Make sense of the inflation conversation

Key inflation-related action steps for risk and internal audit

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Content

There are many perspectives and articles on current market conditions and inflation but don’t worry; this isn’t one of them. We don’t need another armchair analyst projecting the market, but we do need to think differently about the work we do today — in particular, how inflation impacts our current risk management and internal audit activities — and do that now. So, let’s set aside market predictions, and understanding further turbulence is likely, instead focus on two things. The practical action steps required and the information internal audit leaders and risk management executives need to understand for adjusting audit coverage in these evolving, inflationary times.

The potent combination of market volatility and rising interest rates can have far-reaching impacts across your organization, all of which come with risk implications and cost pressures. The valuation of assets and liabilities, capital requirements, changes to predictions and assumptions in models, forecasting, customer behavior, and employee retention are just a few of the many variables that can be impacted. For risk and internal audit, managing this requires reassessing risk and prioritizing those risks that pose the greatest potential impact, both today and within the 2023 planning cycle. As you assess and plan what to do, bring risk management and internal audit functions to the table and consider these strategic steps to protect your business.

Risk assessment: reassess and reprioritize

This critical first step demands a proactive approach. Don't wait for your stakeholders to ask about plans and mitigation strategies. Take charge of the conversation now to assess market conditions and what they may mean for your products and businesses. Then, begin the reassessment process by looking first at your balance sheet, income statement and operations risks for the most likely impacted and material line items.

Consider where volatility is most likely due to higher market, credit and liquidity risks. Ask where complex models are in use. Review the last time models were stressed, backtested and had assumptions updated, then perform targeted reviews for the areas of immediate interest. Revisiting the performance of your model risk management program is just as important now as during any financial crisis. Additionally, consider operational areas where expenses may rise sharply. For example, auto insurers are experiencing a steep rise in repair costs and social inflation in settlements and jury awards. These factors can impact the income statement now and also affect product valuation, pricing, capital models and customers, and increase the incentives for fraud.

When reprioritizing your risk and internal audit plan, favor a top-down view of risk. The quantitative risk equation can and should be weighted more for market, credit and liquidity risk. And the qualitative assessment must focus on a top-down view that incorporates the most likely and material impacts. Consider and build in any other priorities identified through discussions with your risk partners and senior management. Then, cover the top reprioritized risks as soon as practicable, incorporating the next level risks into your outlook over your next-coverage cycle.

Example of likely impacted audits:

- Model risk management
- Capital management
- Governance and risk management
- Asset valuation
- Compression of fee incomes
- Decline in mortgage originations
- Quantitative tightening to manage liquidity
- Product pricing and rate increases
- Reserves and IBNR
(incurred but not yet reported) claims
- Claims processing — social inflation
- Disclosure controls

Proactively communicating your reassessing and reprioritizing approach to management and the board committees will be essential in aligning all parties around a shift in coverage strategy. Keep all parties updated with periodic reporting on all risks, coverage and impacts until the uncertainty associated with changing market conditions and inflation are comprehensively understood, measured, monitored, and governed.

Enterprise risk: focus on the big risks

As you begin implementation, the big risks are important: valuation, capital requirements, hedging and pricing products, and claims costs will all experience varying impacts. Even as you read this, know that the already volatile market has just changed again — and so should your models. Those midyear projections may need course correction and modification. During market upheaval, some models with simpler formulas, certain assumptions and underlying math can experience inaccuracies and additional model validation. You'll need to assess other variables, too: the strain on risk governance and your organization's tolerance for risk, both of which can place stress on the system and result in exposure. Adjusting models and appropriate coverage as frequently as needed is essential, as is scenario planning, which will help the organization understand not just what happened, but what other scenarios may play out and the associated risks they bring.

The pivotal role internal audit must play

The internal audit team (IA) is a valuable champion for this entire process. IA helps leadership ask the right and critical risk-related questions given market change and emerging risk factors. How will the company perform? How might products be affected? How should underwriting and pricing be adjusted based on current and projected conditions? And what processes, safeguards and controls should be put in place? IA is responsible for holding the organization accountable for considering inflationary risk in its business operations and actions. That may involve validating appropriate governance actions, overseeing change management, and helping to ensure model risk management is operating effectively during periods of volatility and severe stress on the organization. IA must act as a critical partner and copilot in helping achieve all of these goals and as lead communicator for providing assurance and updates to executive leadership and the board.

Questions audit committees will be asking:

- How have market conditions and inflation influenced your 2023 cycle?
- Where do changing market conditions and inflation impact your company the most, and how are you addressing them?
- Which are your top models at risk, and what are you doing to re-evaluate them or model risk management's coverage of them?
- What forecasting and stress testing has been modified, and what are your plans to provide audit coverage?
- What is the IA coverage plan and the plan to report out to the audit committee and/or board by topic and frequency?

As you work through systematic reassessing of risk and reprioritization with a laser focus on those biggest threats, be sure to also embrace a mindset of uncertainty and adaptability. Market conditions will continue to evolve, and as they do, so must your risk management controls and processes. It will be essential to monitor risk factors and adjust audits going into 2023 and for the foreseeable short-term, and potentially long-term, future. As you do so, check in with those impacted business units monthly to identify any new business line developments that may require a plan adjustment. Finally, align your C-suite leadership around the overall plan, as well as any changes, for the more turbulent path ahead.

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18412-231US
2211-4144223
ED None

ey.com

Contacts

Jessica Rodgers
Partner, EY Financial Services
Enterprise Risk Leader
+1 212 773 0736
jessica.h.rodgers@ey.com
Ernst & Young LLP

James (Jim) Gannon
Managing Director, Financial Services
Business Consulting
+1 212 773 3780
james.gannon@ey.com
Ernst & Young LLP

Karl Erhardt
Executive Director, Financial Services
Business Consulting
+1 973 908 1932
karl.erhardt@ey.com
Ernst & Young LLP