Front-office control functions

What’s next for capital markets banks

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Contents

1 Introduction

2 EY’s 1 LOD survey – executive summary

4 Most firms are establishing a front-office control function

5 Authority of the function is supported by senior management reporting

6 Staffing models are evolving and will need to combine expert staff with optimization strategies

8 The common purpose is strengthening accountability of the front office

9 Roles and responsibilities between 1 LOD and 2 LOD are unsettled

10 Remit is expanding across surveillance, monitoring and testing

11 Interactive dashboards and workflow tools are under construction

12 Looking forward – challenges and focus areas

13 The call to action
Introduction

Major financial institutions are increasingly focused on effectively controlling non-financial risks in their front-office businesses. Drivers of this increased attention include regulatory pressure for greater accountability (most notably the Senior Managers Regime in the UK), well-publicized conduct issues, and recognition that the complexity of front-office activities requires a detailed application of three lines of defense control principles across non-financial risk types. This focus on improving non-financial risk management is supported by an observed trend toward strengthening first-line accountability.*

Indeed, while the industry has seen a continued evolution of the size, focus and authority of both risk management and compliance groups, which comprise second lines of defense (LODs), there is a related evolution happening in that these second-line groups are insisting on greater first-line accountability and action around risk and control – particularly in the front-office businesses. This push toward the front office has been particularly acute in capital markets businesses, given that many of the recent conduct issues (and resulting regulatory focus) originated in trading and sales businesses.

So, how are front-office groups responding? EY undertook a survey of first-line trading and sales businesses at 15 leading capital markets banks. We asked how front office control of non-financial risk is evolving, including through creation or expansion of dedicated functions within the 1 LOD.

We found that among the banks, there is a common trend toward developing a dedicated front-office control function to enhance oversight of and consistency around non-financial risk management. Banks have taken a variety of approaches in terms of structure, resourcing and tools, but some common themes exist. It also is evident that these functions will continue to transform in the near future, as repeated high-profile compliance issues and regulatory expectations keep the industry’s focus on improving mitigation of non-financial risks. Our survey highlights the expanding mandates and resource contention faced by the front office and suggests that while dedicated control functions have been a significant step forward in managing non-financial risk, there is a need for increasingly sophisticated action plans to achieve a sustainable operating model.

This report shares specific findings and insights from the survey and from follow-up conversations EY held with management of large banks across the Americas, Europe, and Asia-Pacific. We also provide our viewpoint about leading practices, incorporating our experiences designing and delivering 1 LOD control programs.

Without question, the trend toward greater accountability for non-financial risks in the 1 LOD has had a significant impact on how front-office businesses are staffing for and handling non-financial risk and controls. For the large bank management teams with whom we spoke, the journey has moved beyond theory and well into practice, but there are still challenges to confront in both the 1 and 2 LODs. In concluding this report, we have set forth the actions we think are next for capital markets banks to complete the transformation successfully.

As global capital markets banks move toward greater first-line accountability for non-financial risks, a clear trend has emerged – creation of a dedicated front-office control function. However, organization, responsibilities and maturity of controls still vary widely. EY has evaluated this emerging space to identify leading practices and provide insights about future developments that will continue to transform the space.

* For more about the trend toward greater first-line accountability, see A set of blueprints for success: seventh annual global EY/IIF bank risk management survey, EYGM Limited, October 2016.
Front-office control functions have been established as the three lines of defense evolve to have the first line take greater responsibility for non-financial risks.

- Increased regulatory and business drivers are combining to push direct risk management and control accountability to the front-office businesses as 1 LOD.
- Expansion of the 2 LOD oversight remit is a related trend – with corresponding “pushdown” in additional 1 LOD requirements.
- The industry response exhibits a clear trend toward establishing front-office control functions as discrete units within markets businesses, consolidating responsibilities previously dispersed across COO functions and various business roles. These emerging centralized groups are providing critical support to senior business management and line of business supervisors, all of whom are faced with increased responsibilities.
- Exact reporting lines vary, but most front-office control teams report into senior business management (i.e., head of trading business or above) – either directly or via the COO – to demonstrate authority and stature of the function with desk heads.

60% of banks are changing their 3 LODs, with most focus on increased first-line accountability.

Resource models vary and are evolving; expanding mandates and resource contention are driving a push to optimize.

