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INSTITUTO DE AUDITORES INTERNOS DE ESPAÑA

Challenges and Expectations for the Future of Internal Audit in Banking and Credit Institutions



Challenges and Expectations for the Future of Internal Audit in Banking and Credit Institutions

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*We appreciate the collaboration of Andrew Douglas and Emilie Wilcox,
CIA, CCSA, CRMA in translating this document into English.*

All modern economies require that their banking industry be both solvent and efficient. The global financial crisis that has so severely affected our country has truly reinforced this concept. Institutions with sufficient risk governance and adequate control environments have had to overcome severe difficulties. Others, whose attention was not centred on control and risk management have simply disappeared, folded or have needed rescue with huge cost to the economy or public finances.

As Cicero said, history is the master of life. Given that, all the recent events should, and are being used to drive reflection on all areas and functions related to corporate governance and control. This reflection is also being carried out with respect to internal audit as a key function of banking. All entities should have a solid and efficient internal audit function that supports strong corporate governance in line with the three lines of defence.

The Commission that I have had the honour to participate in, and to which I wish to express enormous gratitude for their collaboration with the Institute, has provided experience and deep sectorial insight to help identify the most relevant changes to business models and regulation. After analysing the changes and the reality of internal audit groups, we have summarized the challenges we are confronting and expectations we must meet.

On my part, I would like to outline the vision for the future that is the product of this study:

- Internal Audit will be a very important function: with sufficient authority to be able to conclude objectively and be a driver for change and improvements to internal control systems and risk management.
- Internal Audit will set more ambitious objectives: it will have to align itself with the organization's strategy and produce more relevant and impacting audit reports.
- Internal Audit will be more closely integrated with the rest of the organization: it will cooperate more intensely with other lines of defence and will monitor more closely the projects, businesses and special operations that make up the reality of the organization.
- Internal Audit will need more talent and resources: professionals with knowledge of risks and business. Technology will become a major driver of change in transforming the function and a key tool for attaining higher levels of efficiency.

Achieving these goals is a huge challenge, but a crucial challenge for the profession, the industry, and our country. We hope that this study contributes to vigorous debate and the generation of solutions.

Ernesto Martínez

President of the Spanish Institute of Internal Auditors



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Prologue

Our profession is increasingly seen by regulators, supervisors and investors as a key player in protecting an organization's value.

Aware of the importance of the banking sector to the economy, and of the relevance of internal audit to the proper functioning of credit institutions, the Spanish Institute of Internal Auditors has responded to the need to identify the primary challenges that must be met, so that our profession can continue being a key player in the good corporate governance of the sector.

With this objective in mind, the THINK TANK of the Spanish IIA has produced this document. Based on conversations and debates between credit institutions and consulting firms and the responses of Spain's principal banks' internal audit groups to a questionnaire, it identifies the future trends for the sector.

Our profession is increasingly seen by regulators, supervisors and investors as a key player in protecting an organization's value. In the banking sector, as a component of the three lines of defence model most commonly adopted by organizations and reinforced in the recently updated model for internal control by COSO, internal audit is one of the pillars of good corporate governance in credit institutions.

Far from conforming to the status quo, internal audit must be aware of the need to keep evolving so that key economic players and stakeholders increasingly consider us as a fundamental element within organizations.

To achieve this we must accompany our credit institutions through the continuous change processes of all types they are experiencing.

Only if we are aware of the changes occurring in the financial environment, will it be possible for us to identify challenges for the future of internal audit and for us to drive the changes we need.

The primary drivers of change that are moving credit institutions can be divided into two large blocks:

Business Model Transformation

This affects the relationship of the organization with its clients, the pre-eminence of alternative distribution channels over traditional branch offices, technological changes and greater requirements for technical training for employees, for example.

Changes to International Regulation

These are designed to reduce the impact of possible bank insolvency and to build a more solid and transparent financial system that instills confidence in its integrity, and that protects the consumer. These changes have a huge impact in day-to-day business management and also for internal audit. We should not forget to mention the changes planned for the Single Supervisory Mechanism in Europe.

The first chapters of this document describe the most relevant aspects related to both blocks.

Once the changes have been analysed, the document identifies trends, expectations and the impact that we expect these to have on internal audit functions.

These changes make up the challenges that internal audit will have to face in the short and medium term.

The last part of the document identifies the challenges, underlining the growing importance that will be placed on internal audit's relationship with other assurance functions and with the second line of defence, and how this provides an opportunity to increase value for organizations.

We consider that these aspects are currently very relevant and that this merits debate on how they will affect us. We hope that the analysis carried out by the Commission is helpful in that respect.



Executive Summary

The primary mission of internal audit is to protect and contribute to increasing the value of organizations, which can be achieved through its assurance and advisory engagements. This role is so critical that the future of the banking and credit industries cannot be conceived of without internal audit as a key part of their corporate governance, coordinating communication and collaborative efforts between the different lines of defence.

The financial crisis has instigated significant changes to credit institutions, with considerable impact on business models, and increases in the compliance load coming from new regulation and supervisory models. Entities need

to understand that the financial environment has changed and is still evolving and that they must adapt. Internal audit needs to anticipate the change, developing its structure, scope and objectives.

This document does not have the objective of setting new rules; moreover, it aims to underline the trends that are emerging in the sector. It should be employed as tool for reflection for internal audit groups.

Our commitment to quality and efficiency and our position as a key function within an organization depends on us having a proactive attitude to change.

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BANKING SECTOR · TRENDS IN INTERNAL AUDIT GROUPS



With regard to **HUMAN RESOURCES**, the trend is moving towards integrated audit teams, greater specialization and training for resources, and improved coordination with the second line of defence and the external auditor.

It is ever more desirable that audit resources have sufficient experience, in order to have a level of seniority comparable to that of the executive management of the activities we audit. We need to be able to question not only procedural compliance but also process design and decision-making.

The internal audit function, with greater exposure to the whole organization, should be organized and report directly to the Board or Audit Committee¹, that itself will also play a

more active role in the evaluation and supervision of the internal audit function. Information requirements will increase and audit will play a more significant role in governance structures and the organization's strategic processes.

This increased load of internal work, along with requirements made by the Single Supervisory Mechanism and other regulators should be reflected in the amount of hours dedicated to reporting and, over time, the amount of resources available to internal audit.

With regard to the **APPROACH AND SCOPE OF REVIEWS**, there will be a strengthening of the current trend of remote monitoring and auditing and this will expand into other areas besides branch networks. Continuous auditing

1. Standard 1110 from the *International Standards for the Professional Practice of Internal Auditing* states that: The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

will be employed to dynamically feed risk assessments, with frequent reviews of annual audit plans.

The quest for new ways of adding value will lead to new and innovative approaches to reporting, increasing audit's advisory role, reviewing governance and control frameworks.

For this to be able to happen, **ADEQUATE TECHNICAL RESOURCES** must be made available. Internal audit will increasingly rely on the review of the operating effectiveness of automatic controls and mass data analysis. IT tools will have to evolve accordingly.

Internal Audit has before it many opportunities to add value to credit institutions. If current opportunities are not sufficient, then we have on the horizon more opportunities arising from the work of other assurance functions. The Three Lines of Defence model requires extra effort to assure that each line works efficiently.

This will require implementation of a collaborative work methodology for all three lines of defence and the use of a common language that allows comparable reporting from different lines and communication channels that promote transparency.

Internal audit can lead the implementation of this methodology, adding value through its

knowledge of processes and its globally integrated view of the organization. The analysis carried out by the team underlines that the continued success of internal audit in the coming years depends on:

- a) The ability of internal auditors to find equilibrium between the needs of different stakeholders, where the regulator will have a far more important role than previously.
- b) The implementation of new technology to maximize the efficiency and effectiveness of reviews.
- c) The building of- a strategic alliance with the second line of defence that allows increased coverage of assurance activities and increased reporting activity to the Audit Committee, that itself will demand both more and better quality information on the functioning of a credit institution's control systems.
- d) The capacity to include in its audit universe other aspects of the organization such as strategic management, governance structures and risk management culture.

All this will be characterised by an increasing pressure on resources, requiring they be efficiently deployed.

Internal audit will increasingly rely on the review of the operating effectiveness of automatic controls and mass data analysis. IT tools will have to evolve accordingly.



New Banking Business Models

These changes to business models will oblige internal audit to respond with a pre-emptive approach.

A business model describes, defines and documents the way in which an organization creates, distributes and captures value for its clients, a specific market segment, or for other stakeholders. This definition refers to many more concepts other than just the P&L (for example, client segments, income schemes, resources, activities, partners, cost structures, etc.)

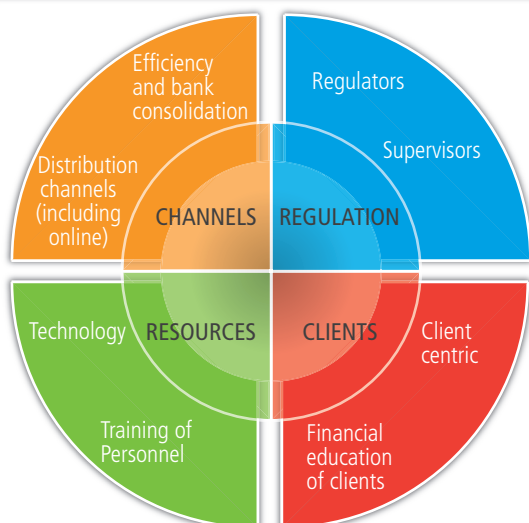
Way before the financial crisis, new banking business models were being debated. We have realized that the world in which we live can be and has changed. Credit institutions that have survived must understand this new

paradigm in order to define new management and client relationship models that deliver efficiency and profitability under complex circumstances.

The computerization process, the digital era, internet access, etc., combined with the need to grow in an environment of shrinking income and margins (fragile recovery, low base rates, etc.) and regulatory requirements on capital and provisions means that change must happen. This change, along with balance sheet restructuring and the management of NPLs, must be reflected in the banking sector's business model. The changes that are happening (in no order of importance) are regarding:

- The regulators and supervisors.
- Efficiency and bank consolidation.
- Clients.
- Client education.
- Distribution channels.
- Technology.
- Training of personnel.

AXIS OF NEW BANKING MODELS



If success for the function is to be guaranteed, these changes to business models will oblige internal audit to respond with a pre-emptive approach and therefore be able to produce added value for shareholders and other stakeholders through a service that is seen as positive and valuable for the organization.

The objective of this chapter is to explain how these changes will affect our profession. We will begin by explaining the previously mentioned points in greater detail.

The Regulator and the Supervisor

*"The current financial crisis can alter the definition of the optimum banking model, both in the medium term, as a result of the crisis, and in the long term, as a result of even deeper transformation of the business model. Up against a future that is difficult to predict, changes to financial regulation resulting from the crisis will no doubt have a continued impact on banking."*²

Through increased requirements, the regulator wishes to avoid recommitting the same errors that led the banking sector into its current state, thereby driving its role in defining the business model of the future.

Examples of said regulation are Basel III (greater requirements for the levels and quality of capital), Dodd Frank (deep financial reform in the USA) or MiFID (model for the protection of customers based on increased transparency and better client relations). These other regulatory measures will be subjected to a more detailed analysis later on in the document.

In the half yearly Risk Assessment of the European Banking System, (July 2013, January 2014, June 2014) undertaken by the European Banking Authority – (EBA) risks to credit institutions are identified. For example:

- Uncertainty around and pressure on new banking models.
- Uncertainty about the robustness of banking management systems.
- Weakening of banking controls.
- Impact of mis-selling of financial products.
- Balance sheet transformation from business model change.
- Macroeconomic environment risk, defined by the EBA as "High" and that covers:
 - The level of regulatory change.
 - The tightness of the schedule for this change.
 - The implication of this change on the development of banking business.
 - Continued lack of confidence in the strength of the banking industry.
 - The lack of uniformity of regulatory change across jurisdictions.
 - Different regulations for asset and liability matching.
 - Delays to the approval of a European Banking Union.

