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STANDARDS AND GUIDANCE

AUDITING LIQUIDITY RISK MANAGEMENT FOR BANKS (BY IIA GLOBAL)

Banking institutions are inherently vulnerable to liquidity risk, one of the significant risk areas in the Financial Services Risk Framework.

The Basel Committee defines two main types of liquidity risk: funding liquidity risk and market liquidity risk. Funding liquidity risk is "the risk that the firm will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the firm." Funding liquidity risk includes the various risks that could cause a bank to be unable to pay its debts and obligations when due. Market liquidity risk is "the risk that a firm cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption".

Liquidity risk is unpredictable and challenging to measure for several reasons:

- Cash-flow obligations are uncertain because they depend on external events and entities.
- The likelihood that a liquidity risk event may occur is hard to predict because of secondary risk events.
- The impact of liquidity risk events can multiply and have wide-ranging adverse effects on the greater financial system and economy.
- Liquidity risk evolves at a high velocity, which could quickly lead to a tipping point beyond which recovery is difficult. This could happen even when an organization has not started to suffer loss of liquidity.
- Changes in financial markets have made financial systems increasingly interconnected, leading to faster transmission of stress and more complexity in containing the impact.

Internal auditors also should be aware of the bank's overall liquidity management framework and practices, such as the volume of high-quality liquid assets, the amount and type of unencumbered assets, the contingency funding plan, and stress test results.

- **Governance of Liquidity Risk Management**
  Risk management is a fundamental element of sound governance. Successful management of liquidity risk, like any other area of risk, requires clearly defined roles and responsibilities throughout the organization. The Basel Framework holds the board accountable for determining that the bank's liquidity and LRM processes are adequate. The bank's management is responsible for establishing and operating the risk management framework on behalf of the board.

- **Three Lines Model and Liquidity Risk Management**
  The first line roles refer to operational management primarily responsible for maintaining effective processes that manage and mitigate liquidity risk in day-to-day business activities. The second line roles consist of separately established risk policy and control functions that independently monitor and challenge the first line, ensuring that it operates within the predefined risk tolerance level. The third line is the internal audit activity, which provides independent assurance over the processes implemented by the first line and overseen by the second line.

  Senior management's asset and liability committee (ALCO) oversees the establishment of policies and strategy, makes key liquidity risk decisions, and regularly reviews the organization's liquidity risk profile. The ALCO should review the liquidity risk profile and monitor conformance to the bank's stated risk appetite. Ultimately, the board is responsible for ensuring that senior management effectively manages liquidity risks.

Liquidity Risk Appetite and Risk Tolerance

The board should establish a liquidity risk tolerance that reflects the bank's business objectives, strategic direction, overall risk appetite, financial condition, funding capacity, and role in the financial system. The tolerance should ensure that the firm manages its liquidity prudently in steady times to withstand a prolonged period of stress. Senior management should articulate the risk tolerance so that the trade-off between risks and profits is clear to all levels of management. The ALCO should continuously review the bank's liquidity developments and regularly report to the board.

Typically, the risk appetite statement includes at least two liquidity metrics during normal conditions and at least two during stress conditions, and the metrics are embedded in the limit structure. The risk appetite and liquidity risk tolerances should be integrated into overall liquidity management, including links to business strategy, risk strategy, internal capital adequacy assessment, and internal liquidity adequacy assessment.

Measurement and Management of Liquidity Risk

A bank's liquidity strategy, including policies and procedures for measuring, managing, and controlling liquidity, should help the bank maintain sufficient sources of liquid funds to meet its funding obligations as they come due.

The policies and procedures should also outline appropriate early warning indicators to alert the bank to a pending liquidity issue. These crises tend to spread quickly, given the rapid dissemination of information through mass media, social media, and other forms of communication. Measuring liquidity risk based on timely internal and external information is key to ensuring liquidity issues are identified and addressed in a timely fashion.

The Basel Framework introduced two minimum standards for measuring adequate funding and liquidity in stress situations. The liquidity coverage ratio (LCR) was designed to promote the short-term resilience of a bank's liquidity risk profile by ensuring that the bank has sufficient high-quality liquid assets (HQLA) to survive a stress scenario lasting 30 days.