- No consistent optimum model exists for the size of the function, but many globally active firms have teams of 70+. In addition to bank size and complexity, drivers of headcount differences included variance in specific activities within the function, such as the extent of testing being performed.

- Some firms are making effective use of offshore or lower cost nearshore resources to support efficiency of metric and report production; other offshore/nearshore activities include surveillance and monitoring activities.

- The functional mandate is still increasing, mostly due to risk and compliance expectations pushed down from the 2 LOD. In many cases, 1 LOD control functions perceive these 2 LOD requirements to have been issued inconsistently and without alignment with work already underway. In addition, most firms say that while 1 LOD resources have increased, increases have not been proportionate to the increase in responsibilities. And, the banks see 2 LOD resources, especially in Compliance, continuing to increase at a greater rate than those in the first line.

- Most firms surveyed describe their current 1 LOD headcount capacity as barely sufficient to meet existing demands and insufficient for the expanding mandates. Yet, they do not anticipate adding to their headcount.

- They cite several specific areas of increased workload, including risk and control self-assessment (RCSA) support; regulatory change management; monitoring and surveillance; ownership of supervisory tools and other enhanced technology solutions; management reporting; and day-to-day support for supervisors executing the control agenda.

- Across these areas, they are challenged by ongoing role definition (1 LOD versus 2 LOD), imbalanced resource growth, and the need to achieve efficiencies through transformation of controls.

Technology and investment are essential looking forward.

- Most firms recognize that, to solve for these challenges and keep pace with the growth in front-office responsibilities – data and technology investment will be essential. Investment areas should include data management, surveillance and monitoring tools, and improved technology to support supervision, such as automated metric production, reporting and dashboards.

- Likewise, firms will need to invest in process enhancements, including standardization, to support offshoring/nearshoring, outsourcing and/or automation.
Most firms are establishing a front-office control function

Bank management we surveyed were fairly consistent in having established a dedicated control function in the front-office capital markets business, centralizing historical approaches to risk and control management that had left activities distributed across a combination of COOs, embedded operational risk staff and desk-level delegates.

Drivers of centralization

- A need to drive greater consistency and rigor with respect to assessment standards and evidence of control frameworks — some legacy models were significantly dispersed, and both roles and methodologies were inconsistent across businesses, desks and geographies.
- An increasing focus and mandate for front-office controls — lines of business are responding to management and regulatory demands for more control infrastructure at the business level to more comprehensively address non-financial risks.
- Demonstrable efficiencies from alignment of resources and capabilities for some activities into centralized “hub” locations.

Emergence of the Chief Control Officer (CCO)

Almost half of banks we surveyed have introduced a CCO position for the dedicated front-office control function reporting line.

The emergence of this role, distinct from the COO, highlights the importance attached to risk and control within the business. CCOs increasingly are empowered executives and are in a position to be held accountable for the effectiveness of the control framework within the business, without diminishing the overall responsibility of the business leadership for the risk and control environment.

Even at banks where a dedicated CCO has not been established, leading practice is an increase in ownership by senior business management of the overall control agenda in the front office, including driving structure, standards and interactions with independent risk groups.

EY point of view

- The formalization of the front-office control function is a leading practice in the progression of in-business management of non-financial risks.
- Given the increase in front-office accountability for non-financial risk and controls, it stands to reason that business heads would appoint a senior-level executive within their leadership teams to frame and execute on the expanded control agenda.
- Under this senior executive, front-office control teams should be performing a far wider set of activities than the delegated broker-dealer supervision tasks of years past. Specifically, the front-office teams should be applying management’s tolerance to the overall identification, assessment and design of controls for non-financial risks in the business.

Authority of the function is supported by senior management reporting

Reporting lines into more senior executives

A trend observed in the majority of firms is a reporting line to the head of the business (i.e., trading and sales) or even the head of the investment bank — either directly from the CCO, or via a COO or a chief administrative officer (CAO) — rather than to a desk head or other line management. A few banks have established a C-suite CCO, either reporting to the holding company CEO directly or to a firm-wide COO, although this doesn’t seem imperative if sufficient stature within the capital markets business is established.

The perceived benefit of this senior-level reporting line is that it provides the CCO with a “seat at the table in business leadership,” creating a high enough level of authority and stature to apply meaningful credibility and challenge at the trading desk level.