These risks mean management must consider certain aspects when developing their banking models for the future.

One other aspect to consider is the Single Supervisory Mechanism, which also introduces fundamental change (a more dynamic approach to capital management and a more intrusive supervisory model). Given the importance of this aspect, how organisations adapt and, particularly, how this affects internal audit will be analysed further on in this document.

These risks mean management must consider certain aspects when developing their banking models for the future.

2. *Algunas implicaciones de la crisis financiera sobre la banca minorista española*. 2008. Santiago Fernández de Lis and Alfonso García Mora. Magazine "Estabilidad Financiera" nº 15. Banco de España.

Spanish credit institutions still have opportunities to make significant cuts to their costs in traditional areas, branch networks, centralized service centres and ICT processes.

These aspects have been highlighted in recent studies carried out on local and international banking by firms such as PwC (2013) and EY (2014).

Efficiency and Banking Consolidation

Efficiency is a core aspect of the management of all credit institutions. Cost control and improvement to efficiency levels will continue to be a key focus for the organisations of the future if they are to consolidate and improve on the advances made in the last few years.

Spanish credit institutions still have opportunities to make significant cuts to their costs in traditional areas, branch networks, centralized service centres and ICT processes.

With regard to branch networks, Spain has reduced the number of branches by 26% since the beginning of the crisis and will continue to do so³. Spain is still the European country with the highest ratio of branches per inhabitant, but because of the growth of alternative channels (internet and mobile) a traditional branch network is becoming less and less important.

In order to survive in the market given the magnitude of change, many entities may opt for different strategies, either voluntarily or by the supervisor's suggestion. One of these strategies is the merger with other entities to give the merged entity a critical mass that enables new product development, cost efficiency and

lets them aspire to enter market segments previously out of reach. This will result in greater efficiency and ability to compete.

EY, in its European banking Barometer, 1H14 underlines that despite the slow pace of actual bank restructuring, 65% of entities questioned expect further significant consolidation in the next three years.

The trend is therefore that consolidation of the banking sector will continue in the future, but will be on a pan-European scale rather than nationally.

This consolidation process will have profound impact on internal audit. On one hand, due diligence needs to be addressed prior to each corporate operation. On the other hand, once consolidated, the final entity may find considerable divergence in aspects such as risk management culture, IT systems, products, etc. This will inevitably make internal audit's review process more complicated in the first few years.

Client Centric

*"Financial institutions must adopt business models that put the client, and not the product in the centre of their organization"*⁴

In the recent past, the financial sector gave more importance to the product over the client. In the new banking paradigm, the client must be the centre of attention (rela-

3. Boletín Estadístico de Bank of Spain, March 2014, at the end of 2007 there were 45.500 bank branches in Spain and only 33.713 at the end of 2013.

4. *Retail Banking in 2020. Evolution or Revolution.* 2014 PwC.

tionship banking). It is critical to be able to understand their needs and what are the best communication channels, to give personalized attention, to use new and innovative technologies, to understand the value of each client and to use sustainability and corporate responsibility principles to manage the relationship.

*"Regulatory change has created the need for a more flexible approach to financial business. More flexibility in client relations, multi-functionality and diversity are necessary to be able to offer a more varied range of products to the public."*⁵

In this manner, Customer Relationship Management studies should be transformed in order to realize the required changes.

Technology will be key to these new client relationship channels. Banks that offer all services are running the risk of being overtaken by competitors who are focused on digital technology. Putting customer service at the centre of their strategy, these emerging competitors are more agile and can roll out new tools and services more quickly, and these will soon become the industry standard.⁶

Value proposals will have the client and client service at their heart, and not the product. The trend will be to monitor client experience, as happens in other industries.

Advisory services should be limited, to make sure the advice is adequate, and CRM studies

should be looking at how to make personalized proposals to clients.

Financial knowledge of clients and training of bank staff

The Estudios Financieros Foundation⁷ has recently published a study that covers the need for financial education.

Mr Antonio Romero, Inés García Pinto and Nerea Vázquez state in the report:

"Since the beginning of the crisis, financial education has been recognized as a vital skill and a key element for stability and financial and economic development. As stated by the Financial Consumer Agency of Canada (FCAC), low levels of financial literacy are a real obstacle for economic growth...from another perspective, there has been much analysis, including a document published in March 2011 by the European Commission that points to the role that low levels of financial literacy have had in magnifying the impact of crisis. Aside from the exact perspective taken for each study, all coincide in the prevailing need to promote financial literacy."

Some improvements to clients' financial literacy is occurring, but it is still highly advisable from all points of view, including the defence of credit institutions' own proprietary activities.

Putting customer service at the centre of their strategy, these emerging competitors are more agile and can roll out new tools and services more quickly, and these will soon become the industry standard.

5. *El aula del accionista*. Caixabank.

6. *Accenture 2013 US Retail Banking Survey*.

7. Document 52. *Nuevos desafíos del sector financiero: Recuperando la confianza y mejorando la cultura financiera*, capítulo VII. 2014. Fundación de Estudios Financieros.

Both client and employee education are inherently linked. In our opinion, they run parallel in time and are a key factor in recovering trust in the system.

It is clear that for the proper management of increasingly more financially knowledgeable customers, even in environments of full transparency and protection, it is still absolutely necessary that client relations are carried out by staff with a similar level of knowledge and understanding of the products and services that are being sold. At this point it is not necessary for us to analyse the malpractice that has plagued the Spanish banking sector, nor the consequences this has had on the confidence placed in it.

So, are bank employees prepared to meet this challenge?

Without a doubt, their knowledge and skills must be brought up to speed and aligned with the new post-crisis, regulation-heavy business models. Distribution channels will be modified and the new model will gravitate towards the client; that will require knowing the clients and understanding their needs. Spanish banks are going to have to undertake an important change management process to implement this.

Both client and employee education are inherently linked. In our opinion, they run parallel in time and are a key factor in recovering trust in the system.

Finally, and to close out this section, a quote from Santiago Fernández and Alfonso García from their study of the impact of the crisis, *"the change in the demographic pyramid we have witnessed in recent years, and above all, the future trend, will require greater specialization, not only in terms of products and services but also in customer management"*⁸

Distribution Channels

Channels are the tool used by the credit institution to communicate with its customers, different market segments and stakeholders to deliver its value proposition.

Communication, distribution and sales channels are what join us to clients. These channels are points of contact that play a major role in the client's experience. Therefore, in order to understand how technology will change this and which traditional channels will survive, we must analyse client channels, aspects of how they can be integrated, their efficiency and their profitability.

In a recent study by Accenture on commercial banking in the USA, it is revealed that more than 70% of customers think that credit institutions should invest in remote communication channels and related technology.

To summarize, client relationship strategy will inevitably involve channel integration and the recognition that the bank must provide the client with channel options that best suit their needs.

La tecnología

Being able to understand the importance of technology in the new world of banking (understood as the resource to support intensive use of information, of knowledge obtained from operations and internet access, etc., based on simplicity and agility).

8. *Algunas implicaciones de la crisis financiera sobre la banca minorista española*. 2008. Santiago Fernández de Lis y Alfonso García Mora. Revista "Estabilidad Financiera" nº 15. Banco de España.

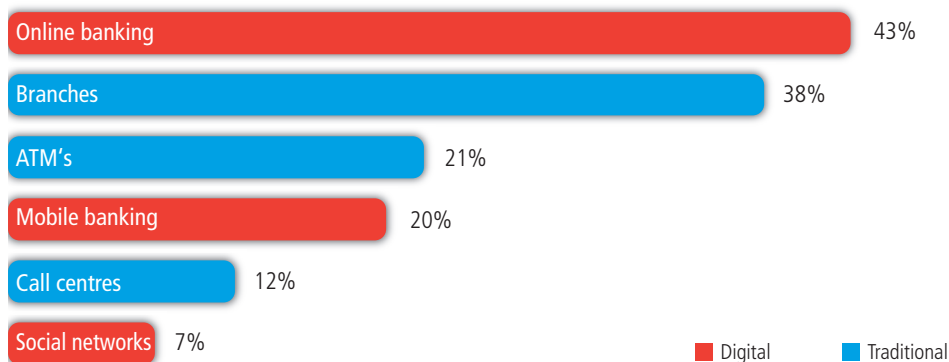
Opinions on this aspect are conclusive. Approximately 40% of IT budgets in larger organizations are for projects to improve customer experience making them agile and efficient at a minimum cost. On the other hand, security is a key issue. (Source: Accenture, 2013)

As we mentioned above, technology was previously employed to improve efficiency but

the future will see it being employed to improve customer experience. This will mean IT security becomes an ever more important issue in remote banking. In the European Banking Barometer 1H14 published by EY, cyber security/data security is number 3 on the list of most important issues of European banking institutions.

Technology was previously employed to improve efficiency but the future will see it being employed to improve customer experience.

Where do consumers think banks should invest?



Source: Accenture 2013 US Retail Banking Survey



Changes to Regulation and Supervision

The European Union has revised its policies related to banking regulation and supervision with the objective of building a strong, robust and transparent financial system.

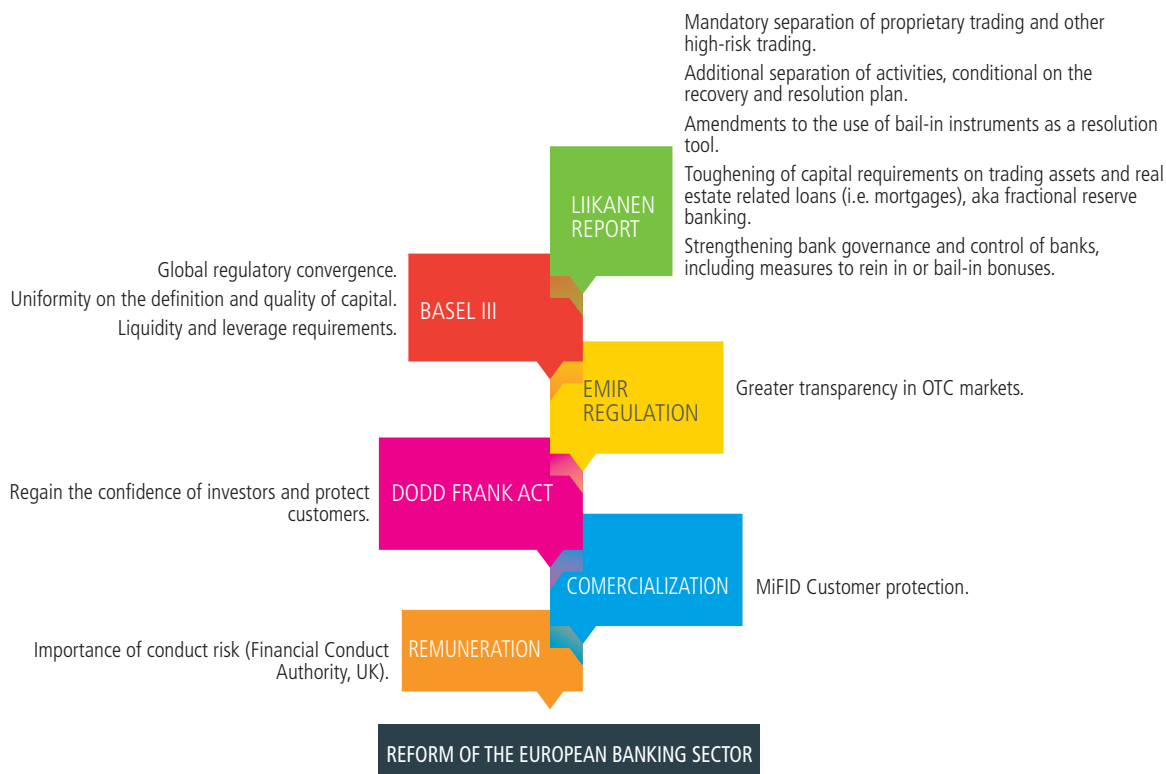
In this chapter, we will first endeavour to describe the regulatory changes that are affecting the banking sector as a whole. Secondly, we will refer to the new Single Supervisory Me-

chanism. We will finish with a brief listing of global regulation that directly impacts internal audit.

