Banking on change: How to respond to new expectations for audit committees

Regulators are expecting more from bank audit committees. Providing strong guidance and oversight is critical.
The heart of the matter

Regulators are expecting more from bank audit committees when it comes to oversight and guidance. As the expectations and roles of the audit committee continue to change, there are three things they should evaluate: the role of the audit committee and how they interact with other committees, the role in determining the strength of the firm’s risk culture, and how audit committees can make sure they have the right information to exercise their oversight appropriately.

As regulators place greater emphasis on how banking and capital markets (BCM) firms address risk, audit committee oversight is often seen as the last stop. What are audit committees at leading firms doing to address these concerns?

While some of the topics discussed in this paper are applicable across other sectors and other countries, BCM audit committees in the US face unique challenges resulting from the complex business and regulatory environment in which they operate. Three of these challenges are:

• The role of the audit committee, and how it interacts with other committees, is evolving. We offer perspective on emerging leading practices.

• Management should establish a cultural “tone at the top” that encourages behavior aligned with the organization’s risk appetite. The board of directors (with audit and risk committees often leading the charge) has a difficult role if the culture isn’t appropriate. We examine how some leading institutions are handling this issue.

• Audit committees often feel overwhelmed by the amount of data available. We explore the ways some firms make that information more usable.
The audit committee’s role in the modern bank is expanding and evolving

Current regulatory guidance on the role of audit committees is not prescriptive and allows a degree of flexibility in approach. As such, we see many BCM audit committees applying this guidance very differently. Which responsibilities should they take on in this new environment, and which should be left to other committees? Should the committee keep its focus primarily on internal and external audit, or do stakeholders and regulators expect some extension of its oversight outside the traditional role of the audit committee?

Audit committees have to balance their responsibilities with risk and other committees

The Dodd-Frank Act requires that “large” BCM institutions have separate risk committees. As BCM firms incorporate these new committees into the lineup, some overlap of duties is inevitable. To address role confusion and coordinate coverage of important tasks, we have found that some audit committee chairs hold regular planning sessions with the risk committee chair. Additionally, we have seen members of the audit committee sit on the risk committee. Having members who serve on more than one committee is beneficial for two reasons: it can help management develop a more holistic view of organizational challenges, and it can help individual committees avoid duplication of responsibilities.

Clarity of roles and responsibilities structured into “three lines of defense”

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1 Large is defined as any institution with more than $50 billion in assets, or any publicly traded institution with more than $10 billion in revenues (Sec 155(h)(2)(A) of the Dodd-Frank Act). While the guidance relates only to large institutions, we have observed smaller institutions starting to create risk committees.
In the short-term, boards that identify overlapping responsibilities should first figure out how to proceed through the current cycle. For example, audit and risk committees tasked with the same function might agree on which committee will take it on, or they might decide that both should be involved. If both take ownership, there are ways to be more efficient, including cross membership between committees, pre-meeting calls between the chairs of the two committees, and close coordination in preparation of the documents for the meetings by the chief audit executive (CAE) and chief risk officer (CRO). In the long-term, however, charters should be updated with specifics about roles to encourage better coordination and less duplication. For example, areas of responsibility and charters should be updated annually to reflect the ever-changing environment facing audit committees today. It is impossible to remove all of the overlap, but the overall goal is to have different committees reach consensus on overlapping issues.

Audit committees should understand the level of involvement expected by stakeholders and regulators

By definition, the audit committee oversees the third of the three lines of defense, which includes internal audit. The third line assesses efficiency and effectiveness of operations, integrity of the reporting processes, and controls over compliance, among other things.

What is less clear is how responsible the committee is for the activities of the other two lines, which can influence the committee’s ability to sign off on financial reporting. The Office of the Comptroller of the Currency (OCC) already requires that audit committees at institutions with more than $50 billion in assets receive annual reports from internal audit that describe significant instances in which the first and second lines are adhering to the board-approved risk governance framework.

The real difficulty for audit committees comes with the first line, which typically owns all material risks, including market, credit, operational, and compliance. BCM audit committees feel intense pressure from regulators to have a solid understanding of the first line because the actions that the committee oversees, such as timing and implementation of management’s plans to address internal control deficiencies, are so central to the board being able to oversee management’s culture and risk-setting responsibilities. This, however, can blur the role that each of the overseeing bodies noted in the graphic on page 2 (board of directors, senior management, audit committees, or other committees) has in the organization.