The liquidity coverage ratio (LCR) promotes the short-term resilience of a bank's liquidity risk profile by ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA). These are assets that can be converted into cash easily and immediately in private markets to meet its liquidity needs for 30 calendar days. The LCR is expressed by the formula:

$$\frac{\text{Stock of HQLA}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100\%$$

Phased timetable for LCR	2022	2023	2024
Minimum LCR requirement	80%	90%	100%

Once the LCR has been fully implemented, its 100% threshold will be a minimum requirement in normal times.

Source: *Basel III: Liquidity Coverage Ratio*

The net stable funding ratio (NSFR) was developed to reduce funding risk over a long-time horizon. It requires banks to fund their activities with sufficiently stable sources to mitigate the risk of future funding stress.

The net stable funding ratio (NSFR) is defined as the amount of available stable funding relative to the amount of required stable funding. This ratio should be equal to at least 100% on an ongoing basis. "Available stable funding" is defined as the portion of capital and liabilities with values that are expected to be reliable over the one-year time horizon considered by the NSFR. NSFR is expressed by the formula:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

Source: *Basel III: Net Stable Funding Ratio*

Good management of information systems, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning are the building blocks of a sound liquidity strategy.

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Proper management of a bank's liquidity position is critical to its ability to withstand financial stress and manage negative cash flows. Internal auditors can play an important role in confirming the sufficiency of LRM process design and execution, which benefits not only the individual bank but the banking sector as a whole.

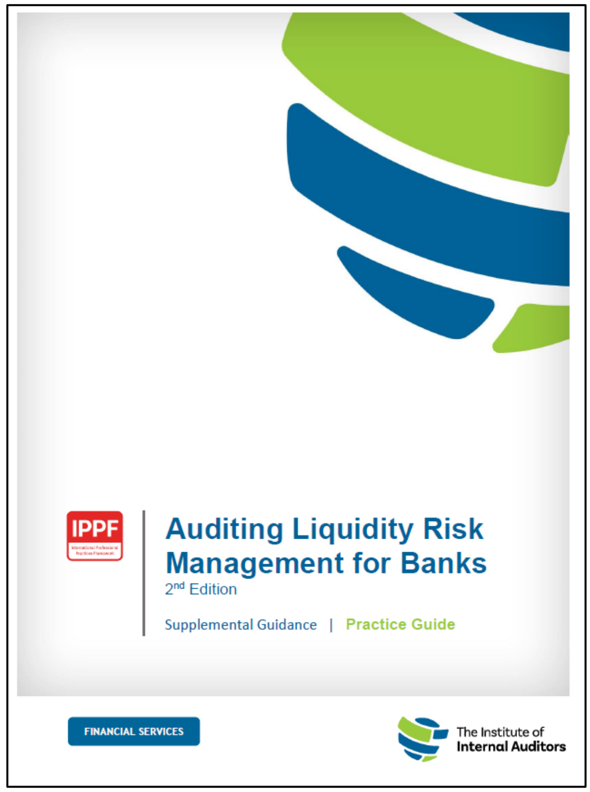
What should Internal Auditors do?

IPPF *Standard* 1220 – Due Professional Care stated that internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

The internal audit activity must evaluate the adequacy and effectiveness of controls related to the bank's achievement of its strategic objectives, the reliability and integrity of its financial and operational information, the effectiveness and efficiency of its operations and programs, the bank's ability to safeguard assets, and the bank's compliance with laws, regulations, policies, procedures, and contracts.

IPPF *Standard* 2120 – Risk Management stated that the internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

In support of the assessment of the LRM processes, internal auditors should obtain the organization's board-approved risk appetite statement. The statement typically includes metrics related to monitoring liquidity risk. Internal auditors should look for these metrics and assess whether they effectively capture the key risks. The statement should describe how management identifies the key risks the bank might be exposed to and how management sets the risk appetite and specific liquidity risk tolerance levels. Risk tolerances may be expressed as exposure limits.



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GLOBAL KNOWLEDGE BRIEF

INTERNAL AUDIT IN A POST COVID WORLD – PART 3: REDEFINING THE RESILIENT ORGANIZATION (BY IIA GLOBAL)

For internal auditors, the pandemic serves as a concrete reminder of how vulnerable organizations can be — even if they're performing well under normal circumstances. It shows how quickly conditions can change under the weight of a severe event, and how important it is to factor that into risk assessments. Understanding how to enhance resilience is essential as organizations confront large-scale disruptions that seem to occur at an increasing cadence.