REFORM OF THE EUROPEAN BANKING SECTOR – NEW REGULATORY FRAMEWORK

From the beginning of the financial crisis, the European Union has revised its policies related

to banking regulation and supervision with the objective of building a strong, robust and



transparent financial system that looks after the needs of the population, of the economy and of the market.

Informe Liikanen

With a view to investigating whether the European banking sector was in need of structural reform, the European Commission commissioned a report, the Liikanen Report, to a group of experts chaired by Erkki Liikanen, Governor of the Bank of Finland. The report counted on the collaboration of many directors, clients and investors from different banking groups as well as renowned academic experts on banking.

The report concluded that the banking model failed during the crisis. The study revealed excessive risk-taking by institutions and excessive dependence on short-term financing. This level of risk-taking was not adequately backed up by capital, and the high interdependency between entities created extremely high levels of systemic risk.

In order to increase and compliment the set of reforms, the European Union, the Basel Committee on Banking Supervision and the national governments of the Union set out a series of proposals included in the report:

- **Separation of traditional banking activities from other more high-risk commercial activities.**
- **Contingency Planning:** the report underlined the need for credit institutions to develop and maintain realistic contingency plans.
- **Reserve holdings to cover losses:** the report underlined the need for banks to build

an adequate layer of reserve provisions (bailinable debt). These provisions should be kept separate from the banking system and would therefore decrease the incentive for risk-taking.

- **Review of capital requirements for commercial and mortgage assets:** the report proposed implementing more solid and coherent risk weightings for measuring minimum capital standard requirements.
- **Greater levels of control and supervision:** in this sense, the report proposed a series of measures to strengthen control in credit institutions:
 - Governance and Control Mechanisms: greater attention should be paid to governance and control in all banks, especially at the Board level in the largest and most complex entities.
 - Risk Management: strengthening control inside banks and building a risk aware culture at all levels of the financial institutions, legislators and supervisors by applying the Capital Requirement Directives III and IV.
 - Bonus Schemes: in order to recover the levels of confidence between the general public and bankers, the report proposed that remuneration schemes be reformed so that they were proportional to sustainable long term results (we will revisit this topic further on)
 - Risk Reporting: to further the recovery of confidence with the public and investors, and reinforce market discipline, requirements on public disclosure of risk were modified to improve quality, comparability and transparency.

The new rules dictate that the authorities must intervene proactively before entities begin to experience financial problems.

- Sanctioning: supervisors should sanction those entities that do not comply with the proposed measures.

NEW REFORMS IN 2013

On the back of the Liikanen Report and based on existing regulation of member states, the European Union has developed a series of additional rules for banking, taking into account worldwide agreed-upon principles for financial stability and on other nation's regulatory development. This covers:

- **New rules on capital requirements.** During the financial crisis, many countries had to look to the state's coffers in order save many in their banking sector. This highlighted the deficient regulation and supervision of the system. Therefore, new rules have been issued to increase the EU banking sector's resilience to future economic crises, and therefore guarantee that banks continue to finance economic activity and growth.
- **New rules on the recovery and resolution of banks.** The new rules dictate that the authorities must intervene proactively before entities begin to experience financial problems. If, even after intervention, the financial situation of a bank were to deteriorate more than was acceptable, shareholders and creditors must take the initial loss and, if further resources were needed, these could be obtained from the deposit guarantee scheme, which would cover 1% of deposits over 10 years.
- **Mandatory separation of traditional activities from proprietary trading and other high-risk trading.** Some activities bring with them higher risks if they represent a

large part of the entity's business (complex securitized assets, derivatives, OTC etc.) Therefore, as recommended by the Liikanen Report, the Commission has made it mandatory to separate high risk activities from traditional banking (deposits and guarantees). Other high risk commercial activities must also be held separate if they threaten the bank's financial stability.

2014 STRUCTURAL REFORM FOR LARGE DIMENSIONED BANKS

Additionally, in January 2014, the European Commission proposed a new set of rules on structural reform of the EU's larger and more complex banks. As stated by the Commissioner for Internal Market and Services, Michael Barnier, this reform constitutes the final piece of legislation for the regulatory overhaul of the European banking system. The structural reform comprises the following aspects:

- Prohibits proprietary trading of certain financial instruments and commodities due to the inherent risks.
- Attributes to supervisors the power in certain situations to oblige entities to legally separate high risk activities, transferring them to legally separate entities.
- Establishes norms regarding the economic, legal, operational and governance relationships between the separated entity and the rest of the bank.

The impact of these measures will become clearer in future years, but according to the European Commission, the benefits can be measured at between 75 billion and 140 billion euros per year, which represents around

0,6 and 1,1% of European GDP, due to reduced costs of potential future financial crises.

European Market Infrastructure Regulation (EMIR) for the Financial Sector

Apart from the reform of the previously mentioned reforms of the European Banking industry, the sector is also affected by OTC markets regulation known as EMIR (European Market Infrastructure Regulation), that came into effect in the last quarter of 2012 and affects all entities that deal in non-exchange traded instruments. The primary objective of this regulation is to deliver greater levels of transparency to financial markets, and help entities evaluate risks. This comes via a set of obligations:

- **Trade Registration:** all parties of an OTC trade should disclose a set of identifying data for the trade to be registered, and this data will be made available to the European Securities Market Authority (ESMA) and other authorities.
- **Required Information:** EMIR requires that trades be confirmed in a maximum time frame that varies depending on the characteristics of the operation. The confirmation details the clauses of the contract and requires a bidirectional process for both parties to reach an agreement.
- **SWIFT⁹ Confirmations:** SWIFT messaging is the industry standard for confirmation of bilateral trades using OTC derivatives, and

all confirmations should be done using this standard.

- **Conciliation and disclosure of information using SWIFT Accord:** The best practice directives issued by the International Swaps and Derivatives Association recommend that the clearing process should involve both parties using electronic to electronic communication, either in-house or third party. This electronic confirmation process automates clearing and is the most reliable and efficient method for confirmation, while mitigating risk in the process.

Dodd Frank Act in the United States

As we have mentioned, the European Banking sector is being submitted to ever greater regulation and supervision so that its conducts its business in more responsible and transparent manner. Nonetheless, the EU is not the only one tightening its regulatory grip. In the United States, there has also been a series of measures, including the Dodd-Frank Act of 11 July 2010.

This law promotes deep financial reform, covering all aspects of banking after the worst financial crisis since the Great Depression. The law's primary objective is the restoration of investor confidence and strengthening of customer protection in the financial markets. The main aspects of the law are:

- **Strengthening of investor protection:** greater accountability, consistency and transparency.

The EU is not the only one tightening its regulatory grip. In the United States, there has also been a series of measures, including the Dodd-Frank Act of 11 July 2010.

9. SWIFT *Society for Worldwide Interbank Financial Telecommunication*.

The global scandals have provoked a regulatory tightening with a spotlight centred on client protection.

- **Systemic risk:** increased levels of supervision and regulation of financial institutions.
- **Global financial markets supervision:** better supervision in securities assets, derivatives and ratings agencies.
- **Other mechanisms for preventing financial crisis:** avoiding repeating “Too big to fail” situations.
- **Increased international regulatory standards and better global cooperation.**

New Global Regulatory Framework

In order to bring in more global regulatory convergence, the **Basel III** regulatory framework has been developed. This third Basel Accord is developed as a response to certain deficiencies in banking regulation and looks to develop greater uniformity in defining minimum capital buffers. With respect to Basel II, it demands greater levels of equity and reserves, and a better quality of capital and credit portfolios.

The main measures of the third Basel Accord are:

- Better capture of risks associated to certain exposures.
- Increase in capital requirements.
- Increase in the quality of capital required.
- Reserve provision requirements.
- Introduction of leverage ratios.
- Better risk management, better supervision and more market discipline.
- Introduction of liquidity requirements.

These measures significantly tighten banking regulation, and therefore there is a transition

period for full implementation that runs from the 1st of January, 2013 to the 1st of January, 2019.

INVESTOR PROTECTION

The global scandals have provoked a regulatory tightening with a spotlight centred on client protection. The most significant initiative in this sense is the Market in Financial Instruments Directive (MiFID) and the ever-increasing importance of conduct risk.

In 2004, the European Unión adopted MiFID I in order to strengthen the regulatory framework around investment services and regulated markets. Through protection of investors and the preservation of market integrity it aimed to promote equity, transparency and the integration of financial markets.

In 2014, after 2008's financial crash, the European Union adopted **MiFID II** to replace MiFID I. Its objective was to develop a new financial practice framework, making financial markets even more efficient and transparent, and therefore strengthening further measures of investor protection. This directive regulates, above all, new requirements for information and registry of operations (EMIR).

Sovereign legislators have adapted the directive to their national markets. Spain passed the directive into national legislation in two laws: Law 47/2007 that reformed the Law 28/1988 on Capital Markets, and the Royal Decree 217/2008 that defined the legal status of entities offering diverse investment services.

In order for investors to be treated equitably, the Law 47/2007 set down certain obligations around pre- and post-deal transparency.

This means secondary markets are obliged to disclose, prior to the deal, the bid and offer prices and bid and offer volumes being quoted on their systems. They must therefore also publish the price and volume of executed trades.

In the case of multilateral trading facilities¹⁰ there are certain transparency requirements similar to official exchanges.

In the case of systematic internalizers¹¹, they will also have to comply with obligations for pre- and post-trade transparency.

- **Pre-trade transparency.** Systematic internalizers should publicly disclose the bid – offer quotes when customer orders are for exchange quoted equities in a liquid market and when orders are equal to or smaller than the standard size order for that class of asset.

When dealing in non-liquid equities, systematic internalizers should only disclose the quotes on the customer's request.

On the contrary, on larger than standard orders for liquid equities, systematic internalizers have no obligation to disclose their quotes.

- **Post-trade transparency:** Systematic internalizers must publicly disclose the volume and prices of equity transactions carried out in regulated markets.

Therefore the tendency, both at European and Sovereign state level is for greater transparency of financial markets, so that investors can be better protected, and that markets can be more efficient and equitable.

IMPORTANCE OF CONDUCT RISK

Conduct risk can be defined as the risk that results from the conduct involved in the decision-making process at each stage of the product cycle and that could lead to customer detriment.

The significance of this risk is increasing exponentially. For example, in the UK, the previous supervisor, the Financial Services Authority (FSA), was split into two separate bodies. One of those, the Financial Conduct Authority (FCA)¹² has, as its name indicates, a specific mandate over this risk. Other countries are also reinforcing their supervision of conduct risk.

In June 2014, the Bank of Spain announced the creation of the new Conduct Supervisory Division, which compliments the creation in 2013 of the Department for Market Conduct and Claims. According to the supervisor:

Conduct risk can be defined as the risk that results from the conduct involved in the decision-making process at each stage of the product cycle and that could lead to customer detriment.

