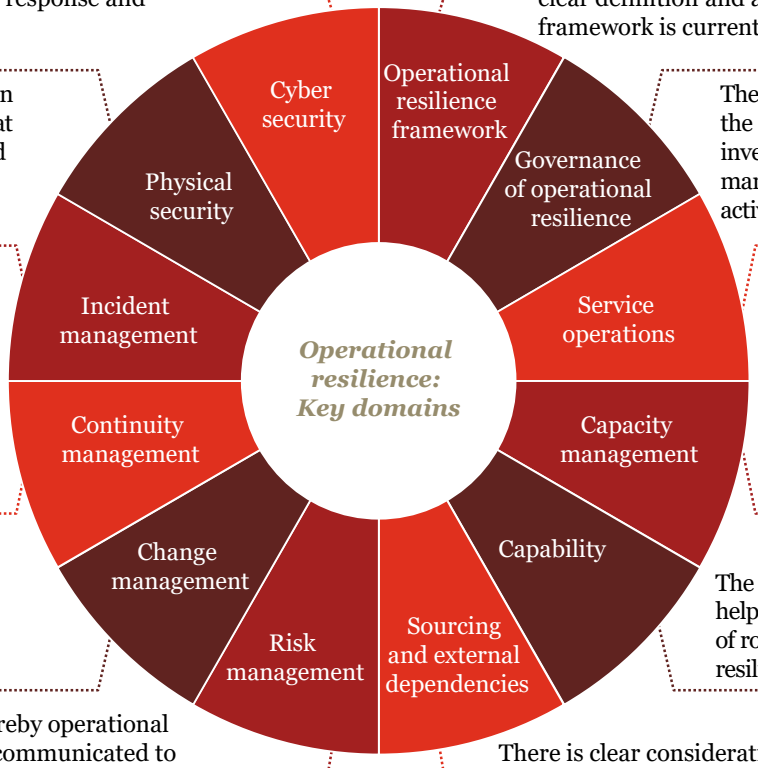
Organisations can demonstrate through testing and monitoring the effectiveness of capacity measures.

Assurance and resilience is embedded in change control and SDLC activity where testing occurs across application development and infrastructure change. Well governed, documented change processes are in place and are fully understood by the organisation.

The organisation has sufficient skills and resources to deliver and help ensure operational resilience. There is a clear understanding of roles and responsibilities and the organisations operational resilience risks.

An effective 'Three lines of defence' model is in place whereby operational resilience risks are understood, assessed, monitored and communicated to the Board and executive management. Risk appetite for critical services have been defined and drive risk acceptance and risk mitigation activities. Risk MI assists in both strategic and tactical decisions.

There is clear consideration and understanding of the dependencies on external or sourcing partners and the level of risk that is introduced into the critical services. Performance, risk and effectiveness of these relationships are frequently assessed and understood.



https://www.pwc.co.uk/industries/financial-services/insights/operational-resilience-in-financial-services-guide.html

Outsourcing

Firms are increasingly outsourcing the delivery of major and critical services, often to unregulated providers.

The FCA wants to ensure that regulated firms have appropriate oversight and control over these providers, and is particularly concerned about third-party providers which support a large number of financial services firms.

The FCA has announced plans to carry out several pieces of thematic and firm-specific work in this area, looking at how firms use third parties, their concentration in the market and potential resulting harm.

AM Ins Br

Third party outsourcing

Financial services firms are increasingly seeking to outsource critical functions to a concentrated set of vendors to reduce cost and gain access to capabilities not readily available to the industry. Growing outsourcing, particularly in emerging technologies, makes it harder for firms to quantity and manage third party risk.

Firms relying on outsourcing arrangements (often to unregulated providers) for the delivery of critical services should note that this is a significant area of focus of the FCA, given some of the recent public issues faced by third party providers. As a result, the FCA intends to increase its understanding of outsourced services and core infrastructure provision across sectors, with particular emphasis on service providers that support many firms. To this end the FCA plans to undertake several pieces of thematic and firm-specific work in this area.

Key risks

- While regulators allow firms to outsource critical functions, they will hold senior management to account over actions of their third party providers. GDPR also places additional due diligence onus on outsourcing providers to ensure than vendors have adequate security controls.
- Failures at third-parties can result in significant disruption and can undermine the security of the outsourcing firm as controls are bypassed through the targeting of vendors.
- As a result of the escalating risk, board level executives are increasingly focusing on outsourcing practices. But in most cases this has not translated into clear accountability which often results in no-one having a holistic overview of who the firm is doing business with and the associated risks.

Internal audit focus

- Consistent approach to oversight of outsourced arrangements applied across the organisation driven by a clear strategy, risk appetite and robust approval process.
- Identification and completeness of outsourced arrangements.
- Consistent and proportionate oversight of third party arrangements including defined roles and responsibilities, robust policy and procedures and defined standards for performing and evidencing effective ongoing supervision.
- Management information available to support oversight of third party arrangements.
- Management of wider third party arrangements including 'Intra-Group' arrangements.

AM Ins Br

Outsourcing to the 'Cloud' and other third party IT services

The FCA updated 'FG16/5: Guidance for firms outsourcing to the 'Cloud' and other third party IT services' on 25 July 2018. The finalised guidance helps firms to understand the FCA's requirements and its supervisory approach for firms outsourcing to the 'cloud' and third party IT services.

This guidance , incorporating additional recommendations from the EBA, has an extensive list of areas firms should consider when outsourcing IT services essential to its operations including:

- Access to business premises
- Relationship between service providers
- Risk management
- Data security, GDPR and access to data
- Exit plans

Key risks

- Whether the outsourced organisation has the right capabilities to govern and operate the 'cloud' environment?
- Regulated firms retain full responsibility and accountability and cannot delegate this to third parties.
- Have management understood the key risks to 'cloud' and IT operations, and set up an effective process to manage and monitor the cloud or IT provider, including understanding any third party service reports on control)?

Internal audit focus

- Firms are expected to use the guidance when designing their outsourcing systems and controls.
- They should consider the complete list of areas in the finalised guidance before outsourcing IT services to the cloud or third-party providers. These include access to business premises, relationship between service providers, risk management, data security, GDPR and access to data and exit plans.
- Firms that currently use cloud outsourcing should consider performing an analysis against the FCA's requirements and remediate any gaps identified.

Cyber

AM Ins Br

Cyber

The frequency and sophistication of cyber-attacks is increasing, with the number of material attacks reported to the FCA up by more than 80% in 2017. Attackers are moving up the value chain, seeking bigger gains while making more substantial investments, making the financial services industry a top target.

The UK industry is categorised as a national critical infrastructure making it a target for increasingly advanced and hostile national cyber capabilities. So called 'hacktavist' organisations are increasingly targeting the industry, which they see as a catalyst for social inequality and corruption.

The cyber landscape is continually evolving, with new technology and risks emerging continuing to disrupt organisations, along with an aging and varied technology estate across organisations providing ever more opportunity for unauthorised and disruptive activity.

Key risks

- In 2017, a series of attacks, raised awareness of not just the scale of the threat but also the vulnerability of many organisations to potentially devastating cyber intrusions. Business leaders' understanding of the potential impact of cyber attacks has changed following an increase in rapid destructive attacks, the collateral damage to companies caused by nation state activity, and huge-scale espionage conducted through supply chains.
- Information security and cyber incidents can cause significant disruption to critical economic functions (CEF) and undermine customer trust. Customers have high expectations around the security of their data with no accidental exposure being deemed acceptable. The complex and changing nature of cyber risk highlights the need for organisations to engage with specialist third parties in order to ensure they have the right supporting skillsets.

Internal audit focus

- Deep dives into core focus areas, including core general IT controls (such as access management, threat and vulnerability management), data governance and protection (particularly given GDPR)
- Do you have the right 'defence in depth' preventative and detective control coverage over your critical assets?
- Attackers are increasingly agile and determined. Can your controls adapt fast enough?
- It's no longer sufficient to invest purely in static preventative or reactive detective controls. Has a real-time detect and respond capability been established?

How to approach a cyber audit

Thematic	Emerging topics	Specific reviews
Cyber governance	Internet of things	Culture and behaviour
Compliance risk	Cloud	Cyber resilience
Cyber risk management	Blockchain	Security by design
External attacks	Quantum computing	Payments systems
Insider threat	Artificial intelligence	Web platforms
Third party	Algo trading	Mobile platforms
Data security	Augmented/ Virtual reality	Mainframe

Transformation

AM Ins Br

Change programmes

As reported in PwC's 21st CEO Survey, insurance and asset management companies are still facing a period of significant change and disruption to the industry with regulatory changes, Brexit, new technology and changing customer behaviours some of the top concerns for CEOs. As a result of this environment, many firms are in the midst of large transformation projects to respond to this disruption and to implement change. By its nature, change is high risk, of strategic importance, and is delivered by activities/resources/budgets outside of BAU.

Typically we see c.3 – 6% of the programme budget spent on independent assurance and Internal Audit are well placed to support programme sponsors, offering independent assurance, alongside assurance activities performed by the first and second lines of defence.

Key risks

It is essential that programmes to deliver transformation are set up and operating in a manner that facilitates:

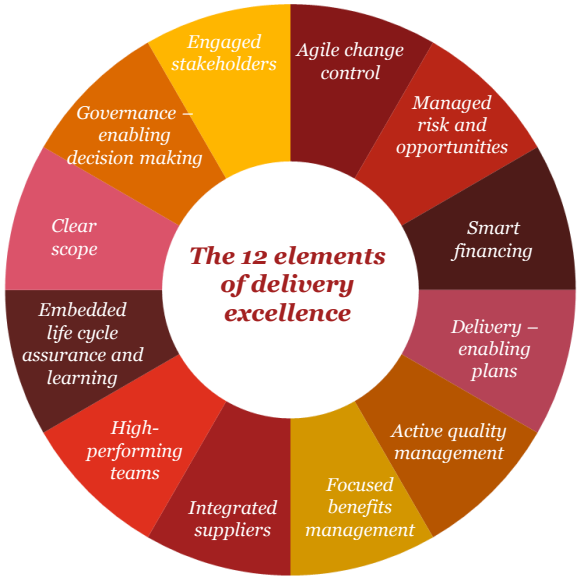
- The right change being delivered;
- Change being delivered effectively; and
- The results of change being sustainable.