Primary reporting line of the 1 LOD control function (ultimately, reporting to business)

EY point of view

- Reporting lines should be within the business, and the head of the function should be a senior executive (i.e., reporting to a member of executive management).
- Banks adopting this structure recognized both the importance of the 1 LOD controls lead being a member of the business leadership team and the need to imbue the function with sufficient stature at the desk and business level to provide an effective challenge that is not subject to undue influence by desk managers.

Staffing models are evolving and will need to combine expert staff with optimization strategies

Staffing

The size of the function varies widely among global trading banks, driven by each bank’s footprint and the activities in which the function is engaged. Banks we spoke to are developing plans to meet current and future needs more effectively, but generally not by increasing headcount – they talked about a range of strategies including optimizing staff skill sets, developing better tools, reducing duplication, offshoring/nearshoring, outsourcing, and process automation.

More than half of the banks surveyed feel capacity is barely sufficient at present and is insufficient for the expansion in mandate the banks anticipate (including the shift of prior compliance and/or operational risk activities into the 1 LOD). Still, the banks describe a strong focus on controlling overall headcount.

Skillsets and experience

Competencies for the 1 LOD control teams tend toward middle- and front-office backgrounds, rather than compliance or operational risk, and 80% of staff have more than five years of control-related experience. The front-office management surveyed cited the importance of direct product and business knowledge to explain this trend.

EY point of view

- The creation of the function staffed with skilled individuals has been an important first step to implementation of a wider scope of first-line accountability, but evolution of the model is still underway.
- These groups will have to look for ways to create more leverage for skilled resources and supervisors, since controlling costs and headcount is a priority.

Location strategy

Banks are starting to optimize the location of their staff to manage costs, while maintaining centers with experienced staff in major trading hubs, e.g., London and New York City. Skilled staff members are located immediately on or adjacent to the trading floor, with a primary role of providing real-time advice, assistance and challenge to the trading and sales staff, and interacting with the bank’s 2 LOD. This staff also tends to drive control enhancement initiatives and regulatory reform agendas on behalf of front-office management.

Labor-intensive, repeatable processes, including surveillance and Management Information (MI) creation, are being centralized and standardized over time, providing leverage and better tools for the front-office staff. These processes have, in many cases, been centralized in nearshore and offshore locations.

Technology strategy

Surveyed banks view process automation as an emerging optimization strategy, but progress in this area is slow. Most banks see the need to first achieve more consistency in the processes and data used in the 1 LOD. Once standardized for nearshoring/offshoring, the processes also become candidates for automation to achieve further efficiencies.

Banks also are making attempts to share operational and technical tools and frameworks between 1 LOD and 2 LOD functions. Having a shared technology framework is viewed as an obvious way to streamline efforts by separate groups responsible for supervision, surveillance and oversight. These efforts fit within a larger theme (discussed in detail below) of reducing friction and duplication between 1 and 2 LODs.


EY point of view

- Front-office control functions will need to continue to invest in optimization efforts — control and technology enhancement, nearshoring/offshoring, automation and outsourcing — to manage workload, streamline interactions with 2 LOD groups, and improve the overall efficacy of first-line management of non-financial risks.
- Standardization and documentation of control processes should be a priority, both in responding to 2 LOD testing and enabling specific trends toward lower-cost locales, and managed services/outourcing. Control teams similarly should look to move toward process automation to replace legacy manual data processing and acquisition.
- In terms of technology challenges facing the CCO, we anticipate a need to devise a multi-vendor approach in order to integrate advanced technologies and custom-built tools into a strategic platform that provides supervisors and business management with sufficient information to support increased accountability. Opportunities from fintech (including big data capabilities and advanced search engines/algorithms) will increase, but will require significant effort to return benefits, given existing bank data infrastructure.
The common purpose is strengthening accountability of the front office

Support for front-office supervision

Despite some variety in the activities undertaken, there is a common core principle amongst front-office control function activities: supporting the ownership of non-financial risks by line of business individuals. In other words, the function tends to be actively involved in designing, implementing and enhancing first-line supervision for non-financial risks. (For the most part, we did not find the functions to be primarily engaged in performing delegated supervision). Thus, the front-office control function is developing as an essential partner to supervisors who find themselves with increased accountability for non-financial risks.

This theme of supervisory support extends across a wide range of non-financial risk types covering a variety of activities, including development and production of metrics, investigation of breaches, documentation of supervisory procedures, training, quality control, issue remediation, and development of supervisory tools.

