Internal Audit impact on Governance and Reputation

Berlin, 11 – 12 May 2017

Prof. Doctor Duarte Pitta Ferraz
Professor of Finance & Governance
Internal Audit impact on Governance and Reputation

• Impact on the banks’ strategy and tactics

• The shifting paradigm for Internal Auditors

• Change of the Business Model

• Leveraging the NED – Non-Executive Directors
Control Functions

- Internal Audit
- Compliance
- Risk
Regulators & Supervisors’ challenges

IMPACT ON THE BANKS’ STRATEGY AND TACTICS
SSM priorities – 2017
(Danièle Pouy* 2017)

- Business models
  Profitability drivers

- Credit risk
  Focus on NPLs [NPE] and concentrations

- Risk management
(...) our activities aim to continue to deliver tough and fair supervision.

(...) we will keep following up on topics needing continued attention, while at the same time scaling up our efforts related to important new initiatives such as TRIM*

Danièle Pouy

• *Targeted Review of Internal Models (TRIM) (ECB 2017)
TRIM* encompasses 2 objectives

Compliance with regulatory requirements related to internal models

Reduction of unwarranted variability in RWA
Asset quality
- High stock of NPL & NPE
- Regulation

Capitalisation
- Increasing equity through earnings
- But banks making losses
- Regulation

Profitability
- Negative interest rates
- Cost-to-income is a challenge
- Product versus Relation
- Commoditization/Public service
- Regulation

Liquidity
- Improved funding profile
- Still reliance on ECB/Central Banks funding
- Sovereign ratings
- Counterpart ratings
- Regulation
Steadily increasing
Face new emerging risks
Implement strategies to face challenges and new opportunities

Pressure to undertake new strategies
New markets, new products, transforming their business models, and dramatically reducing cost
Changes bring more-complex risks
Risk management functions, internal audit, must proactively address them
SREP* Introduces 3 new principles to supervision

1. Forward-looking focus on the sustainability of a bank’s business model (even under stressed conditions)
2. Assessment system that uses industry best practices as a guide
3. Expectation that all banks eventually will reach the same high standards

*SREP – Supervisory Review and Evaluation, ECB
Pillars for change

**Governing Bodies**
- Corporate governance guidelines for banks
- Ambition for BBP – Best Banking Practices
- Change of scope and oversight
- Growing focus on RISK & Compliance

**RISK Profile**
- Financial, sovereign and economic crisis
- Global uncertainties
- Systemic risks
- Banks’ business models

**Regulatory Changes**
- Regulators more prescriptive
- Over 100 publications in 3 years
- Extended role of Risk Function

© Duarte Pitta Ferraz 2017
GOVERNANCE FRAMEWORK
What is Governance?
Why Governance matters?

- Access to markets
- Reputation
- Best Banking Practices
- Improves operational performance
- Lowers the cost of capital
- Increases corporates’ valuation
- Improves share performance
- Reduces risk of corporate crisis and scandals

(Price 2012)
Principles of Corporate Governance
(BIS 2015)

Set of relationships
- The Board, Management, shareholders and other stakeholders
- Structure through which the objectives [vision] of the company are set

Means of achieving
- Objectives
  - Monitoring performance

Authority and responsibility
- Are allocated
  - How decisions are taken
  - Fiduciary responsibility placed on individual executives and NED
Sept. 16 - Deutsche Bank AG's shares and its riskiest bonds
Barclays chairman John McFarlane said:

“*I am personally very disappointed and apologetic that this situation has occurred, particularly as we strive to operate to the highest possible ethical standards. The board takes Barclays culture and the integrity of its controls extremely seriously. We have investigated this matter fully using an external law firm and we will be commissioning an independent review of Barclays processes and controls to determine what improvements may be required.*

Mr Staley said:

“*I have apologised to the Barclays Board, and accepted its conclusion that my personal actions in this matter were errors on my part. I will also accept whatever sanction it deems appropriate. I will...*
BNP Paribas sentenced in $8.9 billion accord over sanctions violations
Performance of 20 large US and EU universal banks,\(^1\) 2009–14, indexed to 2009 value (ie, value in 2009 = 100)

- Operating income has decreased by 10% over this period of time
- Credit impairment costs have decreased steadily over same time horizon
- Meanwhile, regulatory fines and settlements increased by almost 45x
Governance

Deterministic Focus: Structure & Rules

Probabilistic Focus: Human Behavior & Culture
Framework through which the board and management establish and make decisions.