Key risks include:

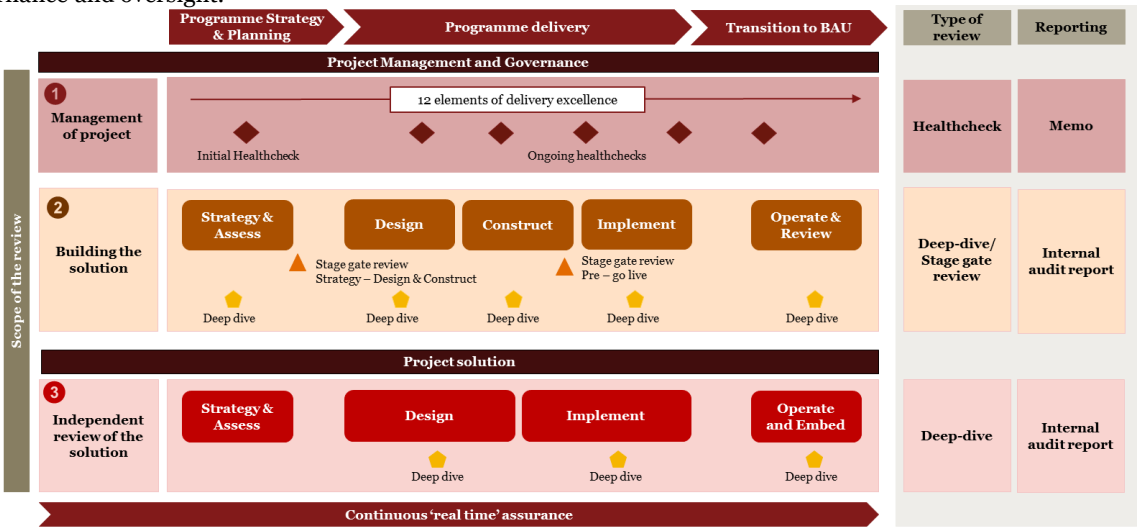
- The scope of the required change is not defined, leading to a change programme which does not achieve the original goal and objectives.
- The change programme is not set up for success with sufficient planning, governance and oversight.

Internal audit focus

- Be clear on the objective of the review; is your focus on the project management and governance of the project and/or are you focusing on the design and implementation of the project solution?
- Healthchecks throughout the programme can evaluate the quality of programme processes focusing on governance and oversight.
- As the project moves into execution, stage gate reviews provide a point in time assessment of project performance, status, and outlook and can be used to assess readiness for the next stage of the project.
- Deep dives focus on a specific stage of the project to assess key project risk areas, potential control weaknesses and improvement opportunities and can be used at a project management level and in assessing the project solution.
- Reporting – is your Internal Audit function able to modify its documentation, communication and reporting style to speed up delivery and provide 'real time' recommendations to the business?



Indicative assurance plan



Insurance specific themes

Insurance soft cycle and regulatory pressure

The PRA has recently raised concerns around oversight of underwriting and associated controls, as well as related issues with reserving, business planning, capital and exposure management. Similarly Lloyd's of London is also taking an increasingly hard line with loss making syndicates.

With rates continuing to remain low, insurers are looking to underwrite new risks in different lines of business that they feel are adequately priced. However, some insurers are being overly optimistic on risks for which they have no or limited historical claims data, and for which previous risk carriers have declined as unprofitable.

On the 31 May 2018, Anna Sweeney, the PRA's director of insurance supervision, released letters to general insurance CEOs, particularly those responsible for specialist risks written in the London Market.

In contrast to previous letter the PRA letter is stronger in tone and shifts its focus onto underwriting discipline and the sustainability of firms' business models. There are nine key findings from the PRA's recent supervisory work covering topics such as:

- Underwriting performance;
- Underwriting governance and controls;
- Optimistic business planning;
- Catastrophe exposure management; and
- Impacts on reserves and capital requirements.

The PRA requested that all firms arrange a specific board discussion on the contents of this letter to consider the issues highlighted and whether any actions should result.

Lloyd's of London has also asked syndicates who have made a loss in three consecutive years to submit remediation plans for approval or face closure of lines of business or the syndicate.

Fundamental to any remediation activity is the willingness to reflect on lessons learned and assess what changes are needed to the governance and oversight of underwriting and reserving. Internal Audit should consider the effectiveness of governance arrangements supported by deep dives in particular topics to support observations and conclusions.

Ins Br

Underwriting governance

With the PRA and Lloyd's of London concerned about the oversight of underwriting and associated controls, firms should be considering the effectiveness of their current governance structure and where accountability and responsibility sits for overseeing underwriting performance and controls within the organisation.

Key risks

- Most insurers in the market lag behind their targets in part because they lack a robust, well-articulated underwriting strategy and the tools, governance, people and processes to implement that strategy.
- Many insurers remain siloed organisations and critical issues are lost in the gaps between reserving, underwriting, finance and pricing.
- Within many firms the control environment is weak and people are writing business they should not be allowed to write.

Internal audit focus

- Review of the effectiveness of interactions between reserving, underwriting, business planning and pricing (considering assumptions and results).
- Design and operating effectiveness of underwriting controls including UW peer reviews.
- Review of the scope and clarity of board communication across underwriting, reserving, business planning and delegated authority.
- Setting and monitoring of the underwriting strategy and how this is cascaded for appropriate underwriter execution.

Insurance soft cycle and regulatory pressure

Ins Br

Pricing

Property and Casualty insurers continue to operate in a challenging underwriting environment. Recent catastrophe losses from Hurricanes Harvey, Irma and Maria, the Ogden discount rate change and evolving cyber threats have bolstered insurers' appetite for rate increases. However, excess capacity continues to suppress rate hardening, driven by a low interest rate environment which continues to attract capital to the market.

Insurers are starting to utilise machine learning applications and in some cases replace often very complex pricing processes. The PRA are becoming concerned that pricing disciplines and controls are slipping.

Key risks

- New processes give rise to significant control risks and could result in errors in pricing.
- Limits and line sizes together with other terms and conditions could be softened to the extent that this results in a material deterioration on loss ratios.
- Disconnect between firms' perception of current price adequacy and their view on recent risk adjusted rate changes with a continued belief that new business is more profitable than on renewal business.

Internal audit focus

Pricing review to include:

- Use of technical pricing models and effective monitoring of model performance.
- Analysis of average premiums offered and written;
- Assessment of how key assumptions are selected, documented and tested;
- Re-performance of key calculations;
- Reconciliation checks on data flows through the pricing process; and
- Investigation into average line sizes, terms and conditions changes, and how these are picked up in peer review process.

Ins Br

Claims Management

Conduct risk has been a focal point for the FCA for several years and clear improvement across the industry needs to be instigated to ensure 'good customer outcomes'. Whilst the eventual outcome of the claim is very important, so is the customer journey/experience throughout the handling of the claim.

Key risks

- The customer journey/experience is not sufficiently considered within the claims handling process.
- Appropriate controls, MI and reporting are not in place or sufficient to guard against poor claims handling.
- Lack of governance and oversight of third party suppliers to support the claims handling process.
- Insufficient intelligence is available to support continued improvement in key processes and the overall performance of the claims function.

Internal audit focus

- Evaluate the customer experience, throughout the processing of claims to determine whether good conduct is at the heart of the process.
- Review the use of third parties to ensure alignment with the interests of the insurer.

Insurance soft cycle and regulatory pressure

Ins

Exposure management

The recent 2017 HIM (Harvey, Irma and Maria) hurricane losses and new emerging risks and regulation continue to create a challenging environment for exposure risk management.

Exposure management and the associated application of reinsurance involves complex processes and a significant volume of big data sets and expert judgment decisions.

Key risks

- Following on from the last few years of relatively benign catastrophe losses, the 2017 hurricane losses have re-raised questions around the challenge of using vendor models to appropriately capture the 'true' extent of losses, and hence a firm's understanding of its actual catastrophe risk exposure.
- Following HIM, overreliance on vendor model outputs, limited use of alternative methods to monitor unmodelled exposure and underlying gaps in the quality and availability of the underlying exposure data have been identified. The effects include incompleteness of the modelled loss estimates and slow reporting of incurred cat losses.
- Exposure managers increasingly face new emerging risks which can be difficult to model, such as cyber risk. This challenge is further intensified by regulatory requirements, including recent communications around the management of silent cyber risks.

Internal audit focus

Our experience has shown that Internal Audit functions can add most value where they are targeted in their audit effort, focusing on specific risks and lines of business – for example the material peril regions, and the non-modelled perils and classes. Specific areas to focuses include:

- Model design
- Catastrophe risk data management
- Catastrophe modelling assumptions
- Catastrophe modelled outputs
- Management information and reporting

Ins

Reserving

The 'Dear CEO' letter from the PRA observed that recent reserving data is highlighting that reserve releases have been flattening out and there have been instances where firms' reserves required significant strengthening.