Representing business management

Banks also view the 1 LOD control function as playing an essential oversight role on behalf of front-office management. This is evident within the business, as the function makes sure that line of business staff members are carrying out their responsibilities and provides quality control. The function also is spending significant time representing the 1 LOD in discussions outside the business unit – representing the business within the bank’s enterprise risk governance framework through participation in various risk committees, responding to challenge from 2 and 3 LODs, and acting as stakeholders in enterprise-wide remediation and control enhancement programs.

As leading practice, the control function effectively facilitates the accountability of business supervisors and oversees non-financial risks and controls on behalf of senior business management.

Most and least common activities of 1 LOD control function (% of functions performing this role)

- Control surveillance and monitoring: 92%
- Reporting on risk, control and compliance: 92%
- Operational loss data collection: 85%
- Control remediation and change program: 85%
- Incident investigation, response and management: 85%
- Fraud management: 31%
- Financial crime compliance: 31%

Is the 1 LOD control team responsible for the day-to-day management of the risk and control framework and governance?

- Yes: 10%
- No: 90%

Of these day-to-day risk framework commitments, which involves the most effort?

- Committee structures: 22%
- Control testing: 22%
- Risk assessments: 22%
- Risk and controls framework: 11%
- Risk registers: 11%

Roles and responsibilities between 1 LOD and 2 LOD are unsettled

Alignment with second-line

The banks are still undergoing a transition of responsibilities from the 2 LOD to the 1 LOD, and this is a source of challenges for more than half of the banks we surveyed. (Similarly, in the EY/IIF survey, a significant majority of firms reported ongoing changes to their three lines of defense, and an increase in first-line accountability was a key driver of that trend).

Key challenges arising from this shift in responsibilities among capital markets banks in the 1 LOD survey are:

- Unclear roles and responsibilities, particularly around testing and quality assurance, which are causing duplication and inconsistent outputs (see next page on testing, for example).
- Controls that were originally designed in the 2 LOD and are not fit for purpose in the front office, with the 1 LOD control function identifying a need to redesign the controls to add value (e.g., RCSAs).

As part of this transition, we saw the 1 LOD control function taking an active enterprise level role in defining the overall control frameworks and having a voice in accepting the 1 LOD’s responsibilities — i.e., designing and implementing the controls based upon standards established by the 2 LOD. This is especially evident in regulatory reform programs, conduct risk frameworks, and the operational risk program. These same areas underlie a trend toward division of responsibilities within the function (i.e., sub-functional splits) although we do not see a consistent driver to suggest how the groups will ultimately be organized.

EY point of view

- The three lines of defense model and the overall control environment are undergoing significant evolution. First, the 1 LOD control function is increasingly driving the control agenda and assessing the value of individual controls. At the same time, the 2 LOD is moving away from performing controls to setting the standards for control and control assurance that the 1 LOD must meet, and performing an oversight, testing and challenge role.
- Confusion and overlaps between the 1 LOD and 2 LOD are a natural part of the transition underway, but will need to be resolved over time to streamline interactions. We believe banks can accelerate this evolution by developing a target operating model that is activities-based and agreed upon by all three lines of defense.

Is there a sub-functional responsibility split?

<table>
<thead>
<tr>
<th>Percentage of respondents with sub-functional split that expressed having these responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational risk</td>
</tr>
<tr>
<td>Volcker Rule</td>
</tr>
<tr>
<td>Regulatory change</td>
</tr>
<tr>
<td>Conduct</td>
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<tr>
<td>Other</td>
</tr>
</tbody>
</table>

Surveillance and monitoring

The role of the 1 LOD control function in surveillance is active and increasing, given regulatory requirements and a shift of these activities from the 2 LOD. More than half of banks say surveillance and monitoring are requiring the highest level of effort from their teams. Almost half also cite it as a near-term priority for investment.

Testing

There remains considerable debate as to the future of control assurance activities rising to the level of testing in the 1 LOD, and how that relates to independent testing currently being, or to be performed by 2 and 3 LODs. For most banks with first-line testing, testing in 1 LOD tends to be focused on enterprise-led regulatory mandates, such as the Volcker Rule and the Comprehensive Capital Analysis and Review (CCAR) attestation process. However, a few banks have adopted testing as a core 1 LOD control function role, establishing extensive first-line testing programs.