While audits have traditionally been conducted in the rearview, internal auditors and the organizations they serve are now increasingly looking forward, searching the horizon for potential threats and helping formulate contingency plans.

How Organizations Are Adapting Their Approach to Resilience

- **Cash Is King**

  "Organizations that were cash rich breezed through the pandemic, while those that may have had successful operations but were not cash rich — they suffered," an internal audit manager says. "Others may have had the liquidity to survive, but they could have thrived had they kept a closer eye on cash flow."

- **Securing Supply Chains**

  Having more than one vendor, understanding how that vendor's ability to perform might be challenged by a catastrophic event, and having a plan to mitigate that risk are key to resilience.

  "That created a huge gap in the availability of resources within the organizations," Rai says. "The lessons learned were to either negotiate better or have a contingency plan.".

- **Communicate and Collaborate**

  A resilient business is one with a clear mission and well-defined priorities that are understood across the whole organization. Indeed, solving problems like the ones posed by COVID-19 requires an entity wide approach that enlists all levels and departments.

  Prior to COVID-19, the organization's business strategy was considered confidential, and only top management was privy to the plan. Now, Khayal says, frontline employees have a clear view of the strategy, which enhances their ability to respond to a crisis.

- **An Adaptable Workforce**

  Implementing hiring practices that focus on adaptability, in addition to expertise, is a critical first step. Instead of staffing with inflexible experts, organizations should seek people who are agile and capable of living with ambiguity, and whose personalities are flexible enough to change directions quickly.

- **Connecting With Tech Budgets**

  Less than a quarter of the executives Deloitte surveyed said that their organizations possessed the technology they needed to support remote work before the pandemic struck. Cloud platforms, videoconferencing, and cybersecurity were all at the top of the list of needed capabilities.

  While having military-grade communications and security may be on every organizational leader's wish list, the ability to fund — and sustain — the technology that enables it may not be within everyone's reach.

How Internal Auditors Can Help Lead in Creating Resilience

Capital planning is key to the safety and soundness of a financial institution, and an institution's board is ultimately responsible for strategic decisions, including capital adequacy.

- **Factor Resilience into Engagements**
  Approaching each audit with an eye toward the area's agility, and its ability to function through adversity, may be a natural outgrowth of the pandemic for some — and something for others to consider.

- **Laser Focus on Technology**
  The pandemic made most organizations more reliant on technology, which can increase both operational and security risks — and that may prompt the need for more technology audits.

- **Review Pandemic Policy Changes**
  One immediate priority for auditors is to review changes to standing policies that were made during the pandemic to ensure those changes don't themselves pose a risk. For organizations that truncated or skipped past policies as a way to deal with the crisis, some of those changes may be working and worth continuing.

- **Recalibrate Risk Assessments**
  Risks that might not have raised major concerns pre-pandemic may now warrant more attention. Now that businesses have seen the shattering consequences of a worldwide disruption, risk management is much more on the minds of organizational leaders and boards — and that has brought increased focus on the importance of looking at where exposures may lie.

- **Pre-act, Don't React**
  The pandemic made many organizations consider the consequences of being caught flat-footed at the onset of a crisis. Invariably, some came to develop a new appreciation for the value of proactive preparation and being ready at all times — not just when faced with challenging circumstances.

A More Resilient Audit Function

- **Reduce Reaction Time**
  Burst audits get actionable information back to the first line faster. As clients face change that demands a quick reaction, internal audit can provide an expedited assessment with minimal lead time to aid decision-making.

- **Incorporate Tech Tools**
  New tools and new techniques will mean a learning curve for many auditors. It's crucial to use this time as the pandemic eases to train before the next emergency. That involves learning how to incorporate data analytics, and other technology such as automation and artificial intelligence, into audit workflows.

- **Leverage Relationships**
  One positive outgrowth of the pandemic is that, in many cases, it brought about a sense of common purpose. It helped unify teams, encourage greater entity wide collaboration, and promote synergy. For internal auditing especially, which historically has faced headwinds in building client relationships, this presents a major opportunity.