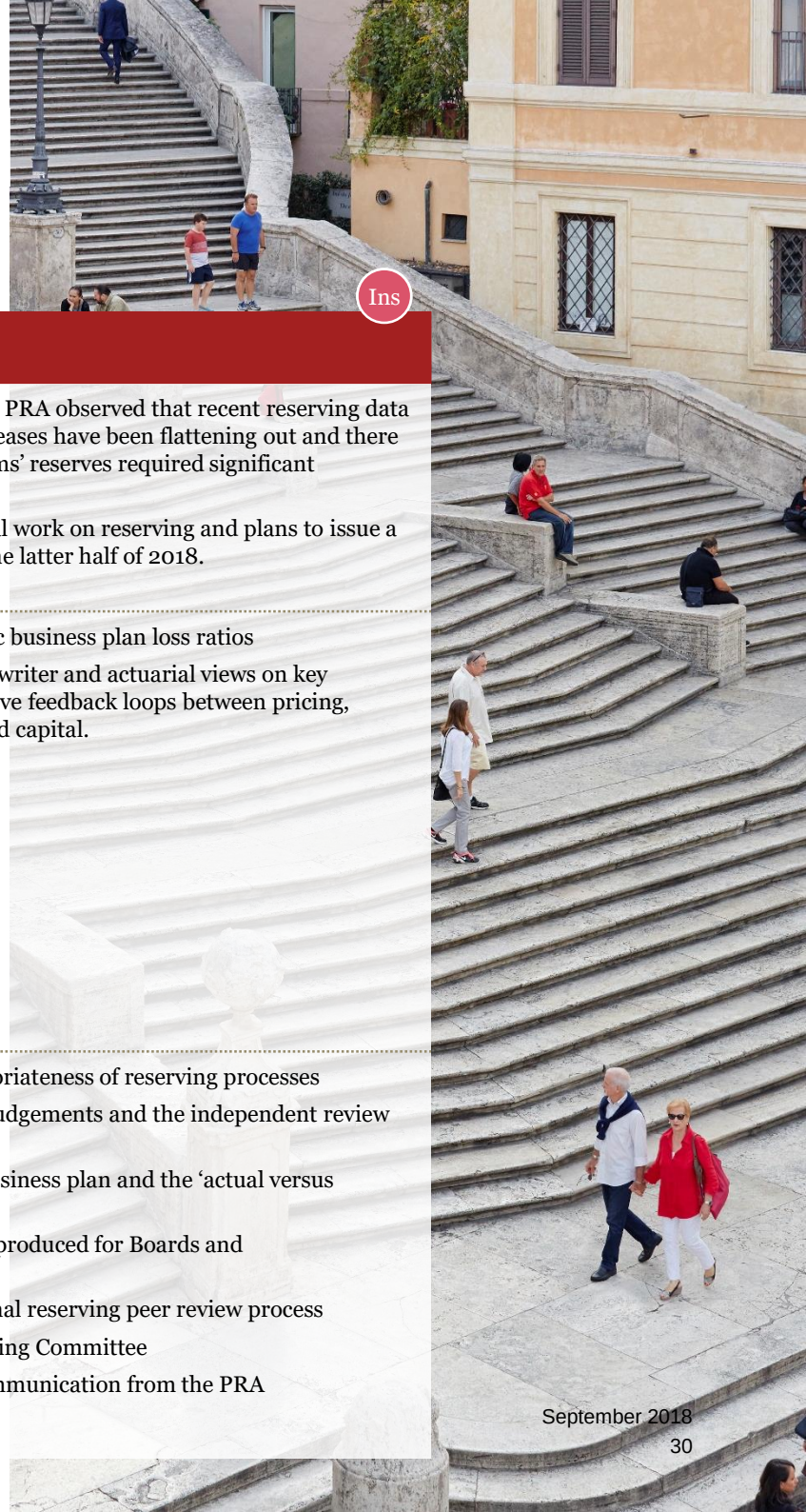
The PRA is planning additional work on reserving and plans to issue a follow up communication in the latter half of 2018.

Key risks

- Over-reliance on optimistic business plan loss ratios
- Divergence between underwriter and actuarial views on key assumptions, with ineffective feedback loops between pricing, underwriting, reserving and capital.
- Reserve strengthening

Internal audit focus

- The robustness and appropriateness of reserving processes
- The application of expert judgements and the independent review of them
- Use of market statistics, business plan and the 'actual versus expected' analysis
- Management information produced for Boards and Executive Committees
- The suitability of the internal reserving peer review process
- Effectiveness of the Reserving Committee
- Response to upcoming communication from the PRA



IFRS 17

Ins

IFRS 17 Insurance contracts

IFRS 17 will be effective from 1 January 2021 with prior comparative reporting required. The standard will impact all aspects of the business and early planning is key. The General model (Building Block Approach or 'BBA') measurement approach is the default model for all insurance contracts under IFRS 17, and although the changes are more complex when using this approach, insurers using the optional Premium Allocation Approach ('PAA') for their short-term contracts will still experience significant change. Although most insurers will be able to defer IFRS 9 Financial Instruments adoption to 1 January 2021, they will need to carefully plan the interaction between the two standards.

We have seen many insurers already complete impact assessments and commence large implementation programmes. Internal audit functions will have a significant role to play in ensuring effective governance and providing programme assurance on the IFRS 17 implementation process. Internal audit functions should also be challenging the business on the steps taken to ensure readiness for IFRS 17.

Key risks

- Business as usual is impacted by the expenditure and distraction of the implementation project.
- Leaving insufficient time to plan and implement is likely to cost the business more.
- Ongoing system and data projects have not appropriately built in IFRS 17 implications.
- The financial impact of the standard is not effectively planned for. Changes to financial results will drive new KPIs and require enhanced disclosures.
- IFRS 9 may increase volatility unless carefully managed with matching elections under IFRS 17.
- The operational impacts are not appropriately planned for. The IFRS 17 measurement model introduces greater levels of system complexity and cost.
- Inadequate data requirements and additional load on infrastructure (processing and storage capacity) resulting in a need to redesign or replace systems.

Internal audit focus

- Programme assurance/project governance – Given the significance of implementation programmes to insurers, IA functions should challenge the business now.
- Insurers should consider special IA projects on providing programme assurance at the beginning, and throughout, implementation.
- Are there clear objectives and robust governance structures, with clear channels for issue resolution? In addition is there granular project plans showing detailed tasks, timelines and ownership?
- Methodology – As the gap analysis concludes, the design/implementation of solutions and how the impact of technical points raised by external auditors is being managed.
- Data and systems – Challenge the business on the plan for developing an information model and a robust data framework, which will enable the transition by preparing/cleaning legacy data and gathering new data where necessary. Ensure the business designs a clear systems plan for the most efficient end state to accommodate the additional requirements.
- Controls – As implementation develops, controls across the business including around data capture, security, modelling and financial reporting will need to be revised for changes in processes.
- Wider business impact – The business's new product development processes and controls incorporate consideration of the IFRS 17 implications including the impact on long term incentive planning, budgeting and forecasting in a new IFRS world.

https://www.pwc.co.uk/services/audit-assurance/capital-markets-accounting-advisory-and-structuring/services/ifrs-17-the-revenue-recognition-standard/how-to-scope-an-ifrs17-internal-audit.html

Regulation

Timeline and key dates

- MiFID II applies from 3 January 2018
- MAR/MAD II – Provisions of MAR relating to concepts under MiFID II apply
- IDD effective from 23 February 2018
- European Benchmarks Regulation – Applies from 1 January 2018
- Payment Accounts Directive – Provisions on transparency and comparability of fee information take effect
- PSD2 – Applies from 13 January 2018
- CRD IV buffers – 1.875% capital conservation buffer
- Basel Committee risk framework – IRRBB rules effective
- Liquidity – LCR 100% and implementation of pillar 2 changes

- Establishing a public register consultation paper
- Accountability Policy statement
- Review of Cryptocurrencies
- Investment Platforms Market Study
- Providing SMEs access to FOS
- Retirement outcome review

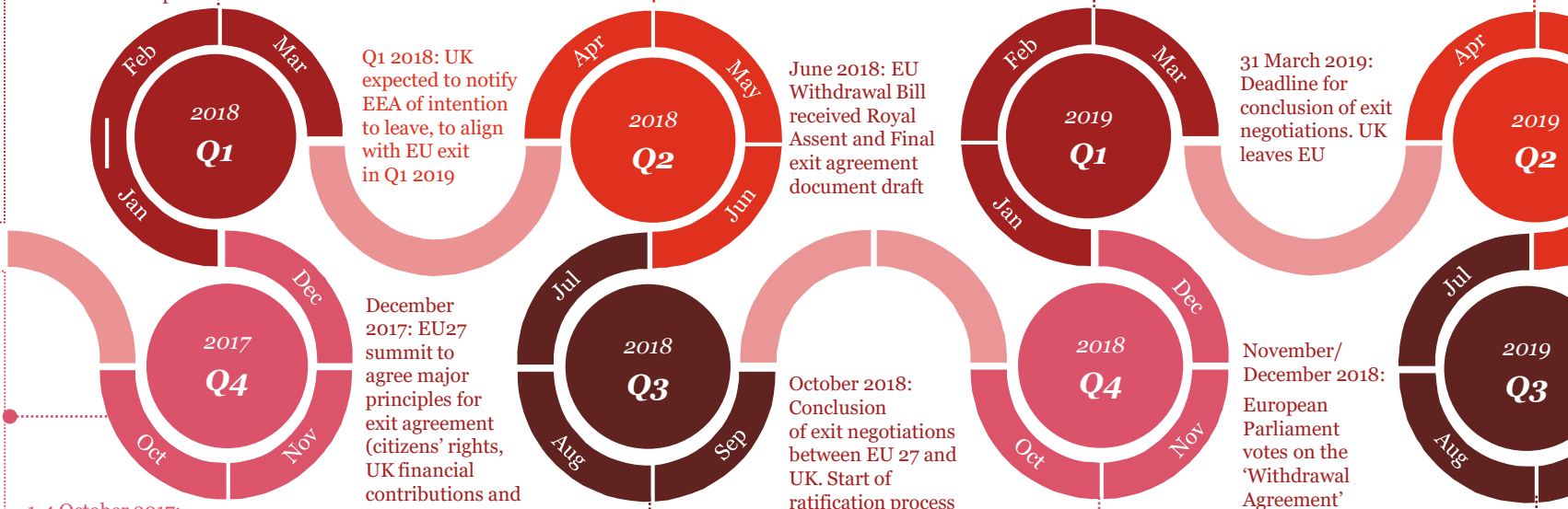
- Money Laundering in Capital Markets report
- EC to deliver report to EP and council on functioning of certain elements of MiFID II
- G-Sills designated in 2017 to apply HLA requirements
- Expected publication of MiFID Investment firm review
- Solvency II: Standard formula changes recommended in 2017/2018 adopted entry
- EIOPA due to publish results of stress testing in January 2019
- Structural reform and the implementation of our policy on operational continuity in resolution by 1 January 2019 will also contribute to the programme

January 2018: UK-EU negotiations begin on future trade relationship

Q1 2018: UK expected to notify EEA of intention to leave, to align with EU exit in Q1 2019

June 2018: EU Withdrawal Bill received Royal Assent and Final exit agreement document draft

31 March 2019: Deadline for conclusion of exit negotiations. UK leaves EU



- SEPA instant payments 'go live' date
- Pillar 3 disclosure – Basel Phase 2 guidance to be implemented. EBA Pillar 3 Phase 1 to be implemented
- PRIIPs Regulation applies from 31 December 2017
- Due date for 2017 IAIS International Capital Standard confidential reporting process

December 2017: EU27 summit to agree major principles for exit agreement (citizens' rights, UK financial contributions and border issues)

October 2018: Conclusion of exit negotiations between EU 27 and UK. Start of ratification process

November/ December 2018: European Parliament votes on the 'Withdrawal Agreement'