Regardless of approach on 1 LOD testing, banks agree that the ongoing migration of control responsibility from 2 LOD functions to the 1 LOD will result in an increase in second-line testing. Plans have not yet developed to align testing efforts across the first and second lines, to establish standards for reliance by 2 LOD on first-line tests, nor to handle the increased resource implications in the 1 LOD from increased 2 LOD testing.

EY point of view

- The existing and future burdens of 1 LOD monitoring and surveillance will mandate increased investment in data integrity, and technology solutions including more holistic and automated 1 LOD data gathering, analysis and reporting.
- The control assurance mandate will increase for banks, impacting both the first and second lines, which will require ongoing formalization of controls and agreement on the level of assurance required for different types of controls. We expect a continued focus on enhancing technology solutions to support ongoing monitoring and “testing ready” workflow – i.e., creating audit trails that will make testing activities more efficient.

Does the 1 LOD control function perform any testing activity (separate from monitoring and surveillance)?

- **YES** – performs testing in formally/regulatory-mandated testing and attestation programs (Volcker Rule, CCAR CFO attestation, etc.)
- **YES** – performs testing for firmwide internal control initiatives (operational risk RCSA, compliance, model control and governance)
- **YES** – performs business-line-specific testing as part of business-line reporting and governance (i.e., business-specific quality control processes)
- **NO** – not at present

Source: *First line of defense survey report, EYGM Limited, November 2016.*
Interactive dashboards and workflow tools are under construction

Front-office supervision dashboards

All banks we surveyed have developed some form of custom reporting dashboard in the 1 LOD, typically tailored to desk or supervisor levels. While there are variances in the specific approaches and metrics in use, common categories include individual policy breaches and key regulatory and trading risk controls.

The dashboards themselves are almost universally described as “works in progress.” There are challenges in how dashboard reports and the metrics are produced across banks; this reflects limitations in the tools the front office has been able to build, as well as challenges with respect to the underlying data they are utilizing. Almost half (42%) report that the process of producing the dashboard itself is entirely manual.

Common metrics reported at granular levels, for day-to-day supervision, include:

- Cancels and corrections
- Fails
- Unsigned confirms
- Regulatory reporting breaches
- Volcker Rule metrics
- Risk limit or sign-off policy breaches
- Profit and loss (P&L) policy breaches
- Market abuse surveillance alerts (price exceptions, wash trades, and layering and spoofing)
- Other compliance policy breaches (personal account dealing, late training, trader mandate violations)

Limited capabilities

Relatively few banks report any ability in their tools to provide trending analysis, drill-through information about the underlying data, or pivots by trading strategy, risk book or individual trader, although some firms have begun to develop these capabilities. Similarly, workflow capabilities exist in some tools but this is fairly limited. And, most metrics are siloed by functional provider (operations metrics are separate from finance metrics, for example) and are not viewed in the context of other measures or risk profiles. While banks have aspirations to combine disparate data sources into more sophisticated risk analytics (for example, combining communications with trading data, or risk data with cancels and corrections), these efforts are generally nascent at best, and banks typically do not have a clear roadmap to explore vendor solutions or build out internal capabilities.

Percent dashboard production supported by a specific technology application

<table>
<thead>
<tr>
<th>Manual dashboard</th>
<th>Semi-manual dashboard</th>
<th>Automated dashboard</th>
</tr>
</thead>
<tbody>
<tr>
<td>16%</td>
<td>42%</td>
<td>42%</td>
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EY point of view

- Most of the front-office dashboard solutions are still limited in scope and cumbersome to run. However, the information provided via these tools is increasingly fundamental to the ability of business heads and individual supervisors to demonstrate that nonfinancial risks – like conduct risk – are well-controlled.

- There is significant potential to improve 1 LOD supervision and risk management and reduce manual processes by investing in development of technology tools. Benefits include not only better trader and supervisor-level transparency, but also efficiencies through workflow capabilities to better prioritize and manage exceptions and other action items, and improved ability to evidence steps taken by supervisors in response.