Identify, measure, manage and control risks
ICF - Internal Control Framework

As part of the overall corporate governance framework

Articulate and monitor adherence to risk appetite and risk limits versus strategy

Strategy and risk approach
Vision

Strategy

Tactics
What is Strategy?
- Framework
- Defence
- Stakeholders

**Ways**

- How to achieve the Vision
- Regulation and Best Practices

**Means**

- Scarce resources
- Fit-and-Proper Talent
- Corporate culture

**Ends**

- Excellent Governance
- Excellent Reputation
- Sustainability

**Assumptions**
Roles & Responsibilities

- Management
- Board of Directors
- Internal Auditors
- Other personnel
- External parties
CHANGE OF THE BUSINESS MODEL
IFRS 9 impact in business models

A silent revolution in banks’ business models

Banks have addressed the technical requirements of the new rules

What about their significant strategic implication

(Maggi 2017)
Business model audit objective

- Adjust the current activity to market trends and current demands
- Ensure that Strategy is adjusted to market present and future needs
- The strategic decisions of today impact future performance

© Duarte Pitta Ferraz 2017
THE SHIFTING PARADIGM FOR INTERNAL AUDITORS
43% of companies say internal audit skill sets are barriers to its ability to contribute to the organization’s strategic initiatives

Source: PwC 2015 State of the Internal Audit Profession Study
• Assess the competence of managers and directors
• Capacity to fulfil the responsibilities of their positions

• Assess integrity
• Assess suitability
Upgrade capabilities on 3 dimensions (Bonomo 2016)

- Models and methodologies for projections
- Strategic-planning process
- Validation and back-testing

To meet SREP supervisory expectations
Control functions’ headcount

- Internal Audit: 3%
- Compliance: 16%
- Risk Management: 81%
4 Lines-of-Defence

Source: Financial Stability Institute, Occasional Paper 11
PwC Capture unrealized value analysis

- Align expectations
- Build capabilities
- Deliver quality
- Increase value

Unrealized value

- Trusted advisor
- Insight generator
- Problem solver

Assurance provider

© Duarte Pitta Ferraz 2017
PwC Capture unrealized value

Add value and proactive strategic advice
(‘Trusted Advisor’)

Suggest improvements and assurance around risk
(‘Insight Generator’)

Analysis and perspective on root causes of issues
(‘Problem Solver’)

Assurance on the effectiveness and efficiency of internal controls
(‘Assurance Provider’)

© Duarte Pitta Ferraz 2017
Surveys aligned to PwC’s
Eight Attributes of IA
Excellence

- Business alignment
- Quality and innovation
- Service culture
- Risk focus
- Technology
- Talent model
- Cost optimization
- Stakeholder management

Protect the business
Deliver measurable value

Internal audit
Contributing to improve the Business Model strategy & Governance

From simply performing mechanical tasks
INTERNAL AUDIT IMPACT ON GOVERNANCE AND REPUTATION

Leveraging the NED – Non-Executive Directors
Principle 1: Board’s overall responsibilities (BIS 2014)

The board has overall responsibility for the company

Approving and overseeing management’s implementation

Strategic objectives, governance framework and corporate culture
Danger
Executives

RISK

Threat
NED
Supervisory Boards/BoD want sound governance & reputation

Critical element in the safe and sound functioning

Affects the RISK profile if not operating effectively

Governance contributes to efficient supervision & control

NED & Governance

© Duarte Pitta Ferraz 2017
NED

Governance

Strategy

© Duarte Pitta Ferraz 2017
1.1 Main conclusions

- Outcome from the Supervisory Review and Evaluation Process (SREP) led to a change in the ISN ratio in Q3 2015. Pillar II SREP add-ons are kept and the specific SREP add-on to pillar 1 REA is either kept or included in the ordinary Pillar 1 calculations.

- The ISN levels remain unchanged at 14.5% for Nordea Bank Danmark, 13.2% for Nordea Bank A/S and 11.8% for Nordea Realkredit.

- The SREP add-ons relates to inadequate second line of defence and its involvement in the governance of the IRB system and modelling. Included is also an add-on for operational risk from inspections relating to IT and key processes.

- The Nordea Bank Danmark Group and its individual legal entities are well capitalised at end-Q2 2016 and have access to available capital from Nordea Bank AB (publ), the parent company of the Nordea Bank Danmark Group, if necessary.

- The CET1 ratio for the Nordea Bank Danmark Group was 15.7% (Q1 2016: 15.9%).

- The Nordea Bank Danmark Group and its legal entities conduct capital adequacy stress testing in
Board of Directors

Discuss with senior management the state of the internal control system and provide oversight

Seek input from the internal and external auditors
Governance Committee

Audit Committee

Risk Committee
Rules & regulations across borders

Complex web of evolving regulations

Lack of effective risk management and internal auditing

IA tends to work ‘in isolation’
What are the priorities and barriers in these relations?
Leverage the SSM and NCA reports

Supervisory activities generate usually tough reports and demanding actions

The Bank has difficulties to answer timely to them due to lack of sufficient resources

These reports represent an opportunity to leverage IA within the Management Body
Reporting to the Board (IIA 2017 # 2060)

The CAE must report periodically to senior management and the board.