10. A multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract.

11. Traditionally called market makers, are investment firms who could match “buy” and “sell” orders from clients in-house, or match them with other orders on its own book.

12. The other supervisory body resulting from the split is the Prudential Regulation Authority (PRA).

Culture change within firms is essential if we are to restore trust and integrity to the financial sector.

*"Our new approach is intended as an answer to the increased relevance and social impact of bank-client relations, and this is a key aspect of the normal functioning of the banking services market and is therefore in need of preferential attention from international regulatory and supervisory bodies."*¹³

The greater importance attributed to conduct risk is no more than a natural response from supervisors and regulators to the malpractice many banks dispensed to their clients during the financial crisis, as these banks were product-sales focused and not client-need focused. Changing this is a significant cultural change.

*"Culture change within firms is essential if we are to restore trust and integrity to the financial sector and the FCA will continue to focus on how firms are managed and structured so that every decision they make is in the best interests of their customers."*¹⁴

The FCA will be able to review management decisions, in some cases even before those decisions have become effective. These reviews, for example, may cause the prohibition of a product before its launch. The supervisor is treating this risk with an anticipatory approach, and it seems that this approach will not be exclusive to Anglo-Saxon jurisdictions in the near future.

In order to comply with current and future requirements around conduct risk, entities will need to:

- Count on sufficient push from senior management in order to make the change with adequate tone and commitment at the top.
- Build conduct risk into enterprise risk management models and align it with the entity's risk appetite.
- Have adequate systems and controls.
- Have employees with the necessary knowledge, skills and professional judgement.

Remuneration related legislation

Last but not least, the international organizations identified that many credit institution's remuneration policies led to non-prudent risk management, and were in some cases causes of the financial crisis.

The European Union was the first to undertake this matter in this respect, mandating the Committee of European Banking Supervisors (whose responsibilities were later assumed by the EBA), to develop a set of directives on remuneration policy. On the 10 December 2010, the EBA published its Guideline on Remuneration Policy that was later passed into Spanish legislation¹⁵.

Even though Spanish Commercial Banking models have historically been more prudent than Anglo-Saxon banking models, insofar as bonus pay has traditionally been less significant compared to total remuneration, our en-

13. Obtained from a Bank of Spain press release, 6th June, 2014.

14. Financial Conduct Authority, Risk Outlook 2013

15. Royal Decree 771/2011 of the 3rd June and Bank of Spain Circular 4/2011.

tities have also had to adjust to this legislation. This includes aspects related to:

- Corporate Governance (Mandatory remuneration committees).
- Deferral of some variable packages for some groups of employees.
- Bonus payments in the form of capital instruments.
- Restrictions on bonus payments in entities that received state aid.

The conclusions reached by PwC in its report, “Remuneration in Spanish Credit Institutions – Regulation and Trends from a Survey of 13 Entities,” are interesting.

- The majority of those surveyed said they clearly understood the implications of deferring remuneration and linking that to risk. However, there was misunderstanding as to the formulas employed to calculate pay rates in capital instruments.
- 69% of entities extended the reach of these measures more than they were obliged to.
- In 93% of cases, bonus payments represented less than 50% of total remuneration.
- 38% of respondents were unaware of the change and 50% were aware of only some aspects. Only 12% were fully aware of where the trends for remuneration are going.

The Role of Internal Audit

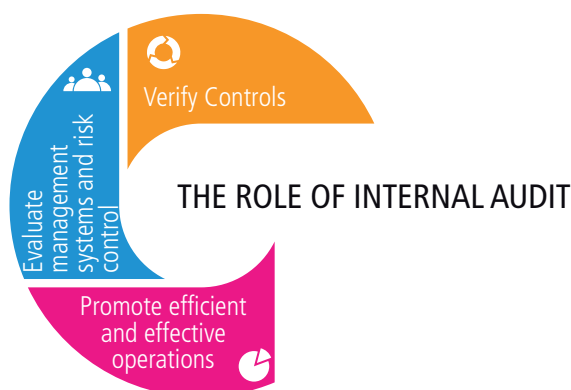
Given all that we have previously noted and the ever-tighter regulation and supervision of banking, internal audit will play a crucial role,

verifying that adequate controls are implemented to comply with the new regulatory environment. Internal audit will be indispensable to promote the efficiency and effectiveness of financial operations and to evaluate risk management and control systems.

In order to comply, the internal auditor should take into account not only the previously mentioned reforms, but also other regulation specific to internal audit, such as the “Supplementary Policy Statement on the Internal Audit function and its Outsourcing” (SR 13 issued by the Federal Reserve of the United States), or “The Internal Audit Function in Banks” and “Guidelines- Corporate Governance Principles for Banks” issued by the Basel Committee for banking Supervision.

Internal audit should also consider best practice from its own profession, such as the “Recommendations from the Committee on Internal Audit – Guidance for Financial Services” issued by the Chartered Institute of Internal Auditor of the UK. We will later analyse these documents in more depth.

The internal auditor should take into account not only the previously mentioned reforms, but also other regulation specific to internal audit.



ADAPTING TO THE SINGLE SUPERVISORY MECHANISM

The supervisor will evaluate the work of the internal audit function and will determine if it can rely on the identified areas of potential risk.

The Bank of Spain has stated *"In June 2012, the heads of European states or governments decided to promote the creation of a single bank supervisor in order to improve the quality of supervision in the Eurozone, thus promoting market integration and breaking the negative link that was created between trust in banks and doubts about the sustainability of public debt. The Single Supervisory Mechanism (SSM) is the first step towards Banking Union that will be completed with the creation of a Single Resolution Mechanism and a Single Deposit Guarantee Scheme"*¹⁶.

The SSM naturally evolved from the scheme devised to build European banking, where national supervisors, like the Bank of Spain, will still have a significant role given the knowledge they possess. However, this integration means change will be needed in the relationship between the entities and the supervisor, and this directly and indirectly affects internal audit.

Listed next are some of the changes that will affect entities as a result of the banking union that will also have an impact on internal audit:

- Entities will have to reorganize internally, and their Boards will have to sign off on a clear risk appetite framework, which will include a capital planning policy, a risk management and control policy and also a policy on internal audit. The way entities approach transparency in their corporate structure will have to be reviewed, along with board

accountability and obligations, a conflicts of interest policy, and appointments, audit committees and compliance functions.

- Entities will have to invest in human resources and technology, as the supervisor's continuous monitoring means that each bank will have to create a dedicated and dynamic solvency function. Internal audit will also require more resources, and will give more weight to risk assessment than control evaluation.
- Entities will have to adapt to a supervisory model that is operational, preventive and strategic, and that relies more on dynamic reviews of internal control, governance and solvency than reviews of accounts and financial statements.

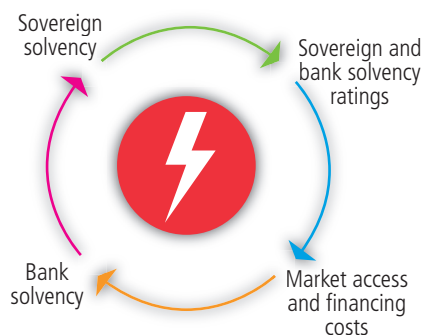
In its consultative document, *The Core Principles for Banking Supervision*, the Basel Committee on Banking Supervision (BCBS), dedicates a specific principal exclusively to internal audit, and other important points:

- Principle 26: Internal Audit and Control: the supervisor determines that banks have adequate internal controls to establish and maintain a properly controlled operating environment for the conduct of their business, taking into account their risk profile. These controls include, in addition to others, an independent internal audit function.
- The supervisor will evaluate the work of the internal audit function and will determine if

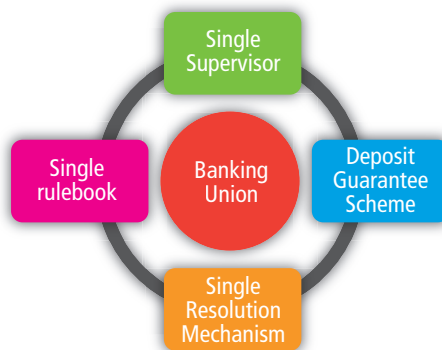
16. http://www.bde.es/bde/es/areas/supervision/El_Mecanismo_Un_565aad4a9a47241.html

EUROPEAN BANKING UNION

The Origins of the Project: The Vicious Circle of Sovereign and Bank Solvency



Components of the Banking Union



it can rely on the identified areas of potential risk.

- The supervisor will also verify that the risk management function is subject to reviews by the internal audit function.
- Well-developed public infrastructure should include internal audit systems; if these are not included, financial markets and systems can become unstable and hamper improvement.

As you can see, internal audit is a key function for the Single Supervisor, but if it is to develop the role, it needs to be strengthened. Some of the potential areas of improvement are:

- Align internal audit plans with those of the objectives and priorities of the Single Supervisor.
- Assure that internal audit has the technical ability required to review the new supervisory processes.
- It is probable the Supervisor will delegate supervisory activities more frequently to internal audit. This would mean more hours for internal audit.
- There are also a number of activities, that although not mandatory, do constitute best practice and that will be favourably viewed by the Supervisor:
- Given the emphasis the supervisor is putting on certain processes, such as capital planning and its integration with management processes, internal audit should not limit itself to providing assurance over data quality, but should look more deeply into such processes.
- The Board should be more implicated in process reviews, and therefore internal audit should assure that the Board receives all the necessary information.
- Internal audit should provide assurance on the coherence of different strategic processes.

Internal audit is a key function for the Single Supervisor, but if it is to develop the role, it needs to be strengthened.

ses (strategic planning, business planning, capital planning, finance planning and recovery planning).

- Internal Audit should assure that the risk appetite framework is correctly embedded into the organization's processes.

EUROPEAN CENTRAL BANK: NEXT STAGES AND CHALLENGES FOR THE SINGLE SUPERVISORY MECHANISM

One of the main challenges that the ECB has had to meet is the extended scope and character of its new functions. Additionally, the timeframe for getting the SSM operational is very tight, much tighter, in fact, than the time given to set up the ECB and Single Monetary Policy.

Another added difficulty is the modifications made to the schedule. The dates pencilled in

for the ECB to take up its supervisory role have been pushed back from March to November 2014, meaning constant revision of deadlines (decision making processes, supervisory schedule, logistics, hiring of personnel, team building and joint supervision).

The ECB will attempt to satisfy legitimate expectations about its accountability and transparency in line with the Inter-Institutional Accord and Memorandum of Understanding, being totally dedicated to the undertaking of its responsibilities.

Because the lack of personnel at the ECB may make it difficult for them to carry out their mandate effectively, it is probable that they will have to rely on the internal audit functions of the supervised entities, and therefore it is critical that the capacity and independence of internal audit functions be strengthened.

It is critical that the capacity and independence of internal audit functions be strengthened.

SPECIFIC REGULATION AFFECTING INTERNAL AUDIT

Up to now this document has covered the great changes that have been forced on the banking sector as a whole. However we should also look more closely at those that are aimed at or directly affect internal audit.

We are referring to rules, regulations, standards and best practice issued by prestigious international bodies, of which we want to highlight *The Internal Audit Function in Banks*, of June 2012 and *Guidelines-Corporate Governance Principles for Banks* (at the


moment in its consultation phase), both issued by the Basel Committee on Banking Supervision; *Supplemental policy statement on the internal audit function and its outsourcing*, from the Federal Reserve, January 2013; and *Effective internal audit in the financial services sector*, from the Chartered Institute of Internal Auditors (UK), July 2013.

One may be inclined to think that international regulatory trends would only be of importance to entities with foreign operations. This,


however, is not correct, given the global regulatory convergence being seen in the sector. In the medium and long term, the principles set down and actions taken by the more active regulators, primarily the Anglo-Saxon ones, will have a pervasive influence on other countries, and therefore these trends are important for local credit institutions.