The role most audit committees perform today—understanding how strategy links to risk and overseeing how management monitors risk thresholds—should be sufficient. As such, the committee should not actively participate in day-to-day management activities.

The audit committee oversees the third line of defense and acts as an independent voice in the company, challenging management’s ideas as warranted. Effective committees push internal auditors to identify key areas of risk and help ensure that the firm stays in line with management’s established risk appetite. The audit committee should leverage its position and independent voice in the company to promote and, when needed, push the organization toward effective management of risk in the institution.

83% of North American board member respondents say that internal audit can improve its role in assessing/responding to strategic risks by “periodically evaluating and communicating key risks to the board and executive management,” according to the CBOK 2015 Global Internal Audit Stakeholder Survey.


Audit committees play a vital role in determining the strength of risk culture

From tone at the top to understanding risk appetite to offering regular credible challenges, regulators expect BCM boards to oversee how management has defined the organization’s culture. But what exactly do we mean by culture? William Dudley, president of the New York Federal Reserve Bank, describes it as “the implicit norms that guide behavior in the absence of regulations or compliance rules.... Culture reflects the prevailing attitudes and behaviors within a firm. ... Culture relates to what ‘should’ I do, and not to what ‘can’ I do.” In other words, it’s about how the firm expects its staff to engage in daily activities, behave in “gray” situations, and interact with customers, investors, employees, and communities.

As role models, executives should present a model of professional, ethical, and appropriate behavior on a daily basis. They should hold themselves accountable for monitoring and enforcing expectations that employees act in ways that mesh with the firm’s desired culture. This tone at the top should clearly demonstrate the organization’s expectations. From there, the audit committee, in its oversight role, should be able to clearly see how these expectations are realized.

Audit committees should take on the challenge of assessing the culture set by management and how it permeates the organization and strengthens its governance. However, assessing an organization’s culture is challenging and complicated. Yet, it can be done provided the committee has a strong and transparent relationship with management, support from an effective internal audit function, and the ability to respond promptly when issues are raised.

Audit committees: relationship with management, including providing credible challenges, plays a key role in promoting a risk-conscious corporate culture

Building an effective corporate culture is a complex, team effort. The typical organization includes many cultural layers, all of which should be managed, monitored, and sustained. To help the CEO and management set the proper tone at the top, we recommend that audit committees:

- Devote more time to understanding the intersection of strategy and risk, with particular attention paid to deterring unethical or inappropriate behavior, such as selling unsuitable products to meet a quota, as well as taking on risks that the organization structure is unable to manage.
- Communicate regularly with non-C-Suite employees to help the board better understand the day-to-day routine of the organization. Many BCM audit committees now regularly invite the chief compliance officer (CCO) or line-of-business leaders to committee meetings. On the flip side, some committee members occasionally attend meetings with the internal audit staff and lines of business.
- Encourage management and the internal audit staff to have open conversations during which everyone feels free to discuss their concerns. Based on these conversations, committee members can refocus their attention as needed.
- Discuss areas where management is concerned about the culture.
- Encourage internal audit to perform periodic culture audits to identify areas for improvement.

Discuss with management how incentive compensation plans, recognition programs, and other strategies are used to reinforce positive behaviors and where incentives could be viewed as encouraging undesired behaviors.5

Provide credible challenges to management’s approach to monitoring risk appetite. This is especially important in situations in which members of the audit committee suspect activity that might expose the institution to excessive risk or in situations that otherwise fail to reflect the firm’s values. It should be noted that regulators now explicitly demand these types of challenges.6 (See sidebar.)

The role of the credible challenge in safeguarding the right culture.

Thoughtful committee members with good information can effectively identify areas that are worth a second look. Indeed, they do and should continue to do so frequently in today’s environment, and management needs to be responsive when asked.

