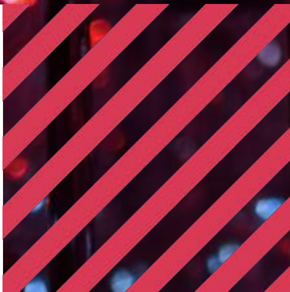
Spotlight on ‘Material Controls’



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This 'spotlight' reflects our current thinking and is informed by our experience across the market. We will make periodic updates as market practices develop.

1. Introduction

This spotlight on material controls focuses on a potential approach that management and boards could use for determining their material controls as part of their responsibilities under the FRC's UK corporate governance code (the Code).

Boards' responsibilities for monitoring, reviewing and reporting on the effectiveness of all material controls, including financial, reporting, operating and compliance controls, have been part of the Code for some time, but were enhanced when the Code was revised in 2024. Under the revised Code, boards will be required to make a declaration as to the effectiveness of all their material controls as at the balance sheet date, as well as describe material controls that did not operate effectively at that time. This will require management and boards to first determine what are their material controls.

The FRC Code guidance states that material controls could include, but are not limited to, controls over risks that could threaten the organisation's business model, solvency, liquidity etc; controls over reporting that could be price sensitive; fraud controls; or certain IT controls.

Material financial and non-financial reporting controls

Material financial and non-financial reporting controls, in our view, are those that address the risks that financial and non-financial reporting is materially incorrect. We have provided some thoughts on how to approach this assessment in this paper, but our focus is, primarily, on determining material operational, compliance and other material controls, as we believe this could be more challenging.

Material operational and compliance controls

When determining material operational and compliance controls, we think a sensible starting point would be the principal risks in the annual report.

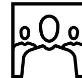
Principal risks can be complex and highly aggregated, so a drilling down will be needed, for example, using the organisation's risk register or current taxonomy/risk categorisation. There are also likely to be multiple controls over any area of material risk, so, again, a drilling down and refinement will be needed to ensure an effective, but proportionate approach.

In the pages that follow we provide a description of a potential approach and real life examples of how it would work in practice. Our potential approach is in alignment with our Restoring Trust guide, where more detail is provided on the overall process supporting the board's responsibilities.

2. Approach to determining material financial and non-financial reporting controls

Identify material financial reporting

Boards and management should identify which of their areas of reporting are material. In doing so they could adopt the principles of statutory audit or other regulatory regimes such as the Sarbanes Oxley act in the US to determine a materiality threshold for financial reporting. These typically are based on measures such as profit; Revenue; or Balance Sheet criteria (such as asset values). This assessment should also take into account any additional qualitative risk factors, such as complexity in accounting, or historical errors, which elevate the inherent risk to any account classes or group entities.



Identify material non-financial reporting

Determining material non-financial reporting will involve greater judgement from the board and management as it may involve qualitative and quantitative data. Judgement as to what is material may include factors such as:

- What information reported by businesses do investors and other key stakeholders rely on when making decisions and what could the potential impact or implications of misstating this be.
- The potential impact to the business that could occur if the information is incorrect or misleading.
- Whether there are existing, or anticipated new, relevant reporting standards.
- Whether the information contains significant estimates or judgements.
- Whether there is existing guidance to inform materiality such as the double materiality guidance in the European sustainability reporting standards.

Identify material controls

Once the material financial and non-financial reporting areas have been identified, the controls most relevant to this reporting area should be identified and assessed as to whether they reduce reporting risk to a tolerable level. To be most effective, controls will need the right level of precision and depth of coverage to give sufficient assurance around the completeness, accuracy and validity of material reporting to the extent considered necessary by the board. These controls (either individually or in aggregate) could be considered material.

3. Approach to determining material operational and compliance controls

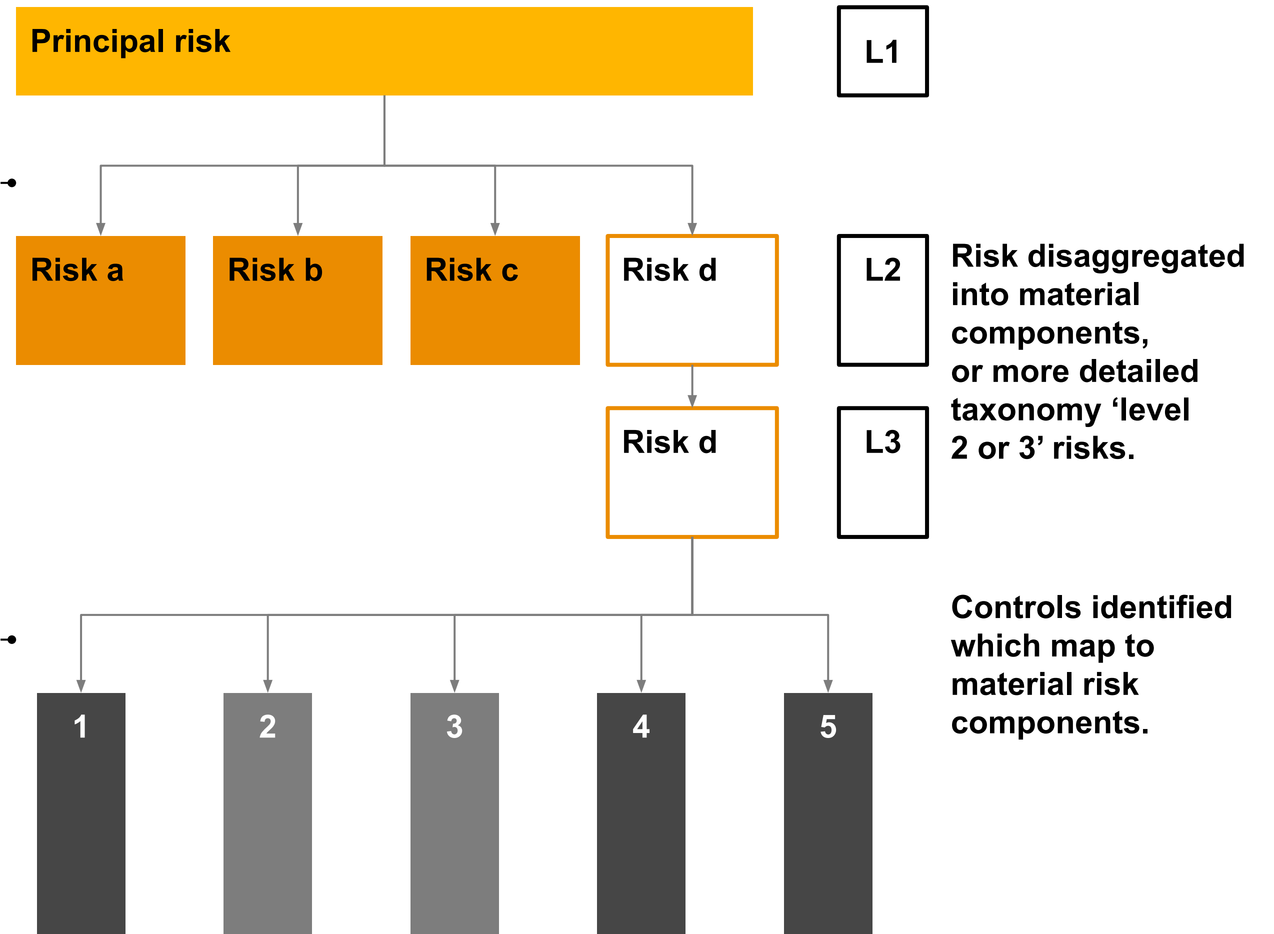
Step 1 - Principal risks identified.