1-4 October 2017: Conservative Party Conference

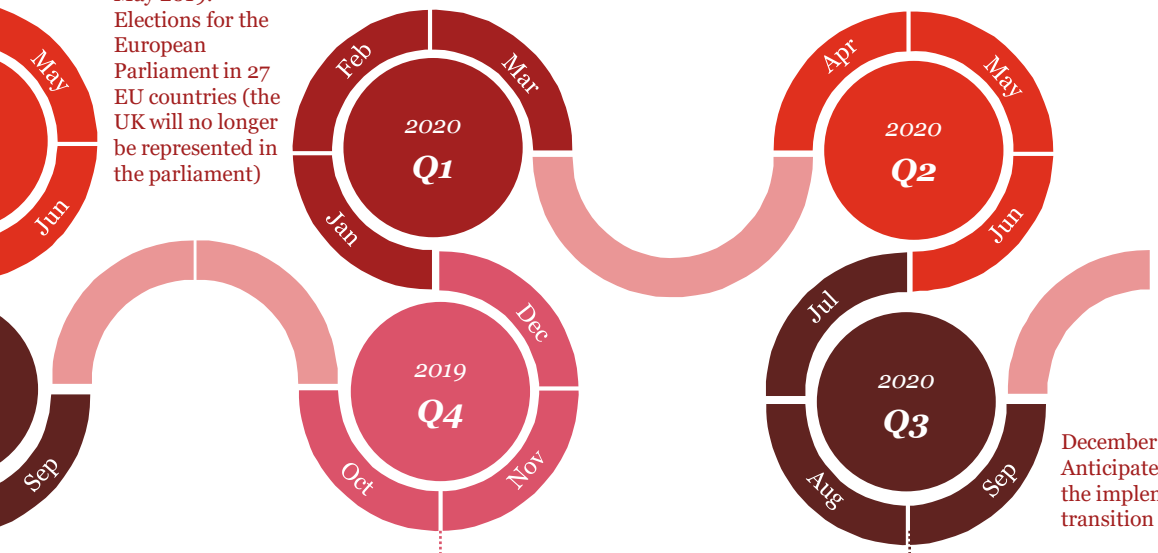
- A number of large UK insurance groups will take part in the 2018 EIOPA stress test exercise, running from May to November 2018.
- Non-workplace pensions
- Fair treatment of with-profit customers
- Unsuitable pension transfer advice
- Strategic Review of Retail Banking Business Models
- Improving competition in current accounts
- High Risk Complex Investments
- Publication of industry group recommendations for improved formatting of disclosure – new rules expected to follow
- Interim report published for FCA Investment Platform Market Study

- Occasional paper on Savings adequacy
- Assessing claims inflation in General Insurance
- Outcomes Testing on Auto advice
- Wholesale Insurance Brokers Market Study
- Asset Management Market Study remedies
- IAIS International Capital Standards (ICS) and Common Framework due date for 2018 confidential reporting process
- Newly effective dates for Insurance Distribution Direction (IDD) 1 Oct 18 & EIOPA to review implementation of IDD across Member States
- Extension of SM&CR to insurers takes effect 10 December 2018

- Investment Platforms Market Study
- Rules on improved disclosure of Fund objectives and benchmarks expected for FCA Management Market Study
- FCA to assess claims inflation in General Insurance

- Standard formula changes adopted for Solvency II

May 2019: Elections for the European Parliament in 27 EU countries (the UK will no longer be represented in the parliament)

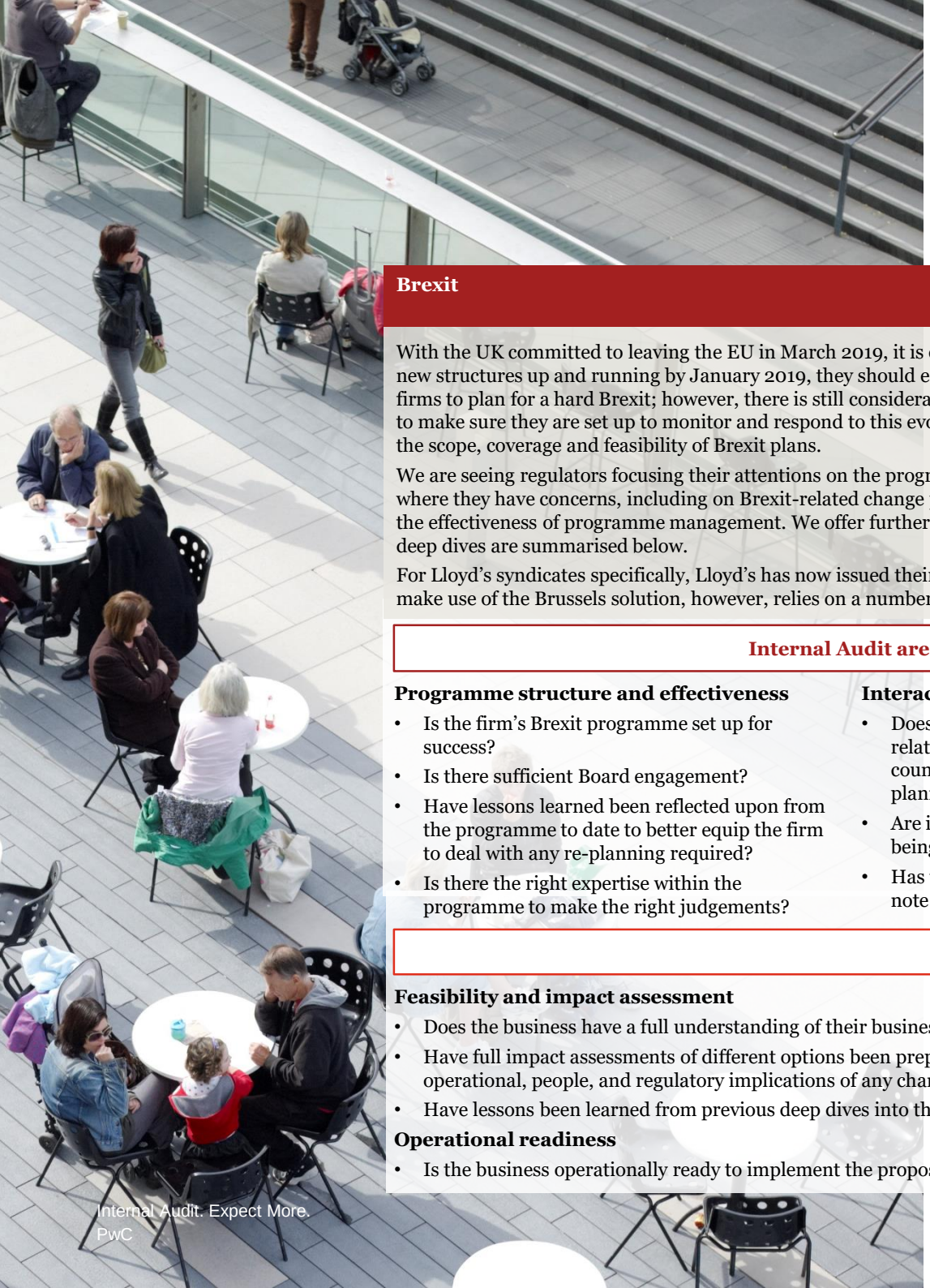


December 2022: Anticipated end date of the implementation/ transition period

- Extension of SM&CR to all FCA firms takes effect 9 December 2019
- IAIS ICS due date for 2019 confidential reporting progress

- ICS adoption of ComFrame including ICS version 2.0
- 31 December 2019: End of five-year exemption for UCITS funds from producing PRIIPs KID (subject to 2018 review outcome)

- Expected implementation, with 5-year transitional for MiFID investment



Brexit

AM Ins Br

Brexit

With the UK committed to leaving the EU in March 2019, it is expected by regulators that plans are now in place. Given that many firms intend to have new structures up and running by January 2019, they should ensure that their Brexit solutions are ready, tested and operational. Regulators have urged firms to plan for a hard Brexit; however, there is still considerable uncertainty about the outcome of the negotiations with the EU. Therefore, firms need to make sure they are set up to monitor and respond to this evolving environment. Internal Audit can support the business by providing assurance over the scope, coverage and feasibility of Brexit plans.

We are seeing regulators focusing their attentions on the programme management of large change programmes within regulated firms and intervening where they have concerns, including on Brexit-related change programmes. Internal Audit therefore has a vital role to play in providing assurance over the effectiveness of programme management. We offer further insights on how to do so effectively on page 26, however, key areas of ongoing focus and deep dives are summarised below.

For Lloyd's syndicates specifically, Lloyd's has now issued their Toolkit to provide guidance around employing the Lloyd's Brussels solution. The ability to make use of the Brussels solution, however, relies on a number of market modernisation initiatives and on managing agents being operationally ready.

Internal Audit areas of focus throughout Brexit preparations

Programme structure and effectiveness

- Is the firm's Brexit programme set up for success?
- Is there sufficient Board engagement?
- Have lessons learned been reflected upon from the programme to date to better equip the firm to deal with any re-planning required?
- Is there the right expertise within the programme to make the right judgements?

Interaction with regulators

- Does the business have sufficiently strong relationships with the regulators in countries within which it currently and is planning to operate within?
- Are interactions with relevant regulators being managed appropriately?
- Has the Financial Services industry briefing note been factored into Brexit plans?

Assumptions and adapting to change

- Is the firm really planning for the worst case scenario or are assumptions being made about what will get negotiated?
- Are contingency plans in place which allow the firm to react as needed to the evolving political environment?

Deep dives

Feasibility and impact assessment

- Does the business have a full understanding of their business model and all the areas of risk affected by Brexit?
- Have full impact assessments of different options been prepared before decisions are taken? These should take into consideration the legal, tax, operational, people, and regulatory implications of any change.
- Have lessons been learned from previous deep dives into the post-Brexit plans?

Operational readiness

- Is the business operationally ready to implement the proposed Brexit plan? Have arrangements been tested?

Cross sector regulation
Financial crime

AM Ins Br

Financial crime

Financial crime is an increasing concern for all insurance and investment management market participants, from the largest global organisations to the smallest syndicates and partnerships. As the risks and potential impacts of Financial crime continues to evolve with recent changes to legislation and increasing globalisation, the risk for market participants who do not put in place effective risk governance and controls frameworks extends well beyond monetary losses to reputation and brand damage, reduced employee morale, and constrained business relations.

Financial crime is one of the FCA's cross-sector priorities, but it looks as though wholesale markets are in line for special attention. The regulator plans to conduct a thematic review examining the impacts of money laundering in capital markets in 2018/19.