Audit committees should document their challenges in their meeting minutes whenever they feel it is justified. This demonstrates to regulators that the committee is performing its duties and establishing accountability with management. Note, however, that the details of documenting a challenge can be a sensitive topic. Minutes should reflect the issues at hand concisely and accurately, making sure that committee members review the content to reduce the chance that the challenge could later be misconstrued.
Audit committees should assess management responses to issues identified

It’s not enough for the audit committee to simply identify issues of concern related to the company’s culture. It should also discuss whether management has alleviated the concern and is addressing any broader, underlying issues. If, for example, a challenge is raised about cost overruns on one IT project, the committee might discuss with internal audit whether it should examine other projects in case similar issues exist elsewhere in the company. Another example would be if the audit committee feels that an undue amount of credit risk has been taken in an area of the company. The committee might then want to have a discussion with both business leaders and internal audit on whether they are comfortable with the additional risk.

It’s important that the challenge process be comprehensive, not a perfunctory, check-the-box exercise. Nor should the answers be taken at face value. It’s not unusual, and it’s often desirable, for committee members to challenge management’s response if they are not satisfied with an answer or need more detailed information to better understand an issue. Committee members should also expect internal audit to seek out and raise thematic issues, and to provide evidence that management has addressed the matter thoroughly.

Audit committees should provide appropriate support to the CAE

While the CAE and internal audit should support the audit committee in the execution of its duties, the reverse also is true. To be effective, CAEs should have sufficient support to investigate issues and challenge senior management, and the audit committee has a crucial role in providing that support.

31% of CAEs in North America say that they have experienced pressure to change a valid audit finding or report, according to results from the CBOK 2015 Global Internal Audit Practitioner Survey.


Audit committees can show support by encouraging a broader discussion of points brought forward by the CAE. The audit committee chair might solicit the CAE’s thoughts during committee meetings to demonstrate that those perspectives are valued. The committee can work closely with the CAE on establishing and then updating an annual audit plan, or publicly request additional information from the audit team to catch the attention of busy operational executives. Committee chairs can convene meetings that include senior management and the CAE in the same room, and attend internal audit planning sessions to demonstrate the importance of the group.
We also see audit committees using subtle yet effective tactics to send the message that the CAE plays a crucial role in the success of the business, such as the audit committee chair’s periodic attendance at the CAE’s senior staff meetings, requests for the CAE to provide commentary to the audit committee on strategic decisions the firm is about to undertake, and requests by the audit committee to the CAE to provide monitoring of new business ventures and projects. Most CAEs today have open communication with the audit committee chair through monthly meetings, as well as instructions to call when an issue demands more immediate attention.

The bottom line: Regulators expect a strong and credible CAE who is fully supported and empowered by the audit committee.

**Audit committees should have the right information**

Many BCM audit committees face information overload, making it difficult to sort through what is important and what is just noise. Successful committees cut through the clutter. They ask management to translate the volumes of data generated by the institution into practical, usable information. Focusing on the information most important to the company is a challenge, and it requires prioritization and planning. The volume of information can make it difficult for some audit committees to figure out where the most important issues are, and many struggle to get useful information on crucial areas such as regulatory changes, evolving strategic and emerging risks, and evolving technology.

**Audit committees need “usable” information**

Audit committees should demand that management, internal audit, external audit, and others present information in clear, concise reports that help them focus on priority issues. The once-common approach of handing the audit committee reams of data and piles of charts and tables is no longer acceptable. Committee members need timely, actionable, well-organized information that can help them grasp the important issues and emerging risks, recognize changes in legislation, and understand the results of root-cause analysis to identify thematic issues within the organization. Effective reporting can help do that.

To manage the ever-expanding workload, we increasingly see committee chairs, CAEs, and other key risk executives holding annual sessions to plan the committee’s work for the coming year. Scheduling allows the audit committee to make sure it has time to tackle strategic items, as well as to discharge every responsibility in its charter. Strategic items may include requesting an in-depth review of critical areas of operations, a deep dive into specific risk areas, review of key IT projects, or related areas of focus. This is also a natural time to review the committee’s responsibilities and charter itself, as discussed previously.

To handle the information flow, many audit committees also encourage management to develop, in advance of meetings, concise executive summaries that highlight crucial issues. Regulators suggest that summaries be organized around key overarching themes. This can help committee members focus their thinking about how risks identified in one part of the company might indicate a larger issue elsewhere. One theme, for example, might be the operational risks raised by having dozens of IT projects in progress at once. Others might include a growing cybersecurity threat or the need to review policies in light of changing regulation or investor sentiment.