- **Elevate Presentations**
  According to research co-published by the Internal Audit Foundation and Protiviti, board-level and C-suite presentations from internal audit should include information about the organization's resilience initiatives, or shortcomings.

Auditors should have an open and frank dialogue with management and the board about what information they would like to have and how they would like it presented.

What should Internal Auditors do?

IPPF *Standard* 1200 – Proficiency and Due Professional Care specifically identifies that engagements must be performed with proficiency and due professional care.

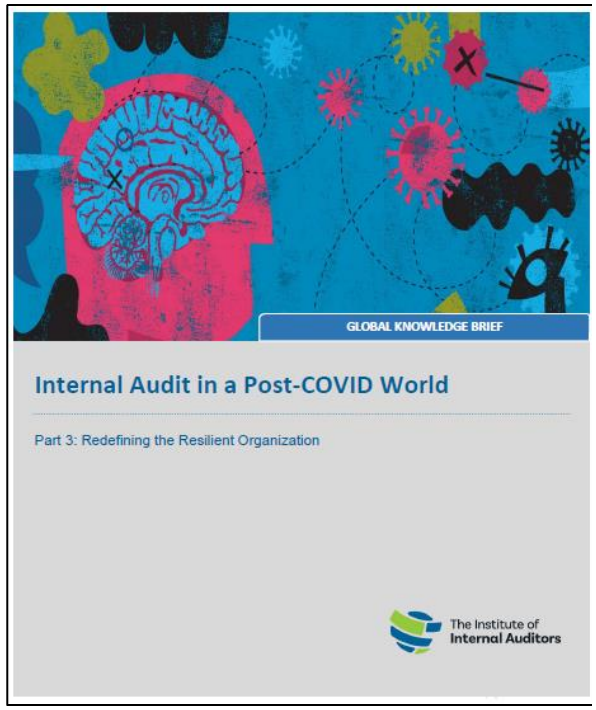
To help ensure continued resilience, internal audit needs to understand the impact of COVID-19 on business operations and across the organization's risk universe. Auditors need to be bold in looking ahead to help identify and prepare for future risks.

Internal auditors shouldn't limit their focus on resilience only to client engagements — they must also turn their attention inward. To help lead the way toward a more resilient organization, practitioners need to ensure the audit function is itself resilient — that it has the habits, skills, and expertise to meet the moment. Effective internal auditors are not sitting back and waiting for the world to "stabilize." They're proactively changing how they think about their function and how they perform their work.

To remain relevant in the eyes of stakeholders and provide optimal value, internal auditors need to squarely face the future and attack the new reality with the skills and diligence they mastered before the crisis, while adding some new competencies in technology and communication along the way.

IPPF *Standard* 2420 – Quality of Communications specifically identifies that communications must be accurate, objective, clear, concise, constructive, complete, and timely.

The increasing use of data analytics also argues for auditors to be skilled in using data visualization tools. Most practitioners already know how to present information but sharing that information in a compelling visual format helps ensure it's clearly understood and then acted upon.



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TONE AT THE TOP

HOT-BUTTON ISSUES AND YOUR ORGANIZATION (BY IIA GLOBAL)

When it comes to social concerns, companies are facing a growing and often murky world of risks. There are risks in taking positions on any of these issues, but there are often equal or greater risks in not doing so.

Exacerbating the problem is the fact that the broad range of issues that fall under the environmental, social, and governance (ESG) umbrella tend to be multifaceted and outside of the traditional business strategic planning process. They are also pervasive, affecting many areas of the company, which means they are important yet can be easily overlooked. Additionally, they involve a large variety of stakeholders.

Boards should expect the attention on this area to intensify as stakeholders sharpen their focus. In a time of great turbulence on global and domestic fronts, organizations must craft strategies to ensure they identify, and address threats related to social issues. That strategy must include seeking out independent and objective assurance from a qualified internal audit function on the efficacy of efforts to mitigate those risks.

Address the Risk

Risks associated with social issues are varied. They can manifest as part of risks related to talent management, third-party vendors, reputation, climate change, and others. Many of these risks can be lumped into the growing ESG risk category, but it is important to recognize the potential for varied risk impacts.