Key risks

- **Bribery and corruption:** Every UK-incorporated organisation has an obligation to comply with the Bribery Act (2010). Failing to prevent bribery by any of its employees (and associated persons) can be enforced as a corporate offence. The past 24 months has seen examples of Bribery Act enforcement actions.
- **Sanctions:** Sanctions put in place by a number of national (UK/US) and supranational bodies (EU/UN) have become the foreign policy tool of choice for placing economic or trade restrictions on individuals, entities, goods and services, and increasing the regulatory burden on companies. Global enforcement activity has also increased, resulting in USD 14bn fines by UK and US enforcement against financial service companies since 2010.
- **Fraud:** All companies face the risk of fraud. Recent statistics suggest that fraud is the most common crime in England and Wales. The risk is particularly relevant to the insurance market with the Association of British Insurers quoting that in 2014 there were £1.32 billion worth of fraudulent insurance claims. However, recent unauthorised trading and market manipulation scandals expose the risks faced by investment firms.

Internal audit focus

- Financial Crime framework design/effectiveness review.
- Look back of claims and claims fraud history.
- Review of associated parties and accompanying controls.
- Investigation support.

AM Ins Br

Fourth money laundering directive

On 26 June 2017 the Money Laundering Regulations 2017 ('the 2017 Regulations') came into force, transposing into UK law the Fourth Money Laundering Directive ((EU) 2015/849). The key shift in the 2017 regulations is the codification of the requirement for a firm's AML controls to be risk based. This was previously seen as best practice but the 2017 regulations make this a legal obligation for regulated firms.

- All regulated firms must have their AML compliance framework informed by an enterprise risk assessment. This risk assessment must consider a range of factors and be specific to the entity's business. Historically, regulated firms have struggled in performing this exercise and ensuring their controls are aligned accordingly.
- The 2017 regulations create new offences, including where a reckless statement is made in relation to a request from a supervisory body. This move could indicate that breaches of the requirements of the 2017 Regulations will be treated with increased severity by Supervisors. This is supported by the FCA's business plan which has indicated that AML will once again be a priority area.

- Enterprise risk assessment and refresh.
- AML framework design review.
- AML framework effectiveness.
- Customer Due Diligence evaluation/remediation.

Cross sector regulation

AM Ins Br

Client assets (CASS)

Client Asset (CASS) rules are in place to protect investors from the risk of loss in the event of a firm's insolvency. Since the financial crisis, this has been a particular area of focus for the FCA and has contributed significantly to the overall level of FCA fines and skilled person reviews in the last five years.

There were significant changes to the CASS rules in 2014 / 2015 which have been embedding over the last couple of years. The FCA continues to develop its view on industry best practice and its interpretation of how specific rules should be implemented. This means that, despite firms considering themselves compliant previously, there continues to be ongoing risk in relation to meeting the FCA's evolving expectations.

With significant press coverage on recent financial services insolvency cases, CASS compliance will remain a high priority area of the FCA.

Key risks

- Complex rules are often difficult to interpret and are challenging to align to existing operational processes, leading to unidentified breaches.
- Changes in FCA interpretation of requirements and how these should be put in to practice, leading to breaches at firms which do not keep up to date with industry developments.
- Changes in products and business models lead to the scope of the CASS rules changing and not being identified by the firm.
- Inadequate governance and oversight arrangements, in particular in relation to third parties performing operational processes.

Internal audit focus

- Applicability of the CASS rules to the business and how this is controlled.
- The adequacy and maturity of the CASS risk framework and how this is effectively monitored.
- Whether key operational areas such as reconciliations align to the specific requirements of the CASS rules.
- The adequacy of governance and oversight arrangements, including third party administrators.
- The impact on CASS requirements and processes in change programmes, migrations and the on-going monitoring of key reports and automated controls.

Cross sector regulation

Ins Br

Insurance Distribution Directive (IDD)

The IDD will replace the Insurance Mediation Directive ('IMD'), and aims to ensure consistent prudential standards for intermediaries as well as significantly raising conduct standards, improving consumer protection and effective competition. The IDD applies to insurers, insurance intermediaries, price comparison websites/aggregators and ancillary insurance intermediaries.
On 20 December 2017 the European Commission proposed to push back the application date to 1 October 2018 following requests from the European Parliament and 16 Member States.

Key risks

- There are a number of areas where the IDD goes beyond IMD rules. Firms will need to assess how FCA implementation of IDD affects their current business models and practices.
- Those UK firms operating elsewhere in the EU will need to additionally consider how each EU Member State plans to implement IDD.

Internal audit focus

Post implementation review to ensure that IDD is operating as designed with specific deep dives into topics such as

- Product oversight and governance arrangements for manufacturers (POG).
- Product distribution arrangements for distributors.
- Insurance product information document (IPID) and other product information disclosure requirements.
- Training and competence.

Other areas to consider include:

- Is there clean governance and accountability for all areas?
- Is the IDD plan aligned to the firms' Brexit planning activity.

https://www.pwc.co.uk/services/audit-assurance/risk-assurance/services/internal-audit/insights/insurance-distribution-directive-internal-audit-perspectives.html

AM Ins Br

General Data Protection Regulation (GDPR)

GDPR is the most significant change in data protection law in a generation and has been in force since 25 May 2018. This piece of legislation impacts every entity that holds or uses European personal data. New obligations include:

- Individual rights - such as the right to be forgotten, data portability, data rectification and subject access requests.
- Mandatory breach disclosure within 72 hours, both to the regulator and individuals affected.
- Demonstrating ongoing compliance and having an audit trail of consent and supporting processes.

Key risks

- Operational ability to enable classification of data and to report breaches within 72 hours.
- Potential fines up to the greater of EUR20m or 4% of global turnover for non-compliance.
- Reputational damage.
- Increased resources required for ongoing compliance.

Internal audit focus

- Assess compliance with GDPR regulation and adequacy of governance of ongoing programme/initiatives.
- Adequacy of governance and oversight arrangements, including third parties, over personal and sensitive data.
- Deep dives into specific areas such as data retention and third parties to assess compliance.

Ins

The PRA has indicated it will continue to refine its approach to Solvency II as they mature in operating the new regime. This includes the matching adjustment, internal model change processes, reporting requirements and the risk margin. Further, the PRA expects insurers to maintain robust balance sheets and manage risks effectively. It's adapting its supervisory approach to focus on core balance sheet risks arising from complex products and asset exposures, and plans to monitor firms' business models and the effects these have on firms ' safety and soundness.

At a sector level, for life insurers the PRA is heavily focussed on the investment strategy of life insurance companies, and particularly whether firms are overstating the benefit gained from the Matching Adjustment ('MA'). The PRA also intends to conduct asset reviews (including of illiquid assets), business model analysis and reviews of capital management, focusing on Solvency II capital regeneration.

The use of illiquid assets (including equity release mortgages) and the Matching Adjustment

Insurers are increasingly investing in illiquid unrated assets to provide a better cashflow match for predictable long-term insurance liabilities, particularly annuity liabilities. The persistent low interest rate environment has seen insurers pursuing high yielding illiquid assets including lower-rated fixed-income securities and often unrated real economy assets such as equity release mortgages, commercial real estate loans and infrastructure. These assets are therefore becoming increasingly relevant for life insurance companies.

On the 13th of July 2018, the PRA published a number of policy and supervisory statements on matching adjustment ('MA'), which is a key balance sheet mechanism for writers of annuities. This clarifies the PRA's expectation in respect of for identifying, structuring, monitoring and management of changes in their matching adjustment portfolios. A separate paper looked into the modelling methodology of the MA under stress within the internal model.

On the same day, the PRA published its final guidance on the internal model change process and governance, aimed at reducing the burden on firms of applying for minor and major model changes.

Key risks

- Illiquid assets can be complex and lack observable market prices as well as external credit ratings, making it difficult to assess the credit risk firms are exposed to.
- Increased regulatory focus, including regulatory reviews
- Potential for insurers to be unaligned to the PRAs expectations regarding the no-negative-equity guarantee ('NNEG') on equity release mortgages, specifically considering their inherent risk, the resulting capital considerations and the amount of matching adjustment benefit claimed.
- The MA provides significant benefits to the regulatory capital surplus for a number of life insurers. However, the rules for managing the MA can be complex and firms need to make sure they are compliant. Breaches could lead to the loss of this regulatory benefit.
- Issues within their matching adjustment, internal model or model change approval processes could result in increased supervisory attention. This would put stress on the company resources, especially at a more senior level.
- The investment strategy is not consistent with the Board risk appetite, or specific risk limits.

Internal audit focus

- Credit risk associated with illiquid assets is understood and managed relative to the assets held, risk appetite and the liabilities they back. There is also an appropriate consideration in the relevant capital requirements calculated by the firm.
- The firm has an Internal Credit Rating framework and process for unrated assets.
- Compliance with PRA approved matching adjustment methodology, including ongoing trading/asset restructuring.
- Management's processes for identifying, structuring, monitoring their matching adjustment portfolios and compliance with the PRA rules.
- Compliance with PRA's proposed changes to NNEG on equity release mortgages and any resulting mitigating actions.
- Management's processes for the identification, assessment and reporting of model changes, whether major or minor, and compliance with the PRA requirements.

Insurance regulation

Ins

With profits

In the 2017/18 Business Plan, the FCA announced a thematic a review into the fair treatment of with-profits policyholders. In June 2018 FCA issued a detailed information request to approximately 30 firms, followed by interviews with selected firms in August. The objective of thematic review is assess the fair treatment of policyholders, including the fairness between interest of policyholders and shareholders, and between different groups of policyholders. This is particularly relevant for the distribution of the estate and the allocation of charges. We expect the thematic to report in Q2 2019.

Key risks

- With-profits funds are not managed and operated in line with the Principles and Practices of Financial Management ('PPFM'). This includes failure to identify
- Failure to distribute estates appropriately inline with PPFM and policyholders expectations (set out in communications).
- Failure to communicate openly with policyholders regarding the distribution of the estate
- Inability to evidence fair customer outcomes in all aspects of the management and operation of with-profits funds

Internal audit focus

- Suitable governance and challenge by the With-profits committee, specifically for customer outcomes. This includes the management of conflicts of interest.
- A defined process and methodology for appropriately distributing the estate to different cohorts and sub cohorts in a fair manner.
- A defined process and methodology for provisioning in line with the PPFM and customer expectations.
- A defined process and methodology for the allocation of charges to policyholders (including different cohorts and shareholders in a fair manner.
- Review of the suitability of investment management and consideration of active vs. passive funds.

Ins

Retirement outcomes

On the 28th July 2018, the FCA published its final Retirement Outcomes Review and provided Consultation paper 18/17 to encourage better engagement and outcomes for those in retirement. The paper proposes the introduction additional client communication ahead of retirement, suggests structured 'investment pathways' to align investment options to customer goals.

Finally, it sets out enhanced product oversight and governance requirements for the Independent Governance Committees. Directionally, this will indicate the FCA's thinking for improving engagement with customers.