Expanding mandates and enhancing tools

Banks we spoke to largely agree that the mandate of the front-office control function will continue to expand. They point to a number of new and emerging topics driving that expansion over the next one to three years, with the top areas mentioned including:

- Continued regulatory change (although slowing) – planning and preparing for specific initiatives, such as Fundamental Review of the Trading Book (FRTB) and embedding cybercrime frameworks
- Emerging/enhanced supervisory expectations
- Response to cost control pressures and a focus on cost efficiency, while maintaining necessary standards
- Sustainability of processes and controls (i.e., making them repeatable, affordable and value-added over the long term)

We also asked front office control function management where they thought their banks needed to invest over the next several years to support the shift to first-line accountability. The responses highlight a shared belief in the importance of data and technology to enable effective management of non-financial risk. Top responses include the following:

- Automation of key control processes through technology development
- Enhanced surveillance capabilities
- Improvements in data quality
- More valuable management information, integrated into front-office dashboards

EY point of view

- A dedicated front-office control function is now a common practice for capital markets banks to enhance the ability of the first line to manage non-financial risks. Now these banks need to transform the capabilities of the 1 LOD control function to support the increased control mandate. Key strategies should include innovative use of data, analytics and other automated control approaches, enhancement and sharing of tools with the 2 LOD, and a focus on preventative controls over time.

- The emerging seniority of the function is a necessary trend, given the need for the first line to strategically invest in and execute transformation. It also should enable the function to have an active voice in enterprise-wide initiatives.

- Finally, in terms of what’s next, there is a need for work by both the first and second lines to define the standards and activities that will comprise each function’s responsibilities for major risk types. This definitional work will lay a foundation for the 1 LOD functions to appropriately invest in evidence of control and implementing 1 and 2 LOD testing.
Four steps forward

Despite the progress made by creation of front-office control functions, capital markets banks can further accelerate and optimize in four major ways:

1. Refine the operating structure. Banks should clarify the 1 LOD accountability model for front-office supervisors, staff and control function groups, and should leverage a target operating model that has been rationalized and agreed with second-line functions.

2. Define key controls. By identifying key controls across disparate lines of business, banks can prioritize testing or other assurance methods applicable to their most important controls.

3. Invest in tools. Banks should continue to develop existing dashboards and MI, control libraries, surveillance, analytics, and workflows with the goal of better evidencing 1 LOD control of nonfinancial risks. Key goals should be to:
   - Improve data quality and aggregation capabilities to support further automation of monitoring and reporting.
   - Increase use of advanced technology, data analytics, and process automation to improve effectiveness.

4. Enhance governance. Oversight of non-financial risk should include escalation and reporting to senior business management, key committees and independent risk functions, as well as issues tracking related to control remediation.

How EY can help

| Enterprise Target Operating Model | • Design end-to-end governance structure, including roles and responsibilities across first, second and third lines of defense  
| | • Align process, risk and control definitions across TOM, including common taxonomy, risk tolerance framework and risk rating scale  
| | • Define management information and enterprise reporting across lines of defense  
| | • Assess technology and data infrastructure to support strategic and tactical TOM functions |
| First Line Operating Structure | • Design effective first line control structure to clarify roles and responsibilities across supervisors, infrastructure and in-business risk and control staff  
| | • Assess first line governance and escalation processes including management information and reporting  
| | • Enhance first line risk and control identification, assessment, monitoring and reporting  
| | • Develop written control and supervisory procedure (WSP) documentation describing first line control activities |
| Metrics and Monitoring | • Assess risks and controls and develop metrics and other processes to support oversight  
| | • Assist with developing surveillance, including requirements definition, analysis of internal and vendor solutions for trade and communications surveillance, and assistance with POCs, data integration and roll-out  
| | • Assess alert thresholds, workflow, documentation and oversight across lines of defense  
| | • Standardize metrics and reporting processes, develop metrics monitoring suites (integrating dashboard reporting, issue management and management information on controls and alert workflows), design and deliver advanced analytics, including first line dashboard reporting |
| Data and Automation | • Assess and define requirements for data governance and data quality to support metrics and monitoring  
| | • Develop advanced data and technology platforms including aggregation layers to facilitate enhanced surveillance, monitoring and alert functions  
| | • Design automated information gathering and improved alert processes |
| Control Assessment and Monitoring | • Develop control assessment frameworks and operating models across three lines of defense  
| | • Develop assessment approaches including identification of risk drivers, key controls, assurance standards and control rationalization  
| | • Develop test plans covering targeted reviews and embedded coverage within impacted areas  
| | • Design and implement testing centers of excellence; automate and/or manage testing and monitoring processes |
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