As is only logical, new rules and regulations are following and extend on the guidelines set out by the International Professional Practices Framework.

It is worth mentioning the emphasis these documents have on:

 Governance structures, defining the internal audit's place in the organization's structure. Key aspects to be considered are the adequacy of the Internal Audit Charter, adherence to the International Standards and of course the quality of the relationship with the Audit Committee and the Board.

These are indispensable elements that guarantee the independence of the function within the organization. For organizations with overseas affiliates or branches, the regulators insist that local audit directors have sufficient seniority, and that this should be comparable to the executive management of the activities they audit.

 The ability of internal audit to question executive management's decisions. Internal audit should be able to push management to improve the effectiveness of governance, risk management and internal control.

It is necessary that the Board and its Committees establish an adequate "Tone at the Top" that supports and promotes the acceptance of internal audit at all organizational levels.

EMPHASIS OF THE NORMATIVE INTERNATIONAL TRENDS



Independence of the Internal Audit Function



Appropriate Tone at the Top



Continuous Audits



Root Cause Analysis, Lessons learnt, Post Mortem



Extended and reinforced audit universe



Continuous risk assessment as part of a dynamic planning process. The documents promote continuous audits as part of the risk assessment process, as well as support for adjusting audit plans and universes.



Internal audit's added value in organizations should not be based exclusively on uncovering the consequences and effects of weaknesses. What is of more relevance and value to the organization is the identification of root causes (root cause analysis, lessons learnt, and post mortems).

It is clear that lessons learnt should not be limited to those in-house. Understanding the causes of financial scandals will help organizations identify weaknesses and improve their own internal controls.



The regulators point to some significant aspects to include in the audit universe: Some are truly new, whilst others suggest that internal audit should place more empha-

Internal audit's added value in organizations should not be based exclusively on uncovering the consequences and effects of weaknesses.

Adding these risks to the audit universe, or reinforcing the depth of the audit will require auditors to have new and more complex skills and therefore training.

sis on aspects that were already being considered. We want to highlight:

- The governance structure for all significant lines of business and at all levels. This includes a review of the adequacy and effectiveness of risk responses.
- The risk and control culture, (Tone at the Top).
- The information reported to the Board and Executive Management for strategic and operational decision-making, reviewed for assurance that it truly aligns with the business model and strategy.
- The adherence to the risk appetite, assessing whether it is being considered in the organization's activities, limits and reporting processes.
- Conduct and reputational risk. Internal audit must evaluate the integrity of the organization in its client relationships, to ensure that it offers clients products that are in line with their needs.
- Capital and liquidity management.
- Strategic risk, as this is most often seen as the cause of shareholder value destruction.
- Emerging risks: Large corporate operations, new product launches and design, investment project management, M&A, outsourcing etc.
- Cyber security risks: Increasingly important given the trend of new electronic channels (internet, mobile banking etc.).
- Business continuity planning and disaster recovery, assuring these are aligned with

the business and that stress tests are carried out.

- Environmental legislation.

Adding these risks to the audit universe, or reinforcing the depth of the audit will require auditors to have new and more complex skills and therefore training. Internal audit may have to rely on external support to cover any gaps in its skill set.

These documents highlight the need and desire of supervisors to rely on organization's internal audit functions, and that they should have an open, constructive and cooperative bilateral relationship. This will allow relevant information to be exchanged so that both parties may correctly and efficiently deliver on their responsibilities.

The supervisors will have the power to review the reliability of internal audit functions. This has a pervasive effect on the supervisor's view of the entity's risk profile, and will allow them to decide if they can rely on internal audit's work.

However, internal audit's relation with the supervisor is not the only one to become more important. The relationship with other assurance providers, both external (external auditors) and internal (second line of defence) also grow in importance.

The sum of all these aspects combine to make up a big new challenge for our profession, and also represent a significant opportunity for us to strengthen our position.

Further on, when we analyse the impact and trends for the profession, we will return to many of these aspects that are critical for the future shape of internal audit.



Trend Analysis, Prospects and Impact

In previous chapters we have talked about the changes that are happening in regulation and to the banking model, and we have looked briefly at how these will impact on internal audit.

It is now time for us to go into more depth and analyse the key transformational aspects we expect to see for internal audit. Our conclusions are based on a survey of CAEs of Spanish Financial Institutions carried out by the Spanish Institute of Internal Auditors.

Each of these transformational aspects, or trends, have been classified in the following categories:

- Human Resources.
- Organizational structure of internal audit departments.
- Approach, scope and the organizations of audits.
- Resources and technical requirements.

The analysis of each of these trends has been summarized in trend and prospect tables in the appendix of this document.

External demands on internal audit and internal demands will oblige internal audit executives to look for greater efficiency in all aspects of their work in order to accomplish their objectives.

TRENDS THAT IMPACT ON THE HUMAN RESOURCE STRUCTURE OF INTERNAL AUDIT DEPARTMENTS

In the 2014 study, the State of the Profession, chartered by the Spanish Institute of Internal Auditors, 26% of the 50 respondent organizations reported that their internal audit departments had less auditors than the previous year, (14% in 2013). Additionally, 26,5% said that the budget assigned to internal audit had shrunk, (16% in 2013). However, we are of the opinion that internal audit groups in Spanish credit institutions will remain stable or increase slightly in the short and medium term.

Along with what we see as a positive trend in terms of resources, we expect internal audit

to increase the efficiency of its work. External demands on internal audit (regulatory and supervisory requirements) and internal demands will oblige internal audit executives to look for greater efficiency in all aspects of their work in order to accomplish their objectives.

Some areas where we might expect to find these efficiency gains are:

Improvements to the audit process

- Greater emphasis on audit planning. This phase of work is key as it forms the basis for fieldwork. Risk and auditable control mapping, process owner interviews and

We need to adopt a holistic view of who the assurance providers are and promote coordination between them.

programme design are all key aspects of planning. This ends with communicating internal audit scope and objectives to management.

- Centring audits on critical risks and key controls. As a result of better planning and better knowledge of processes, internal audit work should be focused on key risks and controls.
- Use of statistical techniques to select samples can lead to time gains and increases the representativeness of the sample with respect to the population, and it will therefore not be necessary to undertake additional testing to confirm findings.
- Use of mass data analysis techniques can enable internal audit to extend its scope, quantify findings and better understand risks. This is an area that still has plenty of scope for growth, as was pointed out by PwC in their 2013 study on the State of Internal Audit. According to this study only 31% of respondents said they used advanced data analysis techniques.

Eliminating duplicity and improving coordination with the second line of defence and the external auditors.

71% of CAEs that responded to the survey confirmed that the three lines of defence model was implemented in their organizations. However, there remain opportunities for improvement that will make it possible to increase its effectiveness.

Obviously it is extremely complicated for internal audit to cover all the risks in an organization, without relying on the assurance provided by the second line of defence and other assurance providers such as the external audi-

tor, often referred to as the fourth line of defence.

For this to be achieved, we need to adopt a holistic view of who the assurance providers are and promote coordination between them. The 2013 document published by the Spanish IIA's Think Tank, *A Framework for Internal Audit's Relationship with other Assurance Functions*, highlights that coordinating assurance activities will provide for more efficient use of resources and improved efficiency for internal audit.

These efficiency gains provide a positive take on the three lines of defence model. We believe that the model will tend to see a strengthening of the role of the second line of defence as they take on additional responsibilities in their organization's control environment. Investment in training teams and systems will therefore be a key aspect.

This could also be an opportunity for rotating internal audit teams in the organization, as departments such as risk management and internal control maybe seen as a natural progression for internal auditors.

Providing assurance over the design and effectiveness of the second line of defence.

Apart from the coordination tasks described previously, we must not forget that internal audit is the only function capable of providing independent assurance. So, on top of the strengthening of the second line of defence, internal audit should include in its audit planning, reviews that provide independent assurance over the design and effectiveness of the components of the second line. As internal audit increases its reliance on second line

controls, more equilibrium can be given to first line reviews.

Greater specialization will be required to deal with specific risks, therefore more training will be needed

The complexity of the business environment and regulatory pressure is pushing banking towards a new supervisory model, which in turn implies changes and more specialization of internal audit. More talent will need to be made available to internal audit functions.

The challenge for internal audit is therefore to keep on improving its capabilities, adding value with respect to the new risks that emerge and increasing in relevance. Plans must be prepared to meet these new challenges, reviewing capability in search of improvement opportunities.

Internal audit needs adequate resources to add value and improve performance, extending its scope to providing not only assurance but advice on critical risks. For this, internal audit needs specialized knowledge on traditional and emerging risks, elevating the level of training required.

There are a number of emerging risks that will require greater professional specialization, such as large projects, new, more complex products, M&A activity, IT infrastructure, business continuity and big data etc.

Internal audit needs to have the capability to audit all areas of an organization, deploying auditors with extensive knowledge and experience. Specialized training is key. This is bac-

ked up by the 2014 Study on the Banking Sector commissioned by the Spanish IIA, in which 62% of CAEs reported that training hours will increase and nearly 85% reported that they monitor the training required and received to guarantee that the internal audit function has the required skills at its disposal.

The US Fed states that, *"auditors should have a wide range of business knowledge, demonstrated through years of audit and industry-specific experience, educational background, professional certifications, training programs, committee participation, professional associations, and rotational job assignments."*¹⁷ We would like to highlight the importance given to professional certification, committee participation and professional associations.

Increases in integrated audit teams made up of auditors with different specialities, with the emergence of super internal auditors that combine knowledge of different relevant areas

In order to meet the challenges of the changing and complex business environment, including regulatory pressure and technological innovation, internal audit teams will have to be multidisciplinary.

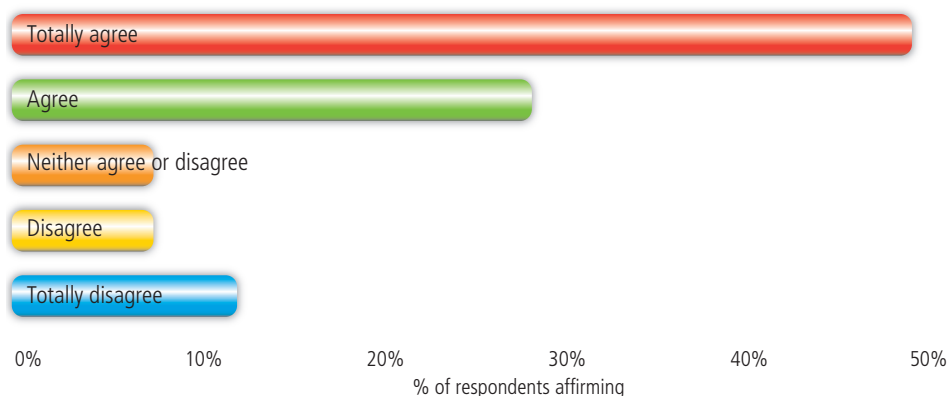
This implies an ongoing fusion of IT related risks with functional risks from audited areas. With this approach, new risks can be constantly detected and evaluated using mass data analysis techniques.

In order to meet the challenges of the changing and complex business environment, internal audit teams will have to be multidisciplinary.

17. Supplemental policy statement on the internal audit function and its outsourcing. January 2013. Federal Reserve.

This will require an ongoing commitment on the part of CAEs and the Audit Committee to quality and innovation in their audit approaches.

Will audit teams become more integrated, with different specialists including an IT auditor?



Source: 2014 Survey of Spanish Banking CAE's. Spanish Institute of Internal Auditors.