Key risks

- The indicative guidelines suggest firms will need to make a number of changes to products, governance and systems. The changes could be disruptive for customers if not managed properly.
- For legacy customer group and legacy systems, this might involve significant amount of resources.
- Communications will need to follow a number of guidelines
- The deadline for implementation is December 2018. Failure to meet this deadline could result in increased regulatory attention, reputational damage and fines.

Internal audit focus

- Information provided to the customer throughout the retirement journey is adequate and complies with the FCA requirements
- Management's processes for structuring, monitoring, managing and reporting on the investment pathways is adequate.
- Product governance, especially at an Independent Governance Committee level is clear with appropriate level of MI from management.
- The project sufficiently captures and deals with the idiosyncrasies of legacy systems and policies.

Insurance regulation

AM Ins Br

Renewed focus on risk management and business resilience

Risk management is a key aspect of the Solvency II regime, and has received more scrutiny from the Prudential Regulatory Authority recently. Solvency II requires firms to have a risk management system that is commensurate to the risks that the insurer faces, and forward looking risk reporting in the form of the Own Risk and Solvency Assessment ('ORSA').

We have seen focus on a number of different areas;

- The risk mandate
- Risk appetite (and its use in business planning and dividend planning)
- Coverage and roles of the 2nd line –any gaps in resource or knowledge for the purposes of oversight.
- Design and implementation of the risk management framework
- Risk culture
- Risk reporting (including regular solvency monitoring tools)

Key risks

- Changing business models and investment strategies lead to new risks; the insurer may therefore fail to properly identify, measure and manage risk effectively.
- The Board and senior management may not have the appropriate risk information to make business decisions. This may lead to actions that do not sufficiently consider risk.
- Dividend planning and policy does not appropriately affect the risk and capital implications, leading to difficulties in funding
- Areas of the business may not have appropriate oversight.
- Regulatory review and intervention.

Internal audit focus

- Risk policies are properly documented, assessed for compliance and reviewed annually
- A risk appetite that is regularly calibrated, reflects the risks that the Board wish to take, covers the key risks of the insurer and informs decision making on a forward looking basis (for example, business planning).
- A risk management framework is appropriate for the risk faced by the insurer, and includes appropriate identification, measurement, management, monitoring and reporting processes).
- A defined ORSA process, resulting in a regular report that considers forward looking risk (which includes stress and scenario).
- Roles and responsibilities in the 2nd line have sufficient coverage in terms of personnel and skill set. Internal Audit may have to provide further assurance where this is weak.

Asset and wealth management regulation

AM

The Markets in Financial Instruments Directive (MiFID II)

2018 Audit Plans predominantly focused on business readiness in MiFID II audits. In 2019 Audit Plans we have seen the focus shift to 'deep dives' into particular topics.

MiFID II enhances and widens the scope of MiFID. It strengthens both investor protection regimes and market structure rules for investment firms. It introduces new product governance rules and extends existing reporting regimes. AIFMs/UCITS ManCos are impacted by some aspects due to FCA 'gold plating' and where they have MiFID permissions as part of their licence.

As part of our firm's research we have identified certain topics within the regime that are of particular concern and focus for asset and wealth managers which we present here.

Key areas of concern across asset and wealth management, mirror those raised by investment and retail banks and include inducement bans, the impact of cost disclosure, transaction reporting and market structure. The one area we see asset managers focus on in much greater detail is product governance for distributors. Unique to wealth managers we have observed a much greater focus on staff capabilities and the ability of staff to deal with the volume of change.

The FCA also highlighted best execution, payment for order flow and research unbundling as areas of focus.

Costs and charges

As part of improving levels of investor protection afforded to clients, MiFID II requires investment firms to provide disclosure of costs and charges to enable clients to make more informed decisions. The new rules require disclosure on ex-ante and ex-post information on:

- All costs and associated costs charged by the investment firm for the investment service or ancillary service provided.
- All costs and charges associated with manufacturing and managing of financial instruments.

Key risks

- Implementation has required firms to develop suitable methodologies, design and implement technology solutions, and embed new processes and controls to manage the process of capturing data and providing disclosures.
- Given the scale of the requirements and changes required, many firms have deferred some non-critical day 1 activities and have used 2018 to complete or enhance what has already been implemented.

Internal audit focus

- Have the disclosure requirements in MiFID II been captured including which costs are to be disclosed and how the cost has been calculated?
- What does the communication to the client look like and does this make the margin more understandable for the client.
- Is the supporting technology operating effectively?

https://www.pwc.co.uk/industries/financial-services/insights/transparency-of-mifid-ii-costs-and-charges.html

Transaction reporting

Transaction reporting under MiFID applied only to financial instruments admitted to trading on a regulated market. MiFID II will extend transaction reporting by:

- Extending reporting to transactions completed on multilateral trading facilities (MTFs) and organised trading facilities (OTFs)
- Increasing the scope of reportable transactions to instruments where the underlying is traded on venue and instruments where the underlying is an index or a basket which is traded on venue
- Incorporating a wider range of transaction types and requiring greater volumes of information from transaction reports.
- The FCA plans to continue monitoring markets using this data, but with a particular focus on the fixed income, currency, commodity and non-standard derivative markets.

Key risks

- The regulation poses many challenges for the industry, requiring 65 fields to be reported across new and existing asset classes.
- This is seen as one of the main priorities for the regulators, with the potential for significant fines for non compliance.

Internal audit focus

- Does the firm keep records or all orders and all transactions in financial instruments that have been carried out, for at least five years?
- Does the firm take reasonable steps to ensure and verify the completeness, accuracy and timeliness of transaction reports it submits directly and how are these evidenced?
- If reliance is placed on information transmission on external sources, are the appropriate controls in to ensure reporting within the reporting deadline?

https://www.pwc.com/gx/en/financial-services/pdf/ transaction-reporting.pdf

Asset and wealth management regulation

AM

The Markets in Financial Instruments Directive (MiFID II)

Best execution

When executing client orders, firms are required to act in the client's best interest by taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. In addition the following must be disclosed:

- A quarterly own quality of execution report which has to be published by all execution venues.
- An annual top 5 execution venue report (applicable to all investment firms executing client orders).
- An annual report about the assessment of the execution quality of all execution venues used (when executing client orders).

Key risks

- Firms must continuously assess whether they constitute the definition of an execution venue.
- Extensive order and transaction data will have to be collected and consolidated which requires intensive interaction between IT systems and external vendors and platforms.

Internal audit focus

- Has the firm established and implemented effective arrangements for complying with best execution requirements, in particular a formal order execution policy in order to obtain the best results for clients.
- Does the firm monitor the effectiveness of its order execution arrangements and execution policy in order to identify and where appropriate correct any deficiencies.
- Does the firm summarise and make public for each class of financial instrument the top five execution venues in terms of trading volumes where they executed trades in the preceding year, and include information on the quality of execution obtained on each venue.

Product Governance

MiFID II aims to strengthen investor protection by enhancing governance around product manufacturing and distribution by:

- Ensuring conflicts of interest are managed as opposed to simply being identified.
- Tightening controls around the product manufacturing processes.
- Obliging firms to specifically consider target markets and investor risk during production.
- Imposing requirements for a charging structure review for new products.
- Requiring firms to provide appropriate information to distributors.

Key risks

- Availability of all appropriate information on the financial instrument and the product approval process (maintain, operate, review), including identified Target Market to distributor.
- Application must be applied to both existing and new products.

Internal audit focus

- Governance of the manufacturing process including effective Board oversight and the role of Compliance.
- Has the target market and negative target market been defined?
- Do distributors have sufficient information available to ensure the product is being distributed to the right target market? How is this monitored?
- What processes are in place for ongoing product review?

Suitability and appropriateness of advice

MiFID II obliges firms giving advice to clients to increase transparency over the nature of that advice. Firms are required to provide detail on:

- Whether advice is independent or not.
- The range of products which advice is being provided and the nature of the advisors' relationship with product manufacturers. Advice cannot be limited to products produced by themselves, firms with close links to them or firms with which they have a relationship that may create conflicts of interest.
- Any periodic assessment of suitability the advisor plans to undertake.

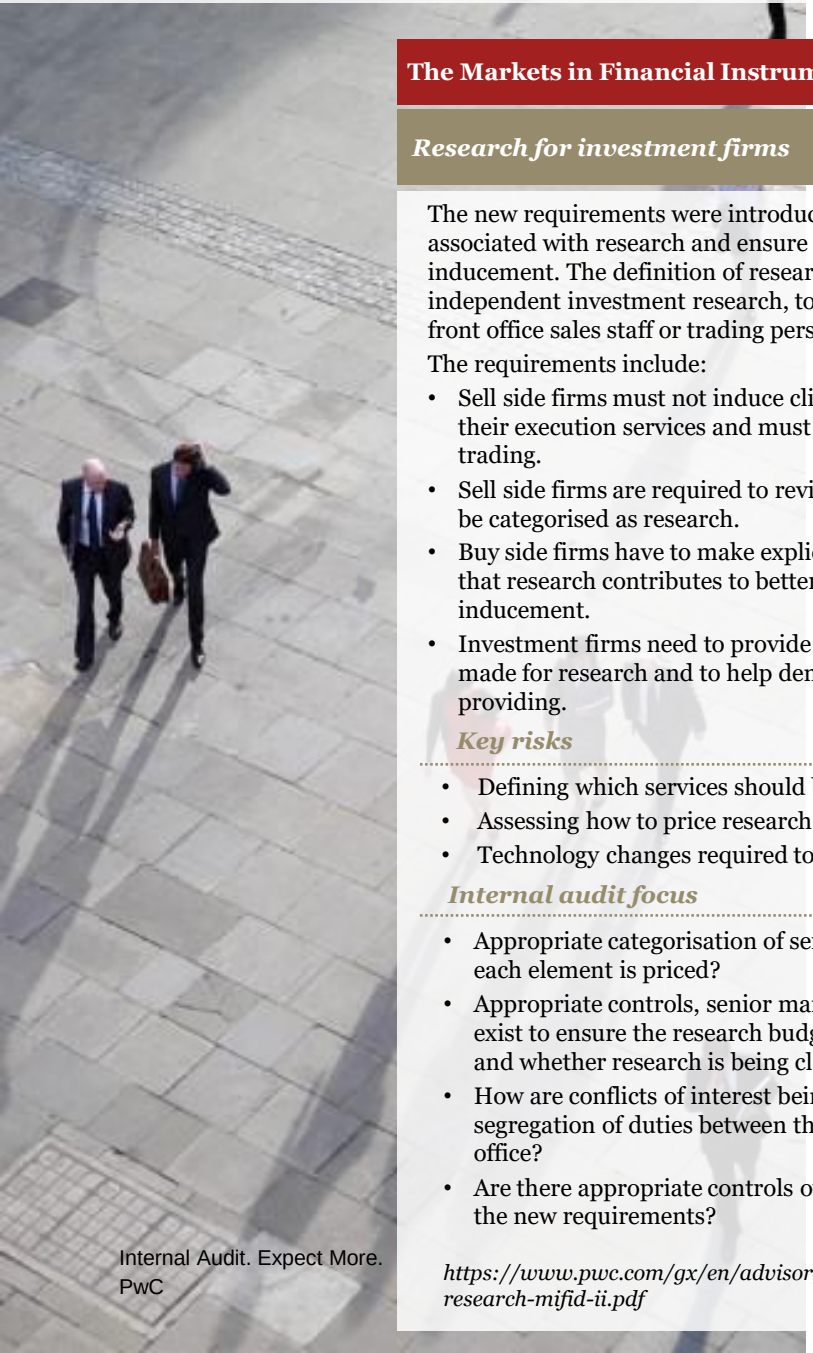
Key risks

- Investment firms will have to gain an increasingly better insight into the personal (financial) situation of their clients.
- Sufficient record keeping to demonstrate the suitability and appropriateness of advice given.