Organizations also may have an unrealistic idea of how well they are addressing ESG concerns as the study found executives are typically overconfident about their companies' progress on sustainability efforts.

Getting an Independent Perspective

Social issues should be part of the company's strategic planning, particularly if they can have a significant impact on its finance or reputation. As trusted providers of independent assurance and advice, internal auditors can help organizations map their objectives regarding social issues and identify metrics or other measures that hold them accountable for achieving goals, while providing advice on how to do so.

- **Coordinating with senior management and the board to initiate a review and discussion of the organization's mission, vision, and values**
  Companies may find updates or revisions to their governance documents necessary to cover current considerations. The updated documents then can be used in strategic planning so that organizations face fewer calls for change in their own practices and can more quickly and confidently respond to new developments.

- **Providing analytical or qualitative assessment of whether the organization's culture aligns with its mission, vision, and values**
  "Internal audit has the mandate to see holistically across the organization; to audit against a framework, criteria, policies, and procedures; and to test whether the talk is being walked by leadership," according to a report on DEI from IIA. That can be important in preventing and addressing internal concerns.

- **Consulting on which board committees are best suited to oversee social issues and how best to assign responsibility over such issues**
  Internal audit can develop baseline data on how well the organization's activities truly reflect its intended approach to social issues and consult on how to fill any gaps. It might also review the organization's philanthropic and lobbying activities to see if they align with company values

and spot any associated risks. In addition, internal audit can examine how successful the company is at promoting diversity among its suppliers and preventing exploitation of workers and human rights abuses throughout the supply chain.

- **A Growing Consensus**

  "There is growing consensus that for an organization's values and culture to be perceived as authentic, the organization must take meaningful action to support those values," according to The IIA report.

  Organizations that are responsive and accountable to employees and customers are better prepared to make prompt, appropriate, and meaningful responses on social issues and differentiate themselves in the marketplace. In their efforts to prepare for and address social issues, boards should be sure that their organizations are making the best use of the independent assurance and objective advice that internal audit can offer.

What should Internal Auditors do?

IPPF *Standard* 1100 – Independence and Objectivity specifically identifies that the internal audit activity must be independent, and internal auditors must be objective in performing their work.

Many company websites offer inspiring declarations of their values as they relate to current social concerns, but internal audit can provide an independent assessment of whether corporate actions support those statements. Having an objective review of an organization's comments and actions on volatile social issues can be invaluable and deter potentially embarrassing miscues.

IPPF *Standard* 2320 – Analysis and Evaluation stated that internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

Given its unique holistic view of the organization, internal audit can use root cause analysis, interviews, data analytics, or targeted consulting engagements to provide a comprehensive picture of where the organization actually stands and where it needs to be.

Reference:
https://www.theiia.org/en/content/articles/tone-at-the-top/2022/hot-button-issues-and--your-organization/

INTERNAL AUDITOR MAGAZINE

THE GREATER GOOD (BY MARK MARACCINI AND KATJA FREEMAN)

Technology changes and economic pressures pose challenges to auditors in local and regional government.

What are the most prevalent issues facing public sector internal auditors?

First, internal audit is being asked to make recommendations that allow management to make more timely, effective decisions. This means internal audit is having to look beyond just the performance and efficiency of processes and is expected to write findings for deficiencies to help streamline or automate them.

Second, business operations and technology are changing faster than they ever have. The technical expertise required to audit all areas of a business are so expansive that it would be almost impossible, especially with budgetary restraints, to have an expert for each area.

How are economic pressures impacting internal audit in local and regional government?

First, economic pressures on people result in the need for greater scrutiny over red flags for potential fraud, waste, and abuse. Any time there is an economic downturn, auditors must understand that people face additional pressures, which increases the likelihood for rationalization and motivation to perform a fraudulent act.

Second, with high inflation and supply chain issues, prices are rising fast, yet most departments are experiencing budget cuts. There is pressure to continue to perform services at an expected level, yet with reduced means. This creates an incentive to use less-than-ideal goods or service providers or cut corners when it comes to purchasing.

What technology skills are the most important for internal auditors in local and regional governments?