Technology is not just for detecting IT risks, it is also a facilitator of mass data analysis in audit field work. Risks can be detected more effectively and at no extra cost.

Multidisciplinary teams will help all involved to better understand risks and applicable controls. In the medium term we will see the

emergence of what we will call the *super auditor*, capable of understanding the majority of risks faced by a bank. This will require an ongoing commitment on the part of CAEs and the Audit Committee to quality and innovation in their audit approaches, which will in turn generate improvements to data analysis and audit conclusions.

TRENDS THAT WILL IMPACT ON THE STRUCTURE OF INTERNAL AUDIT DEPARTMENTS

The CAE will report directly to the Board or an Audit Committee that in turn will be more involved in the building of the audit plan and understanding of audit conclusions.

Firstly, the draft version of the Spanish Mercantile Code, Section VIII, states that the responsibilities of the Audit Committee include, among others, providing supervision over the internal controls of the entity, providing supervision over internal audit and risk manage-

ment systems, and providing supervision over the process of the development, disclosure and integrity of financial statements and reporting.

The Unified Corporate Governance Code for publicly listed companies in Spain recommends in point 47 that, "all publicly listed companies should have an internal audit function that, under the supervision of an audit committee, is responsible for the effectiveness of information systems and internal con-

tol.” Point 48 states, “the person in the position responsible for the internal audit function should present their annual plan to the audit committee, should elevate any issues related to the execution of the audit plan, and should present an annual report on internal audit’s activities.”

As we can see, the Audit Committee is extremely important with regards to the internal audit function, and specifically to the annual audit plan, the understanding of findings, the follow-up of recommendations, and the performance review of the function. This is backed up by the PwC document, *New Challenges for Audit Committee in Publicly Listed Companies*.

The Committee is also extremely important for aligning internal audit through the strategic and annual audit plans.

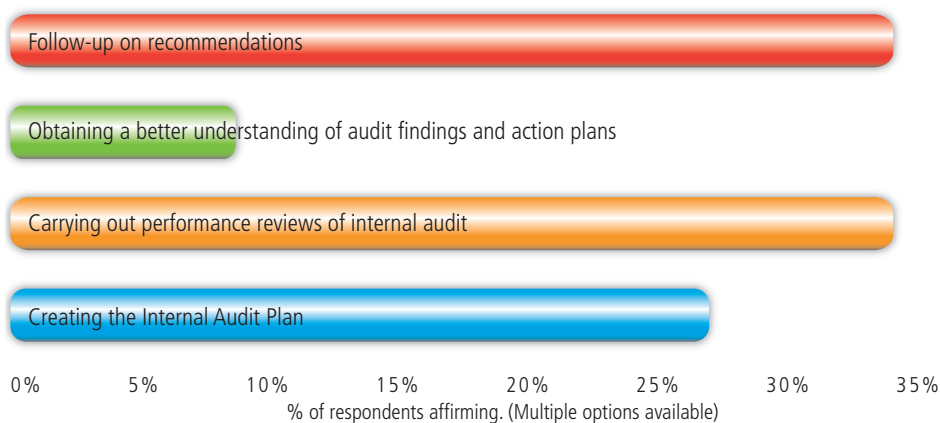
The Spanish IIA survey on the banking sector highlights the involvement of Audit Committees with internal audit functions and that in the medium term this will be evidenced by performance reviews, follow-up of recommendations, and internal audit planning.

This level of the Audit Committee’s involvement with internal audit requires frequent, open and candid communication that is not merely a formality. This requires:

- Opportunities for Audit Committee members and internal auditors to comment on themes of interest, industry risks, business model changes, new operations, regulatory changes, as well as opportunities to meet more regularly, including outside formal work sessions.
- More meetings between the Audit Committee, management and internal auditors, so that communication may be improved and the Committee’s horizons widened.
- Adopting a risk-based approach that separates management and supervisory functions.

Additionally, internal audit should strengthen its relationship with Executive Management Committees, given their expectations for internal audit may not coincide with those of the Audit Committee. Internal audit should consider both.

Audit Committees will be more involved in...?



Source: 2014 Survey of Spanish Banking CAE's. Spanish Institute of Internal Auditors.

Internal Audit should therefore leave behind its traditional role of looking exclusively at control testing in mature processes, and should adopt a risk-based model that allows it to look at emerging processes and risks.

There will be greater demands for information (quantity and quality) as the Board's and Audit Committee's responsibilities become clearer.

The Single Supervisory Mechanism has implied that board members have greater responsibility in the organization's risk management. To achieve this, it is required that institutions have Board Delegated Committees, such as the Audit Committee, that can reinforce risk management and supervision and support the Board as a whole.

This means a greater demand for information and reporting to the Board and its Committees. The trend is for effective and transparent communication channels to exist between the audit committee and all stakeholders, including other Committees.

In a study carried out by PwC on the state of the profession of internal audit, it was reported that stakeholders are satisfied overall with the contribution of internal audit in traditional areas of action: financial controls, fraud and

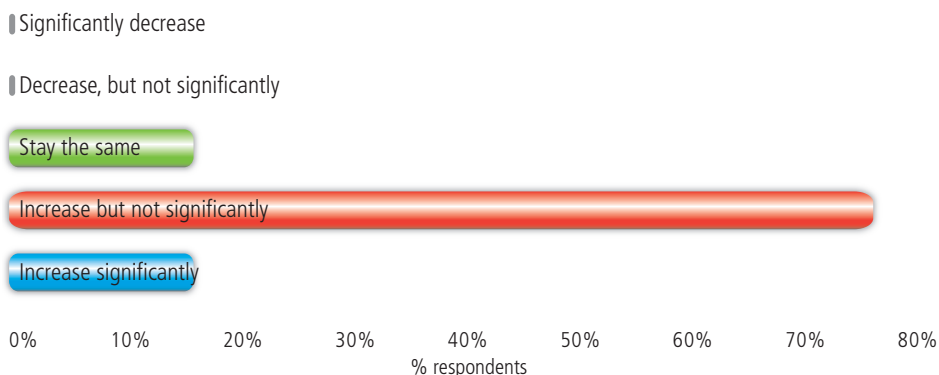
ethics. However, they are less satisfied with the contribution internal audit makes in less traditional areas, such as reviewing large projects, product launches, the management of investment projects and M&A.

Internal Audit should therefore leave behind its traditional role of looking exclusively at control testing in mature processes, and should adopt a risk-based model that allows it to look at emerging processes and risks, which can add value to the organization at this time.

With this in mind, internal audit should understand the expectations of each interest group, which, in many cases these may not be the same, and it should also be able to communicate the services internal audit can provide each one.

The majority of organizations responding to the IIA's survey stated that the one of the challenges for internal audit is the quest for avenues through which it can extoll its value adding capacity to the organization, through

How will the number of special projects evolve in the next three years compared with traditional audit projects?



Source: 2014 Survey of Spanish Banking CAE's. Spanish Institute of Internal Auditors.

better stakeholder understanding and more reactivity to these expectations.

Internal audit should gain the confidence of these stakeholders. It should provide information that demonstrates that its activities are aligned with the business's critical risks, that its resources are efficiently deployed and that any deficiencies are adequately remediated.

Benchmarking studies are helpful in comparing the audit function to those of industry peers and through the use of metrics and KPIs, it will be possible to monitor the performance and development of the function.

The number of requests from management for internal audit to undertake special projects is a great barometer of the confidence in the function and the value it creates. The study undertaken indicates an increase, though not significant.

Internal audit needs to be empowered, in terms of resources and reporting lines, as well as sponsorship, integration and participation on executive committees, and involvement in their strategic processes.

We need first to refer to the Spanish Draft Law of the Organization, Supervision and Solvency of Credit Institutions from 14th February 2014, which underlines the importance of having an independent internal audit function. The current economic climate and the requirement for better corporate governance have contributed to the changes and constant adjustments being made to regulation and the promoting of best practice in corporate governance.

Given that the audit committees must rely in the internal audit function for many of its supervisory responsibilities, it is critical that internal audit knows the organization's strategy, and should attend executive meetings to gain this insight.

CAEs that answered the survey have indicated that in the next three years they will be looking closer at governance and strategic risk.

Internal Audit, as the third line of defence, is responsible for providing supervision and assurance over good governance, risk management and compliance. This further enforces the need for an audit function with sufficient knowledge and experience.

High powered internal audit functions, as they should be perceived by the organization's stakeholders, require the right level of sponsorship and adequate human and technical resources to be able to add value.

The seniority of the CAE is critical, given the closeness of the relationship with the Audit Committee and its president. The audit committee is chosen based on its knowledge of accounting, risk management, and audit, as well as their experience in different industries, (financial, non-financial and teaching). Most are members of other boards and have extensive professional experience. The CAE should possess a level of experience, knowledge, and interpersonal and negotiating skills to be able to interact appropriately with the audit committee.

CAEs should encourage the function to reach out for new challenges, questioning the status quo and redefining the future of the profession.

The number of requests from management for internal audit to undertake special projects is a great barometer of the confidence in the function and the value it creates.

Internal Audit will face organizational change derived from change to banking business models.

The changes identified for banking business models, regulatory requirements, the single supervisor, and the makeup of other stakeholders will entail changes in the risks requiring audit and therefore in internal audit's resources, media and approach.

This state of constant change, with ever-tighter regulation and greater compliance costs means that business models will change, and internal audit should adapt. This will require new and innovative policies to improve efficiency and profitability.

New business models will mean entities will have to:

- Implement a clear framework for risk appetite that should be audited, which will require a period of adaptation and further investment in human resources and technology.
- Build an infrastructure that responds to the new regulatory requirements, with preventative systems for strategy, corporate governance and processes that improve innovation and quality through greater technical deployment.

Internal audit should conduct its business while taking into account the organization's risk profile, developing capabilities that keep it up to date in a changing environment, and employing innovative and creative solutions that add value.

This change should be met head on by internal audit and it should develop the capacity

to deliver real time responses the expectations of administrators and stakeholders.

New resources will be deployed to deal with, and respond to the Single Supervisory Mechanism, and to the Audit Committee.

Currently most of internal audit's administrative tasks, such as report writing for the Audit Committee or executive management and internal quality assurance programs are undertaken by internal audit staff and the CAE.

We expect that in the short and medium terms, an effective SSM will require more and more information from the entities. This additional requirement will mean that resource planning will have to take into account any extra hours dedicated exclusively to covering this task.

After understanding the true impact this makes on resources, we should be looking at how to strengthen internal audit teams and whether this can be achieved by existing resources. This is likely to drive organizational change, with separate audit teams doing fieldwork and reporting.

Some larger entities already have specific teams dedicated to creating and communicating reports. These teams:

- Have specific knowledge of information requirements specific to each stakeholder
- Have a dual view of work carried out: High level, of all the work carried out by internal audit, and in detail, so that reporting is clear and precise.

TRENDS THAT WILL INSTIGATE CHANGE IN THE APPROACH, SCOPE AND ORGANIZATION OF REVIEWS

Traditional, onsite internal audit of branches will decrease and become less important in terms of auditors deployed and branches visited.

One key aspect of change that will bring more efficiency to internal audit is the reduction of traditional onsite branch audits.

The truth is that this is already happening and internal audit has been carrying out remote branch audits rather than on-site. However, the trend is not finished and is set to continue as new technology allows internal auditors to gather and review more and more information remotely.

Contributing to this accelerating trend are document management techniques that allow for more and more information to be available in electronic formats (contracts, ID etc.)