Internal audit focus

- Identification of products where advice is being provided.
- Do suitability reports issued to the client cover all regulatory requirements including an outline of he investment advice, an explanation of why the recommendation is suitable and whether a periodic review will be performed, what they will cover and what trigger a reassessment?
- What records have been maintained to demonstrate appropriateness assessments, including the result of the assessment and any warnings given to the client and whether the firm accepted a request by the client to proceed despite such warnings?

Asset and wealth management regulation



AM

The Markets in Financial Instruments Directive (MiFID II)

Research for investment firms

The new requirements were introduced to mitigate conflict of interest risks associated with research and ensure research is not being offered as an inducement. The definition of research has been expanded, from only independent investment research, to also include advisory services provided by front office sales staff or trading personnel.

The requirements include:

- Sell side firms must not induce clients to trade by bundling research within their execution services and must provide clients with unbundled costs of trading.
- Sell side firms are required to review and identify services provided that could be categorised as research.
- Buy side firms have to make explicit payments for research and demonstrate that research contributes to better investment decisions and is therefore not an inducement.
- Investment firms need to provide better reporting to facilitate payments being made for research and to help demonstrate the value that research is providing.

Key risks

- Defining which services should be categorised as research.
- Assessing how to price research.
- Technology changes required to capture data required for increased reporting

Internal audit focus

- Appropriate categorisation of services that are considered research and how each element is priced?
- Appropriate controls, senior management oversight and audit trails must exist to ensure the research budget is being used in the client's best interests and whether research is being classified correctly.
- How are conflicts of interest being managed and is there appropriate segregation of duties between those that produce research and the front office?
- Are there appropriate controls over new technologies developed to manage the new requirements?

https://www.pwc.com/gx/en/advisory-services/publications/assets/the-future-of-research-mifid-ii.pdf

Conflicts of interest

Conflicts of interest processes within MiFID II require firms to pay more attention to conflict management and discourages them from overreliance on conflict disclosure. It sets specific procedures and measures for firms to implement in managing conflicts, requiring firms to:

- Control information exchange between relevant persons if that exchange could harm clients.
- Implement separate supervision of staff where they may be open to a conflict of interest.
- Remove direct links between remuneration of relevant persons in different functions if their remuneration targets create client conflicts.
- Prevent any person from exercising undue influence over any client's investments.
- Stop any person from being involved in sequential transactions if conflicts arise as a result of their repeated involvement.

Key risks

- There is much greater focus on conflict management and the policies and procedures surrounding it. Previously firms have depended on disclosing risks and not dealing with their mitigation.

Internal audit focus

- Have conflict of interest policies and procedures been updated to reflect the new requirements?
- Does the register of conflicts include all potential risks and not just 'material' risks?
- Are staff appropriately trained to identify potential conflicts?
- Is the conflicts of interest policy overly reliant on disclosure rather than mitigation?
- Do communications explain the nature and source of the conflicts of interest inherent to type of activity, providing details about the specific risks related to such practices to enable clients make an informed decision?

Asset and wealth management regulation

AM

The Alternative Investment Fund Managers Directive (AIFMD)

The AIFMD was implemented in 2013 and introduced a harmonised framework for the authorisation and oversight of hedge fund managers, private equity firms and other alternative investment managers.

AM Ins

Packaged Retail and Insurance-based Investment Products (PRIIPS)

PRIIPs aims to harmonise disclosures across packaged retail and insurance-based investment products, which fall within the scope of MiFID. PRIIPs requires that a standardised Key Investor Information Document ('KIID') is presented to investors pre-sale; KIIDs will replace UCITS KIIDs from 31 December 2019.

The FCA has indicated it will continue to engage on PRIIPs implementation, signaling that it may issue additional UK-specific guidance similar to its previous statements on potentially misleading performance scenarios.

Key risks

- Breach of local marketing restrictions where using private placement or relying on reverse solicitation (e.g. for third country AIFMs).
- Incorrect Annex IV reporting and breach of risk limits disclosed to the regulator.
- Lack of robust valuations process, especially for hard to value assets.
- Readiness for the implementation deadline.
- Incorrect reporting to PRIIPs manufacturers/ distributors.
- Incorrect calculation summary risk indicator (SRI), performance scenarios and costs.

Internal audit focus

- Valuations (fair value, hard to value assets).
- Annex IV reporting.
- Risk management framework.
- Liquidity management.
- Process for marketing sign off and record keeping.
- Assurance over the project governance and technical implementation of PRIIPS.
- Post implementation review of the a) Accuracy of data and calculations (SRI, performance scenarios, costs); b) KIID compliance with template and rules; and c) KIID lifecycle (ad hoc and regular updates).

Asset and wealth management regulation

AM

Individual Capital Adequacy Assessment Process (ICAAP)

The Individual Capital Adequacy Assessment Process (ICAAP) of a firm's capital is an important discipline that most asset and wealth managers should be undertaking. This process involves firms identifying and assessing applicable risk to them, and applying stressed scenarios which enables the firm to identify the amount of capital resource they should hold to mitigate these risks.

Further, the ICAAP report and the stress and scenario testing results are often the first set of documents and data that the FCA will assess before a Supervisory Review and Evaluation Process (SREP) visit and the quality of these will set the tone of the questions asked.

Key risks

- Poor articulation of risk management framework and risk appetite i.e. disjoint from business objectives.
- Stress scenarios not sufficiently varied and lack of combined testing.
- Lack of knowledge at Board level, inhibiting effective challenge.

Internal audit focus

- Design and robustness of strategies, policies, processes and systems in place in identifying risks inherent within the business.
- Stresses are appropriate to the risk exposures and the economic environment in which the business operates.
- Design and operating effectiveness of controls and governance over the ICAAP process.

AM

Liquidity Management

All investment firms need to have sufficient liquid resources to ensure there is minimal risk they cannot meet their liabilities as they fall due. They must have in place robust strategies, policies, processes and systems that enable them to identify, measure, manage and monitor liquidity risk over an appropriate set of time horizons.

They also need to have in place a contingency funding plan setting out adequate strategies and measures that can be implemented in the event of a liquidity shortfall.

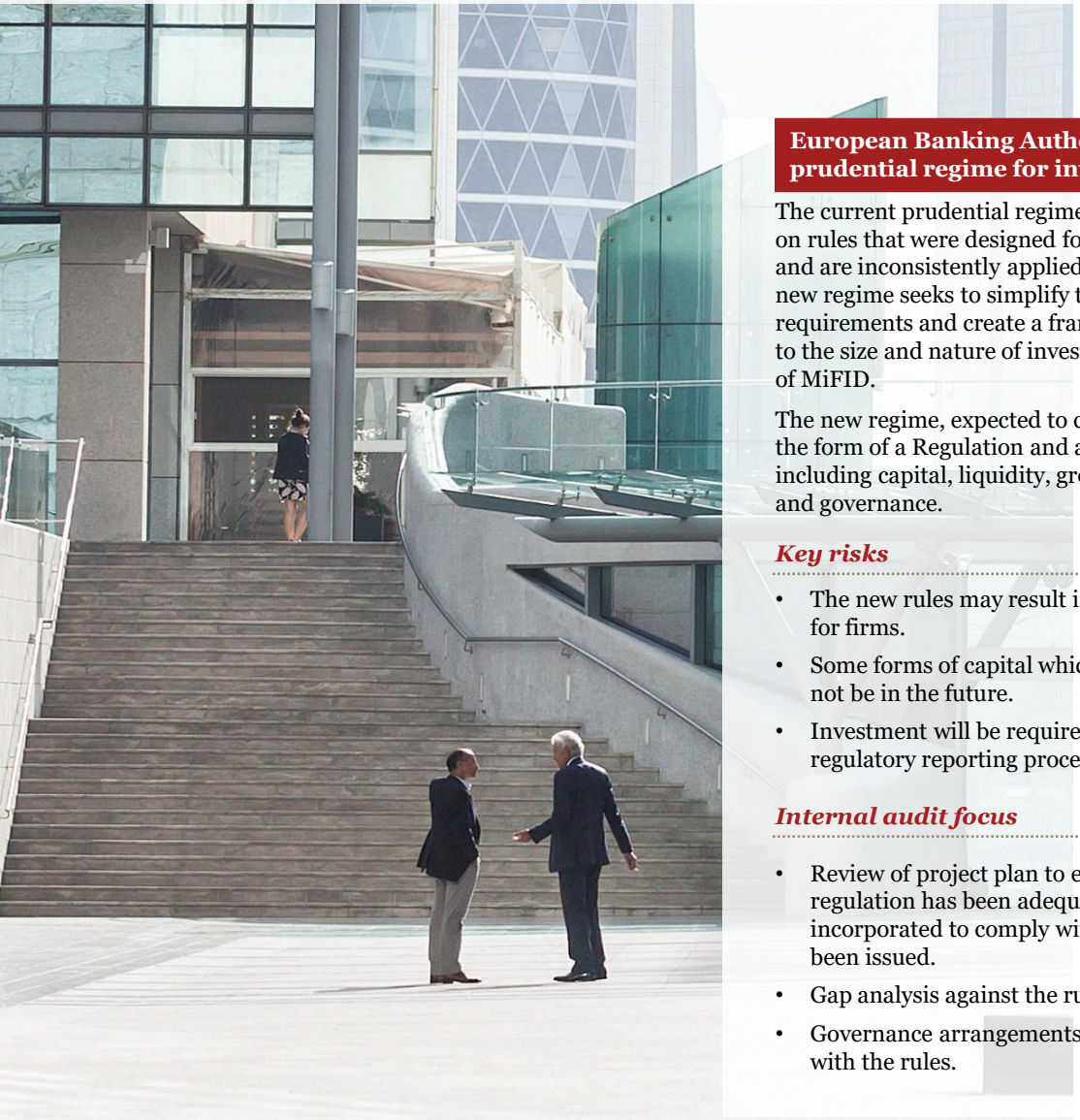
Key risks

- Firms overlooking the relationship between liquidity and capital.
- Firms not reviewing and updating their liquidity policy with the most up to date information.
- The risks resulting from potential adverse events are not appropriately managed leading to financial loss and/or regulatory censure.