It may be more useful for the audit committee to receive a summary of 10 key themes, along with management’s plans to address them, than to receive a detailed 200-page report with the key themes buried within.
Audit committees should understand changes in the regulatory environment

Many audit committees seek advice from both inside and outside their companies on the latest rules, pronouncements, and investigations.

Some BCM firms appoint regulatory coordinators to serve as information clearinghouses. These coordinators compile calendars of exam schedules, maintain a regular dialogue with agencies, keep tabs on document requests, and monitor regulatory websites, among other things. If coordinators are present in a BCM firm, they can provide valuable insight and information to the audit committee. The key is to anticipate what’s coming and keep the organization a step ahead.

External advice can come from the regulators themselves, advisors, or other outside experts. Some audit committees arrange biannual or quarterly meetings with regulators. Some audit chairs contact regulators more frequently to stay abreast of matters between formal meetings. This also allows them to benefit from the regulators’ perspective and insights based on the regulators’ experiences with other institutions. To gain understanding of the issues that BCM audit committees confront, some committees employ advisors who can share insights in broad terms. Another trend is to invite outside experts in areas such as cybersecurity or anti-money-laundering compliance to walk through the latest guidance from regulatory agencies and to share how other companies are responding.

Audit committees should understand the changing technology environment, as well as related risks, responsibilities, and responses

The financial world is driven by technology. From tantalizing front-line innovations such as virtual currency, using social media for payments, and blockchain to large investments in back-office core- and payments-processing systems, every area of business continues to be reshaped by technology. Regulators are particularly interested in the role that bank directors play in ensuring that managers safeguard their institutions against cybersecurity threats. They also demand that banks use increasingly sophisticated technologies to track risk within their organizations and monitor compliance with laws and regulations.

These complex topics require more than passing knowledge to fully grasp. Few audit committees have members with deep technological expertise. Most need additional guidance or education before they can feel comfortable assessing and, as needed, challenging strategic IT decisions. Audit committee members should understand the implications of the Federal Financial Institutions Examination Council’s cybersecurity assessment tool, which will become part of the standard in future bank regulatory examinations. They also should understand the strategic risks and rewards presented by emerging nonbank FinTech companies as their firms consider whether to acquire, partner with, or compete against these companies.

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9 For more information, see PwC’s Financial Services Regulatory Practice “A closer look—Cyber: Think risk, not IT,” April 2015.
10 For more information, see PwC’s Financial Services Institute “Q&A: What is FinTech?” April 2016.

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To meet these challenges, we see a growing number of committee members seeking additional education and training. Typically, the committee chair will ask the board secretary or CAE to arrange for an expert to discuss the technology and strategic aspects of a specific issue, and many committees ask for regular briefings on the latest trends and how they might lead to potential challenges and risks within the business.

Management is generally the primary source of information on an institution’s technology strategy. Committee members facing a complicated technology-related decision should not be afraid to assert a credible challenge to management’s position if they feel the need to better understand an issue. If committee members are hearing about cybersecurity threats constantly in the news but aren’t receiving regular reports on their own institution’s experiences, for example, they should ask.

Audit committees should discuss whether all key participants (for example, management and internal audit) have the required technical expertise to do their jobs properly. If not, the audit committee should ask how they can improve or supplement their technical skills. Considering technology’s central role in the industry, these questions are too important to ignore.

In PwC’s 2015 Director’s Survey, 56% of BCM directors said their boards are “very engaged” in overseeing the risks associated with a cyber-attack, while 35% reported that their boards devote more than a tenth of their total meeting time to cyber-risk discussions. Perhaps not surprisingly, almost half (46%) of BCM directors had discussed a specific incident in the past year. 11

What this means for your business

From setting tone at the top to understanding new technologies, the increasing complexity of the regulatory and operating environment requires that BCM audit committees stay actively engaged in risk management and ensure the effectiveness of management plans.

Committees are constantly refining and improving the ways they address important issues with management through the use of credible challenges and by identifying broad thematic issues. In addition, committee members are receiving better information and are starting to receive support from both the risk and IT committees for specific issues.

In the short-term, BCM audit committees may naturally face growing pains. In the long-term, however, they need to be able to respond more effectively to the industry's shifting regulatory and competitive landscape and provide strong guidance and oversight to their firms.
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