This will drive more changes:

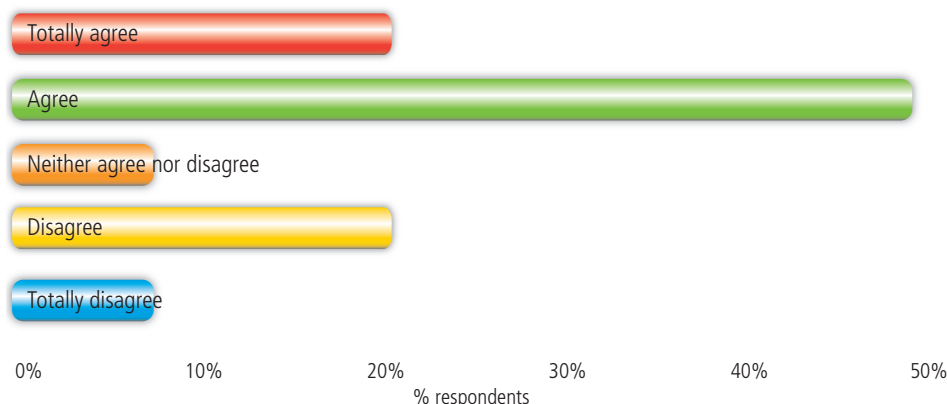
- Some entities will only do onsite visits when a risk or compliance flag is raised,

and this will break the traditional concept of audit frequency. (Low risk offices may not be visited in many years).

- However it is very likely that top management will still want internal audit to evaluate branches, as these evaluations add significant value to management. So, one of the challenges will be to develop a single risk indicator for branches that groups together remote and onsite audit conclusions.
- Increase in cross-functional audits, where the audit objective is not the branch, but a specific risk. (Evaluations of the level of control for that specific risk will be reviewed across branches)
- This cross-functional approach may drive internal audit functions to radically change their organization, deploying teams specialized in specific risks. This may mean the complete extinction of dedicated branch network auditors.

Now that remote auditing of branches is highly developed, it is time to dedicate resources and budget to develop remote audit techniques to review other risks.

Will resources dedicated to onsite audits decrease?



Source: 2014 Survey of Spanish Banking CAE's. Spanish Institute of Internal Auditors.

For example:

- The credit risk audit group will audit all aspects of credit risk and will visit branches just to audit credit risk and define remotely observable indicators that should be monitored.
- The business risk audit group will monitor business risk in branches.
- And so on with other risks.

This new approach does have a downside, and that is the ability of the different audit teams to work together efficiently and not lose the integrated view of risk associated to the branch network.

We will see an increase in remote auditing, and this will extend to areas other than just the branch network.

Remote auditing has evolved tremendously to help financial entities evaluate risks in branch networks. However, the use of remote techniques for auditing other auditable entities in the audit universe has been very sporadic and mostly scarce.

This is probably due to the fact that remote audit has been traditionally employed by internal auditors with a deep knowledge of branch risks and little understanding of other areas of risk. On the other hand, audit teams that review non-branch related risks have not had the opportunity, and do not have the knowledge or budget to develop remote audit techniques.

Now that remote auditing of branches is highly developed, it is time to dedicate resources and budget to develop remote audit techniques to review other risks. Some key areas where this may be deployed are IT risks, capi-

tal and liquidity risks, and financial reporting risks.

However, this will require considerable investment with limited return on that investment in the short term.

There will be an increase in dynamic risk assessment to prioritize internal audit assignments.

As we have mentioned previously, credit institutions' internal audit functions have been considering questions related to remote or continuous auditing. This debate is not only applicable to the banking sector. Some questions being asked are:

- What are we using remote audit tools for? What is the objective of these tools?
- Is the development and use of these tools really the responsibility of internal audit? Should this be an activity carried out by the second line of defence?

We believe that internal audit functions will use these tools and techniques for two specific objectives:

- Detecting fraud red flags (where internal audit is primarily responsible for detecting internal fraud). However this approach must overcome a considerable obstacle: how to build effective fraud metrics and indicators that really do detect and prevent fraud. Remote audits of branches generate reams of information, indicators and alerts for review, but precious few are designed to detect internal fraud.
- Using remote indicators to carry out dynamic risk assessments. This will mean that:
 - Branches to visit on site will be decided in real time and based on levels of risk.

- Internal audit planning will also be dynamic and adapt to the dynamic risk assessment.

Audit will place more emphasis on process reviews, management information and corporate governance.

The SSM has placed emphasis on processes such as capital planning and how it relates to the management of the entity, as well as how it integrates with other processes. Internal audit should not limit the scope of its reviews to data quality, but should extend it to include these processes.

For example, with regards to capital calculations, many internal audit functions will create integrated teams (especially IT auditors) in order to:

- Build simulation models with the help of IT auditors (and integrated teams). However this alternative is particularly expensive in terms of resources and can only be afforded by large internal audit functions.
- Understand all processes contributing to capital calculations, taking into account that most calculations are highly automated.

Certain aspects will gain importance in an entity's audit universe, and will require including assignments related to:

- Corporate governance.
- Information delivered to the Board and executive management for strategic decision-making.
- Strategic and business risk.
- Other emerging risks: ever more complex sales processes, new product launch, M&A and CAPEX projects.

New approaches to projects will be implemented, with innovative scopes and conclusions.

One key question that internal audit functions are looking to answer is, how can they add more value and help drive improvements through their work, reports and conclusions?

For internal audit to do this, various developments might happen:

- Management-requested audits may increase.
- Governance framework reviews will increase.
- More audit teams will employ new approaches, traditionally out of their comfort zone. These assignments will be more daring, where conclusions will be more focused on opinions, with a larger component of subjectivity. For example, we may be expected to provide an opinion on:
 - Whether customer contracts and clauses are clear.
 - Whether credit risk analyst reports are of sufficient quality.
 - Whether costs associated to specific projects are reasonable (emphasis on IT).
 - New product launches prior to their launch.

The type of work undertaken by internal audit will change significantly in the medium term.

This will be a product of various events:

- First, the requirement to provide new reports to regulators and supervisors will drive a new approach and require new capabilities to be made available to internal audit teams.

More audit teams will employ new approaches, traditionally out of their comfort zone.

The risk assessment process will become more relevant, meaning that more resources will be needed than previously.

- Changes to rules and standards specific to internal audit, (Fed, Basel, etc.) will oblige audit to monitor new risks that emerge from different areas: risks associated to strategy and business, capital and liquidity, conduct and reputation, risk appetite, governance and M&A.
- We should highlight the need for internal audit to align itself with risks (legal, reputational, etc.) that are associated to new products. This requires that the internal audit function is present, at least in an observatory role, in the communications and meetings held on the matter. This has a dual purpose:
 - Prevent and detect new risks that emerge in the constantly changing financial environment.
 - Promote a risk and control culture throughout the organization.
- Internal audit will also have a role in monitoring new risks that are emerging. Aspects such as cybersecurity, environmental rules, etc. will drive changes to corporate risk maps and audit universes and therefore require a progressive and constant capacity to adapt.

The profound change in the regulatory framework will have a direct impact on internal audit's methodology.

These changes will happen in all phases of audit work, specifically:

- The volume of work included in the annual audit plan will increase as a direct result of regulatory demands.

This will require that internal audit has more resources for the additional work. Given that the outlook for the internal audit head

count is stable (some entities do envisage large increases), it will mean that the number of reviews included in the audit plan will have to be revised. This, in turn, means that audit coverage must be supplemented with continuous audit techniques and technologies.

On the other hand, Audit Committees will increasingly be involved in the annual audit plan. This, along with the need to adapt to the predicted changes and to align internal audit to strategy, will require internal audit plans to be more dynamic and flexible, and open to change after approval by the Audit Committee.

- The risk assessment process will become more relevant, meaning that more resources will be needed than previously.

A continuous approach to risk assessment will be adopted that will employ continuous monitoring systems, indicators, and automatic risk alerts. Remote and continuous audit techniques that are currently used in branch audits will be employed by other areas.

Models for risk assessment will be based on a harmonized evaluation methodology that will be borne of the new supervisory model.

- Greater regulatory involvement will mean that requests for assignments will be carried out with less flexibility on scope.

On the contrary, projects voluntarily included in the audit plan will have new approaches, and an innovative scope. Fixed audit programmes will give way to ad-hoc, project-specific ones that adapt to the environment, the entity and stakeholder demands.

With regards to combined assurance, it does not seem likely that in the short term, that this will have an impact in assignment

scope. Despite the majority of entities seeing evolution in that direction, there is still a long and winding road ahead.

TRENDS THAT WILL IMPACT ON RESOURCES AND TECHNICAL REQUIREMENTS

Internal audit teams will rely more frequently on evaluations of the effectiveness of automated controls and mass data analysis in order to reach audit conclusions.

The increase in the use of technology in banking has generated enormous amounts of data, and this means that processes must now contain many automated controls.

Internal audit teams should now look more closely at the functioning of automated con-

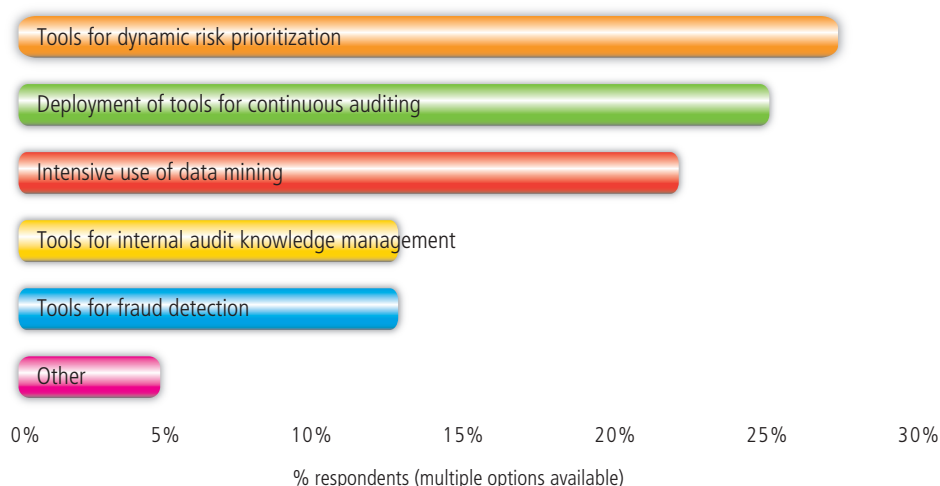
trols, and use mass data analysis to obtain assurance on business processes and appropriate risk mitigation. There will be occasions when sampling will be substituted with whole population analysis.

This will mean that teams will include personnel with specific technical knowledge, including IT specialists, as is evidenced by the result of the survey on team composition (*see graph on page 34*).

Continuous auditing is a key technique for evaluating the probability and impact of risks

Teams will include personnel with specific technical knowledge, including IT specialists.

What changes do you expect to see in the resources and technology used for internal audit?



Source: 2014 Survey of Spanish Banking CAE's. Spanish Institute of Internal Auditors.

The internal audit function has a fascinating and difficult, but achievable challenge of assuring that applications that generate data leave a reliable audit trail.

and for detecting one-off findings that must be corrected by the organization and used for internal control improvements by the business. The development of continuous audit models and procedures is a challenge that needs to be met by the majority of internal audit departments in Spanish credit institutions, as was evidenced in the survey.

The internal audit function has a fascinating and difficult, but achievable challenge of assuring that applications that generate data leave a reliable audit trail. Technologically advanced platforms will allow the auditor to naturally correlate and analyse these trails.

Traditional audit must not be abandoned as this will still provide assurance on diverse activities, but we should employ new tools for the reviews, as the validity of the data that the entity manages is a key mechanism to guarantee effective oversight.

The evolution of business and technology will go hand in hand with the use of new tools to support audits.

The massive amounts of data available in entities are a paradigmatic change that implies

the use of new tools for data management, discovery and processing.