Internal audit focus

- Design and robustness of strategies, policies, processes and systems in place to identify liquidity risk inherent within the business.
- Firms' ICAAPs cover their exposure to liquidity risk, including how they manage it and their stress results.

Asset and wealth management regulation



AM

European Banking Authority (EBA) prudential regime for investment firms

The current prudential regime for investment firms is based on rules that were designed for banks, which can be complex and are inconsistently applied by European regulators. The new regime seeks to simplify the calculation of capital requirements and create a framework which is proportionate to the size and nature of investment firms who are in scope of MiFID.

The new regime, expected to come into force in 2020, takes the form of a Regulation and a Directive and covers elements including capital, liquidity, group consolidation, reporting, and governance.

Key risks

- The new rules may result in a higher capital requirement for firms.
- Some forms of capital which are currently eligible may not be in the future.
- Investment will be required in establishing new regulatory reporting processes.

Internal audit focus

- Review of project plan to ensure the impact from the regulation has been adequately considered and incorporated to comply with the new rules once they have been issued.
- Gap analysis against the rules.
- Governance arrangements to ensure ongoing compliance with the rules.

AM

Stress testing

On the 19th July 2018 the EBA published the final guidelines on stress testing. Stress testing of firms' financial stability is a key tool to assess the resilience of the business to potential adverse events on the profit and loss, balance sheet and ability of the organisation to meet its regulatory capital requirements.

The ongoing political and economic uncertainty associated with Brexit may give rise to some of these adverse events. The outcome of the stress testing allows management to determine the impact on capital plans and the management actions which may be required to manage the resulting potential impacts.

Key risks

- The risks resulting from potential adverse events are not appropriately managed leading to financial loss and/or regulatory censure.
- Insufficient capital to meet regulatory requirements and adverse events.

Internal audit focus

- Design and operating effectiveness of controls and governance over stress testing.
- Stresses are appropriate to the risk exposures and the economic environment in which the business operates.
- Alignment of content and timing of stress testing with business planning and strategy.

Tax

Tax authorities and policymakers in the UK and globally have an increasing focus on tax governance, control environments and tax policies generally at the current time.

In the last couple of years we have seen a significant shift in the UK towards increased public and wider stakeholder (analysts and investors) transparency over tax affairs of companies, backed up with the government's reaffirmation towards making tax digital and the new legislation of publication of tax strategies in larger businesses.

Tax

AM Ins Br

EU Mandatory Disclosure Regime (EU MDR)

The directive introducing EU MDR came into force on 25 June 2018. From 1 July 2020 any cross-border arrangements entered into by taxpayers which fall within certain broadly-defined hallmarks will have to be reported to the tax authorities. There are also transitional rules which require any disclosable arrangements occurring on or after 25 June 2018 to be separately reported by 31 August 2020.

Intermediaries based in an EU Member State will need to disclose reportable arrangements to their domestic tax authority within 30 days of certain, specified, events. Where reportable arrangements occur with a non-EU intermediary, or the intermediary is subject to legal professional privilege, the burden of disclosure passes to the taxpayer.

Key risks

- Groups will need to ensure any reportable cross-border arrangements are appropriately identified and reported. The reporting intermediary will have to be identified and this may not be straightforward when there is more than one intermediary involved. Some financial institutions may have reporting obligations as intermediaries themselves.

Internal audit focus

- Reviewing the processes and testing the controls in place to ensure any reportable arrangements are identified.

AM Ins Br

Business Risk Review (BRR)

In 2017 HMRC conducted a public consultation on the BRR process by which it risk-assesses large businesses. This assessment is a key determinant of the level of scrutiny applied by HMRC and the level of resource the business needs in response. Currently each large business is classified as either 'low risk' or 'not low risk'. However, the revised BRR process, which is expected to be rolled out in 2019, will instead have a spectrum of risk ratings.

HMRC have also indicated that the revised BRR process will take account of Senior Accounting Officer ('SAO') arrangements and the published tax strategy. HMRC note that both SAO and the tax strategy are underpinned by the concept of the OECD's Tax Control Framework ('TCF') and companies operating an effective TCF should be rewarded.

Key risks

- Groups seeking to achieve low risk status will need to be able to demonstrate they have in place an effective TCF, and that this is consistent with SAO arrangements and the published tax strategy.

Internal audit focus

- Testing the governance, controls and processes in place to ensure the TCF is effective and fit for purpose.

AM Ins Br

People movement

Following the Organisation for Economic Co-operation and Development ('OECD') Base erosion and profit shifting ('BEPS') initiatives we are seeing tax authorities (both HMRC and overseas) increasing their efforts to track people movements in order to identify whether there is taxable activity taking place.

Key risks

- Creation of a branch (taxable permeant establishment) in UK or overseas for corporation tax.
- Staff working overseas creating local PAYE and income tax liabilities.
- Supplies being deemed to be made from an overseas location triggering a requirement to register for VAT.

Internal audit focus

- Identify appropriate tax/HR policies and ensure they meet the rules in the territories where you operate.
- Track people movements using travel systems or other data.
- Review activities in these jurisdictions for high risk areas.

Tax

Corporate criminal offence (Tax)

AM Ins Br

Since 30 September 2017 there has been a new corporate criminal offence of 'failure to prevent the facilitation of tax evasion'. Under the offence, a company can be held criminally liable if one of its associated parties (which can include staff, directors and some third parties) criminally facilitates tax evasion.

The offence is modelled on the Bribery Act in that the company can avoid sanction if it can demonstrate that it has reasonable procedures in place to prevent the facilitation from happening.

Key risks

- With successful prosecutions leaving businesses open to possible unlimited fines, loss of operating licenses and prohibition from bidding in public tender processes, in addition to serious reputational damage, the importance of businesses not falling foul of new legislation must not be underestimated.

Internal audit focus

- Groups will need to undertake a risk assessment and, based on the output, implement new and enhance existing procedures and controls.
- The monitoring and review of procedures, controls and the risk assessment is one of the six guiding principles of the rules. Whilst first and second lines of defence are key, internal audit can play a crucial role in monitoring and review – particularly design and operational effectiveness testing.

Tax strategy

AM Ins Br

The 2016 Finance included a requirement for large groups to publish a board approved tax strategy on their website covering the company's UK tax planning appetite and approach, how it manages its relationship with HMRC and its approach to tax risk and internal governance.

This requirement applies to groups considered qualifying under the SAO legislation (i.e. £200m aggregated UK turnover per annum or £2bn UK assets) with the intention being that all groups with a Customer Relationship Manager (CRM) within large business be ultimately covered.

Key risks

- Non-compliance will attract a fine (expected to be £7,500 with additional fines due for continued non-compliance).

Internal audit focus

- Groups must consider how the strategy will be embedded in practice as this will be HMRC's focus, and implement governance to achieve this.
- Internal audit can add value by testing the controls and procedures in place to ensure the strategy is embedded –, a focus by internal audit on tax is widely acknowledged as evidence of good governance.

Senior Accounting Officer (SAO)

AM Ins Br

The Senior Accounting Officer (SAO) regime, in place for large groups since 2009, requires annual certification by the SAO that each company in the group has appropriate tax accounting arrangements – essentially that tax returns are free from material error. In the early years of the regime HMRC took a 'light touch' approach but recent evidence suggests that HMRC is increasingly likely to scrutinise and challenge arrangements and assess penalties.

Key risks

- The rules have a heightened focus within large groups as the SAO is personally liable to penalties. Whilst tax compliance procedures and controls may have been subject to review in the past, HMRC has an expectation of continuous improvement.

Internal audit focus

- On-going application of governance.
- Maintaining evidence that the SAO has taken reasonable steps to discharge their duty and the Board have understood and agreed the tax impact of business decisions.
- Properly communicating tax governance procedures with clear guidance on control framework standards and responsibilities.
- Monitoring key UK tax risks throughout the year.
- Implementing, maintaining and monitoring a risk-based testing programme addressing all material processes over an appropriate time frame.

Contact details

Paul Pannell
Internal Audit Partner
M: +44 (0)7725 068227
E: paul.pannell@pwc.com

Alison Morris
Internal Audit Partner
M: +44 (0)7714 226313
E: alison.c.morris@pwc.com

Pete O'Brien
Internal Audit Director
M: +44 (0)7776 081944
E: peter.obrien@pwc.com

Philippa Mace
Internal Audit Director
M: +44 (0)7736 258311
E: philippa.s.mace@pwc.com

Tracy Yam
Internal Audit Director
M: +44 (0)7483 400022
E: tracy.x.yam@pwc.com

Martin Simpson
IT Internal Audit Director
M: +44 (0)7768 376052
E: martin.simpson@pwc.com

Pritesh Patel
IT Internal Audit Director
M: +44 (0)7711 194575
E: pritesh.patel@pwc.com

Other reference material:

2018 State of the Internal Audit Profession Study: Moving at the speed of innovation

https://www.pwc.co.uk/services/audit-assurance/risk-assurance/services/internal-audit/insights/2018-state-of-the-internal-audit-profession-study.html

PwC 21st CEO Survey for Insurance and Asset & Wealth Managers: The Anxious Optimist in the Corner Office

https://www.pwc.com/gx/en/ceo-survey/2018/deep-dives/pwc-ceo-survey-2018-insurance.pdf

https://www.pwc.com/gx/en/ceo-survey/2018/deep-dives/pwc-ceo-survey-awm-key-findings.pdf

The PwC Internal Audit. Expect More.

https://www.pwc.co.uk/services/audit-assurance/risk-assurance/services/internal-audit.html

180912-191503-PM-OS