Frequency and content of reporting are determined collaboratively by the CAE, senior management, and the board.
Ensure awareness of Management and Board of Directors/Supervisory Board

Structure reports to add value (e.g. strategy and governance) and become a Trusted Advisor

Cooperate with and leverage the Governance, Audit Committee and Risk Committee

Develop a plan and create awareness for the critical need of keeping Internal Auditors Fit-and-Proper for the job

Internal Audit

© Duarte Pitta Ferraz 2017
NED

INTERNA\nL AUDIT
Prof. Doctor Duarte Pitta Ferraz
IVENS | governance_advisors™, CEO

NOVA - School of Business & Economics
Professor of Finance & Governance
dpf9@me.com | +351 96 400 2 800
REFERENCES AND CV OF DUARTE PITTA FERRAZ
Duarte Pitta Ferraz – selected scientific publications on Corporate Governance


References

• BCBS 2005. Compliance and the compliance function in banks. Available at www.bis.org/publ/bcbs113.pdf
• BCBS 2012. The internal audit function in banks. Available at www.bis.org/publ/bcbs223.pdf
• BCBS 2012. The internal audit function in banks. Available at www.bis.org/publ/bcbs223.pdf
• BCBS Corporate Governance Principles for Banks, July 2015. Available at http://www.bis.org/bcbs/publ/d328.htm
References

• ECB 2017. “ECB Annual Report on supervisory activities 2016 to the European Parliament’s Economic and Monetary Affairs Committee”. Introductory statement by Danièle Nouy”, Chair of the Supervisory Board of the ECB. Brussels, 23 March 2017
• ECB 2017b. “Information on the current version (February 2017) of the guide to the Targeted Review of Internal Models (TRIM)”. ECB – European Central Bank
• German, R. 2010. Global Politics and financial Governance. UK: Palgrave Macmillan
• PwC 2015. “Internal Audit Strategic Planning – Making internal audit’s vision a reality during a period of rapid transformation“. 2015 State of the Internal Audit Profession Study.
References

• Oliver Wyman 2016. Compliance and Governance - Compliance & Governance
• Oliver Wyman 2016. OW – Risk communication
• Oliver Wyman 2016. Oliver Wyman's Compliance and Governance - Risk Management
• Oliver Wyman 2016. Risk Governance Amid Regulatory Changes. Finance and Risk Practice
• Pedersen, C., Ying, C.W. 2016. Streamlining Risk, Compliance and Internal Audit. Oliver Wyman
• Pierce, C. 2012. Corporate Governance in the European Union. UK: Global governance Services
• PWC 2016. Governance, risk and compliance. Available at: www.pwc.com
Summary CV of Dr. Duarte Pitta Ferraz

Duarte Pitta Ferraz holds a Doctorate of Business Administration (Nottingham Trent University – Nottingham Business School, UK), a Bachelor’s in Law (University of Lisbon) and a Bachelor’s in Accounting and Management (Commercial Institute of Sá da Bandeira), Non-Executive Directors Programme at Cranfield University, AESE/ Business School and INSEAD. He is a qualified Statutory Auditor (‘Revisor Oficial de Contas’) and lawyer (‘Advogado’).

Professor of Finance & Governance at NOVA School of Business and Economics—Universidade NOVA de Lisboa (Chair of Corporate Governance and Raising Capital in Global Markets), Visiting Professor at Nottingham Trent University (Doctoral Programme), and CEO of IVENS Governance Advisors. Independent Non-Executive Director at: EIB—European Investment Bank (Audit Committee), Infraestruturas de Portugal (Supervisory Board and Committee of Financial Matters), Banco BIC Português (Board of Directors and Commissions of Audit and Internal Controls, Governance, and Remuneration Committee), GESTMIN SGPS (Audit Committee), as well as member of the Privatization Committee of TAP—Air Portugal. Has published scientific papers at Measuring Business Excellence, Corporate Ownership & Control, and IJBEX - International Journal of Business Excellence. Has been chairperson and a member of various audit committees. Member of the Harvard Business Review Advisory Council, executive panellist for McKinsey Quarterly, and member of the Financial Times Feedback Forum.

Managing Director (MD) of the International Division at Banco Comercial Português (20 years) and a member of the Corporate and Investment Banking Committee, as well as member of the Board of Directors (BoD) and of the Executive Committee (2011–13) of the BAFT - Bankers’ Association for Finance and Trade (Washington, DC), and co-chair of its European Council (2008–13), and vice-chair of the Portugal–China Chamber of Commerce (2012–13). Member of the BoD and executive committees (Nova Bank – Greece, Bank Europa – Turkey, Banco Millennium Angola, SOFID – Development Bank. Also, MD of Private Banking and a member of the Private Banking and Asset Management Executive Committee, Deputy General Manager of Corporate and Business Banking, and head of Corporate Investment Banking. Was also member of the Privatization Committee of CTT - Portugal Postal Service.

In auditing worked at Deloitte (9 years) and at Philip Morris USA (4 years), and was Financial Planning Officer of Black & Decker Ltd.. He has spoken widely at conferences in the USA, UK, Hong Kong, Canada, Austria, South Africa, Germany, Japan, and The Netherlands.

May 2017