Knowing how to use analytical software is a great skill for an auditor that brings immense value to their organization and enhances their career prospects. It can be put to use when dealing with typical transactions in government auditing, such as tax or payroll information, by reducing the time it takes to analyze all the data. However, these analytical skills need to be paired with strong critical thinking skills to help auditors understand root causes and make recommendations that alleviate the issues they find.

How are these internal auditors working with AI, robotic process automation, and data analytics?

There is growing interest in using RPA, which involves rules-based mini-programs that help an auditor automate tasks. For instance, RPA can conduct compliance tasks that require a high degree of accuracy, are repetitive and manual, and involve collecting information from a variety of data sources. Using RPA has the benefit of freeing up auditors' time so they can focus on more complicated issues that require critical thinking.

What are the barriers to conducting cybersecurity audits in government audit functions?

Cost and lack of skills are some of the biggest barriers to cybersecurity audits.

What should Internal Auditors do?

IPPF *Standard* 1200 – Proficiency and Due Professional Care specifically identifies that engagements must be performed with proficiency and due professional care.

The use of data analytics plays a major role in this effort to identify trends and metrics that management can use to measure success and adjust, if needed, in real time.

In addition, internal audit functions are needing to look for creative ways to gain the necessary technical expertise for audits, which may include methods of cosourcing certain audits.

If RPA is used for financial reporting or internal controls management, the auditors need to understand the design of the technology that has been used to create and process the data.

IPPF *Standard* 1210.A2 – Proficiency specifically identifies that internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

Therefore, auditors should stay focused on the basic fraud indicators, such as employees who are experiencing financial hardships, living beyond their means, demanding to control certain processes, or refusing to take time off and allow others to do their work.

IPPF *Standard* 1230 – Continuing Professional Development identifies that internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.

Government audit leaders will have to increase spending on cybersecurity audits and support their auditors to get trained to be prepared for the growing threat.

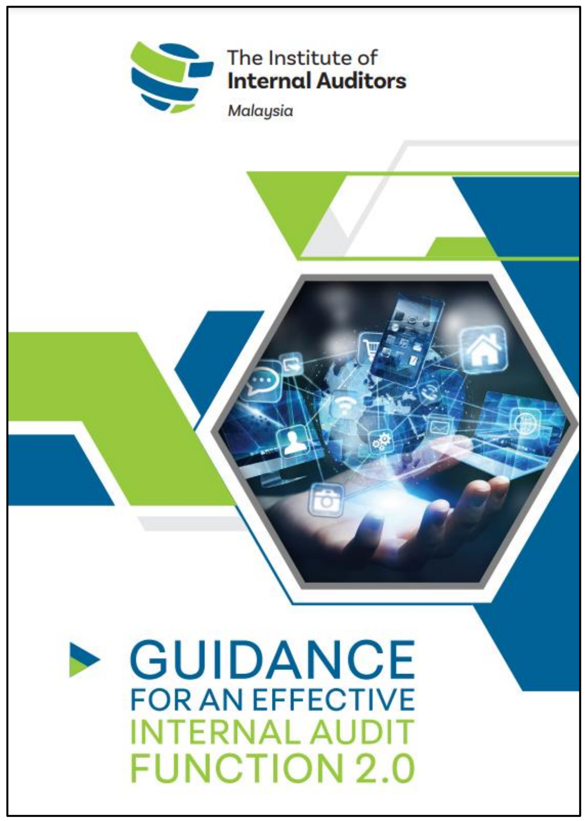
Reference*:*
https://internalauditor.theiia.org/en/articles/2022/october/the-greater-good/

NEWLY LAUNCHED!

GUIDANCE FOR AN EFFECTIVE INTERNAL AUDIT FUNCTION 2.0 (BY IIA MALAYSIA)

On 19th October 2022, IIA Malaysia launched the **GUIDANCE FOR AN EFFECTIVE INTERNAL AUDIT FUNCTION 2.0** during its National Conference 2022.

This Guidance for an Effective Internal Audit Function 2.0 comes as a comprehensively refreshed edition to serve as a reference point for everyone who has a duty or interest to uphold the highest level of governance, risk and control in any organisation.



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https://iiam.com.my/guidance-and-advisory/

If you missed out the previous issues of e-techline, you may visit our website at https://iiam.com.my/technical-qa-services/e-techline/.