The term “Big Data”, so fashionable of late, looks to connect this idea with the technology necessary for processing. Without abandoning traditional, well-structured relational data that is usually a result of mature processes, there is now a need to enrich the conclusions we can extract from the data that is more unstructured and comes from non-traditional activities.

The possibility of being able to employ tools to agilely manage these amounts of data can mean the difference between creating and not creating value. Internal audit should therefore be able to use this type of tools, as their appropriate use will mean better assurance for the business.

According to the CAEs who participated in the survey, changes to the capacity of technology to manage huge amounts of data and the integration of this technology into the internal auditor's fieldwork will have a big impact on the function. Specifically in this order, it is expected that technology will boost dynamic risk assessments, the use of continuous auditing tools and intensive data mining.



Assurance and Combined Assurance

To add to the many opportunities that internal audit has to create value in the banking industry, on which we have previously com-

mented, there are further opportunities related to other assurance-providing functions. Our study has revealed that the majority of

credit institutions have a risk management model based on the three lines of defence model.

This model, despite being considered best practice, does bring with it a series of challenges:

- That there exists a clear definition of responsibilities.
- That there is assurance that business unit objectives are aligned with strategic organizational objectives.
- That control processes add value to the business.
- That assurance providers have profiles, capabilities and common tools that are comparable.

The magnitude and complexity of risk management in credit institutions means that the responsibilities undertaken by the second line of defence have to be shared between various units or departments. This requires establishing mechanisms that ensure adequate coordination between different functions and the comparability of reporting.

This means the three lines of defence model requires a workable scheme that guarantees efficient and effective interaction between the lines.

In order to be effective:

- Organizations should have a clearly defined methodology and adequate responsibility assignment for all elements of the model.
- The organization's objectives, at all levels, should be understood and shared by the three lines of defence, and risk appetite should be appropriately defined and communicated.
- The profiles of the professionals should be equivalent to the challenges of each function, and their lines of reporting should coincide with the weight of their responsibility.
- The methodology should encourage proactivity, and responsibilities should strengthen the preventative rather than corrective nature of assurance.

EFFICIENCY AND EFFECTIVENESS IN THE THREE LINES OF DEFENCE MODEL

- Clearly defined methodology. Clearly assigned responsibilities.
- Objectives understood and shared between lines.
- Adequate professional profiles.
- Adequate reporting lines.
- Preventive over corrective.

+ EFFICIENT

- Collaborative working between all three lines. Transparent communication.
- Single source of data for risk management.
- Assurance coverage maps that identify who is responsible for risks and with what frequency.

+ EFFECTIVE

There are many reasons why internal audit has been chosen to lead the implementation of combined assurance in banking entities.

In order to be efficient:

- Organizations should have a coherent working methodology that promotes collaboration between lines, uses a common language, generates comparable reporting and includes transparent communication.
- Technological support should be common and allow for transfer of information between lines, so that there is just one single set of data used for risk management.
- Organizations should create an assurance coverage map, that allows the organization to see the depth of assurance cover over significant risks, and who is responsible for those risks.

All this should be backed up by an independent evaluation undertaken by internal audit.

COMBINED ASSURANCE

Opportunities for the future of internal audit do not end here.

The previously described situation has not been lost on many entities, nor ignored by regulators, and this has driven the emergence of management models intended to solve the problems.

The King Code of Corporate Governance, better known as King III, proposes a Combined Assurance model that it defines as, *"the integration, coordination and alignment of all assurance functions within an organization, in order to improve the level of governance, risk and control."*

Ultimately, combined assurance looks to maximize the efficiency of control, risk manage-

ment and governance and increase the comfort levels audit and risk committees have regarding their assurance models, including how this relates to the established appetite for risk.

The implementation of combined assurance models has highlighted that internal audit is the function best suited technically and organizationally to lead such an initiative.

There are many reasons why internal audit has been chosen to lead the implementation of combined assurance in banking entities, some of these being:

- The extensive knowledge it has of processes and controls.
- A global and objective view of control structures.
- No conflicts of interest with regards to segregation of duties and responsibilities.
- Knowledge of the whole organization and its operations.
- Experience managing cross-functional projects.
- Experience in communicating with executive management as well as all other levels of the organization.

The response to the obvious question of how this impacts on the independence of the internal audit function, if it is involved in the implementation of a combined assurance model, can be found in the Practice Advisories from the IIA. Specifically 2050–1 dedicated to coordinating combined assurance, which lays out certain criteria that should be followed by the internal auditor.



Appendix – Trend Table

HUMAN
RESOURCES

ORGANIZATIONAL
STRUCTURE

APPROACH, SCOPE AND
ORGANIZATION OF REVIEWS

RESOURCES AND TECHNICAL
REQUIREMENTS

TREND: There will be an increase in effective resources, which will, in turn, improve efficiency.

HUMAN
RESOURCES

EXPECTATIONS

- Audit critical risks and controls.
- Improve sampling and data analysis techniques.
- Improve internal audit planning (knowledge of auditable entities and risks).
- Better coordination with the second line of defence.
- Reinforcement and improved relevance of the second line of defence.
- Independent assurance over the second line of defence.

TREND: Greater professional specialization in specific risks, and therefore better training of auditors.

EXPECTATIONS

- More complex environments that require a better knowledge of risks in order to evaluate control effectiveness.
- Identify risks that require greater specialization.
- As a consequence of requirements made in MiFID, BII, BIII, EMIR, DFA etc. and due to the role as assurance provider on different matters it will be necessary to:
 - Train internal auditors on these matters.
 - Add new specialized resources who have the required underlying knowledge.

HUMAN
RESOURCES

TREND: There will be an increase in the use of integrated internal audit teams that include distinct specialists, and result in the emergence of a “super auditor” that combines knowledge of risk over multiple areas.

EXPECTATIONS

- Processes cannot be understood without technology.
- It's difficult for an auditor to know everything, including IT.
- Not just focused on IT
- Multidisciplinary teams will be needed to better understand risks and necessary controls.
- And, if possible, “super auditors.”

ORGANIZATIONAL
STRUCTURE

TREND: The CAE will report directly to the Board or the Audit Committee, whose members, in turn, will have a greater role in defining the audit plan and understanding the results of the audits.

EXPECTATIONS

- Direct accountability of the CAE to the Board or Audit Committee.
- Greater Audit Committee involvement in:
 - Strategic audit planning.
 - Annual audit plan.
 - Internal audit performance reviews.
 - Understanding of findings and recommendations.
 - Recommendation follow-up.

TREND: Greater requirements for both quantity and quality of information as a consequence of the increased accountability of Boards and Committees.

EXPECTATIONS

- Audit committees will demand more information.
- Creation of value reporting for the Board and executive management that anticipates and evaluates potential risk events.
 - Large scale projects.
 - New product launches.
 - CAPEX projects.
 - M&A.

ORGANIZATIONAL
STRUCTURE

TREND: Internal audit will need to be reinforced in terms of people, resources, reporting lines and adequate sponsorship. This should include integration with and participation in management committees and strategic processes within the organization.

EXPECTATIONS

- Audit needs to be strengthened in terms of people and resources, reporting lines and adequate sponsorship.
- More participation and integration in management committees.
- More involvement in strategic processes of the entity.
- Acknowledgement of the experience, knowledge and prestige of the CAE.

TREND: There will be organizational changes in internal audit departments driven by business model change.

EXPECTATIONS

- Changes to business models, regulatory requirements, the single supervisor and stakeholders will produce, among others, changes to the risks that need to be audited, requiring organizational alignment of internal audit, its people, resources and approach.

TREND: Internal audit will obtain new resources to deal with the reporting for the Single Supervisory Mechanism and the audit and quality committee.

EXPECTATIONS

- Greater demands for information will draw more time from the CAE and other internal audit management.
- Planning will need to be adjusted, with time assigned to this task.
- Possible growth in specific reporting teams.

TREND: Traditional internal audit/branch audits will diminish in terms of resources assigned and branches reviewed.

APPROACH, SCOPE AND
ORGANIZATION OF REVIEWS**EXPECTATIONS**

- There will be more intensive use of remote auditing techniques due to ever more technological processes, such as digital signatures and electronic documentation.
- Cyclical reviews of branches could disappear, and branches may only be visited when certain alerts or red flags are raised.

APPROACH, SCOPE AND
ORGANIZATION OF REVIEWS

TREND: There will be an increase in remote auditing and this will extend beyond the branch network.

EXPECTATIONS

- Increase in remote auditing of other, non-branch risks, (IT, capital, liquidity etc.).
- This approach entails significant cost and complexity and may not generate short-term results.

TREND: There will be more dynamic risk assessments to create the audit plan.

EXPECTATIONS

- Continuous auditing will be used to feed dynamic risk assessments.
- Annual plans could be reviewed many times a year.

TREND: There will be more emphasis on process audits, management information and corporate governance.

EXPECTATIONS

- Certain audits of processes unique to banking will require greater scope and will be more complex. These audits will require intensive use of resources.
- Other entities in the audit universe will become more important, such as corporate governance, strategic and business risk.

TREND: The types of assignment undertaken by internal audit will change in the medium term.

EXPECTATIONS

- Supervisors and regulators are requiring internal audit to carry out certain engagements that require new and different approaches.
- New regulation will cause the emergence of new audit entities (new processes or direct requests made by the supervisor). Additionally the FED and Basel Committee have published regulation with direct impact on internal audit, and point towards reviews of strategy and business, capital and liquidity, conduct and reputation, risk appetite, corporate governance and other corporate movements.
- In line with the last point we may see new risks that make demands of internal audit, linked to new product launches, M&A, large corporate events, etc.

TREND: There will be engagements that require new approaches, new scopes and fresh opinions.

APPROACH, SCOPE AND
ORGANIZATION OF REVIEWS

EXPECTATIONS

- New approaches will add more value for executive management.
- There will be more advisory projects.

TREND: The profound changes in the regulatory environment will have a direct impact on the working methodology of Internal Audit.

EXPECTATIONS

- Changes in the regulatory environment will affect the main phases of work of Internal Audit, in particular:
 - The development of the annual audit plan, which must meet the requirements of regulators.
 - The risk assessment process, for which major improvements are required to ensure it meets the harmonized methodology of the regulators.
 - The scope of work, which is subject to the specific requirements of regulators and the Audit Committee. In turn, the remaining work will be directed towards more innovative approaches.

TREND: Internal audit teams will rely more on evaluating the effectiveness of automated controls and on mass data analysis in order to reach conclusions.

RESOURCES AND TECHNICAL
REQUIREMENTS

EXPECTATIONS

- Audit conclusions and opinions will be based increasingly on:
 - Results of mass data analysis and less on statistical sampling.
 - Automatic control testing in business processing.
- The possibility of exploiting large amounts of data and correlations to detect trends, patterns and one-off events.

TRENDS: The evolution of business models and technology will go hand in hand with increased use of IT tools to support audits.

EXPECTATIONS

- The development of continuous auditing will depend on the capability of exploiting massive amounts of data.
- The requirement of tools that allow the mining of massive amounts of data.
- Internal auditors should have knowledge of, and be able to use these tools.

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This new document of LA FÁBRICA DE PENSAMIENTO (The Thinking Factory) addresses the new challenges the banking and credit institutions are facing in Europe. A modern economy needs this industry to be solvent and effective. The global economic crisis has demonstrated that only those entities with an adequate governance on risks and an appropriate control environment are able to survive. The others have simply disappeared or had to be intervened with a huge cost for the economy and public accounts.

This document analyses the banking industry in order to identify future changes and trends in the business models as well as in regulation. Thus we will be able to anticipate challenges and expectations the CAE will face in the years to come to accomplish their mission.