Step 2 - Disaggregate principal risk into material components.

Principal risk disaggregated to sufficient degree of detail to identify its most material components. If businesses hold a risk register, this may require disaggregating to greater levels of precision (or 'levels 2/3' in risk taxonomies). This disaggregation should be undertaken to sufficient extent to allow individual controls to be identified and meaningfully attributed to the disaggregated risk(s). The inherent impact and likelihood of the disaggregated risks should be assessed to determine which are considered material.

Step 3 - Identify relevant controls that mitigate the material risk to a tolerable level.

Controls relevant to the risk component should be identified.
The controls that will be material (either individually or in aggregate) will be those that reduce the likelihood of the risk occurring to a tolerable level.
To be most effective, controls will need the right level of precision and depth of coverage to prevent the risk occurring.



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Practical examples – linking principal risks to material controls

Practical example: Risk of regulatory non-compliance

This example is based on an a real-life scenario from an insurance business, highlighting how a risk-based approach to identifying material controls can be carried out in practice. The risks and controls contained here are illustrative only and have been simplified for the purposes of the example. We would anticipate that, for example, controls would be specified with a greater degree of precision than what follows.

Context and principal risk – Failure to comply with relevant laws and regulations

A large insurance business has identified the failure to comply with relevant laws and regulations as a principal risk. Its rationale is that the insurance sector is highly regulated by the FCA and PRA. Given the size and complexity of its business, and the number of compliance requirements in place, it has determined there is a strong inherent likelihood that it may unintentionally breach those requirements. It has assessed the potential inherent impact as material, given the possibility of some form of a sanction or penalty. As the principal risk covers a very broad area, the business is now seeking to identify the components of that principal risk it believes are most material so as to define and apply material controls. It will do this through disaggregating the risk into successively more granular layers (‘level 2’ and ‘level 3’) of its risk taxonomy to home in on the most material components. We will focus in on a single risk component of the principal compliance risk.

Risk disaggregation

Level 2 risk

Non-compliance with the new FCA consumer duty requirements has been identified as a material component of the principal risk. The business considers it possible that a breach may occur given this is a new requirement which the business must adapt to, and the business deals with a very large number of customers. It considers the impact of the risk crystallising to be high as the FCA have the power to implement a range of fines or sanctions in the case of breaches, which can be significant, financially and operationally.

Level 3 risk

The business has further assessed a failure to identify vulnerable customers (VCs) and support them as the most significant component of the Level 2 risk. Its rationale is that vulnerabilities may not be immediately obvious to staff contacted by phone or internet so there is a heightened likelihood that staff will not identify VCs or offer measures to support them. The potential inherent impact of the risk crystallising is as per the Level 2 risk.

Having identified the material components of the principal risk, the business must now identify what it considers to be its most important controls over those elements, ie. its material controls.

Controls identification extracts

The business has identified the following controls against the level 3 risk:

C.01 Staff receive annual training to identify VCs and understand how to respond. Training completion is monitored by the L&D team and staff are not permitted to handle customer interactions until they complete the annual training assessment.

C.02 Staff prompt sheets are provided and regularly reviewed to ensure staff handling communications are prompted to ask questions to help identify and record VCs, and offer reasonable adjustments for them.

C.03 Telephone and internet exchanges are quality assured to validate that VCs have been identified. The QA team test interactions on a sample basis to identify where a VC may be present. Where this is the case, the tester assess if they have been correctly identified as a VC and responded to appropriately by staff.

C.04 Key risk indicators to identify VCs and offer suitable adjustments are reported and reviewed by management. The outcomes of assurance testing are compiled and reported to senior management on a monthly basis, with any trends and root causes commented on. Management review the risk indicators and explanations, and take action where appropriate such as identifying staff who consistently underperform, or implementing remedial training.

Rationale

The business considers the combination of controls C.02,C.0 3 and C.04 as material as they reduce to a tolerable level:

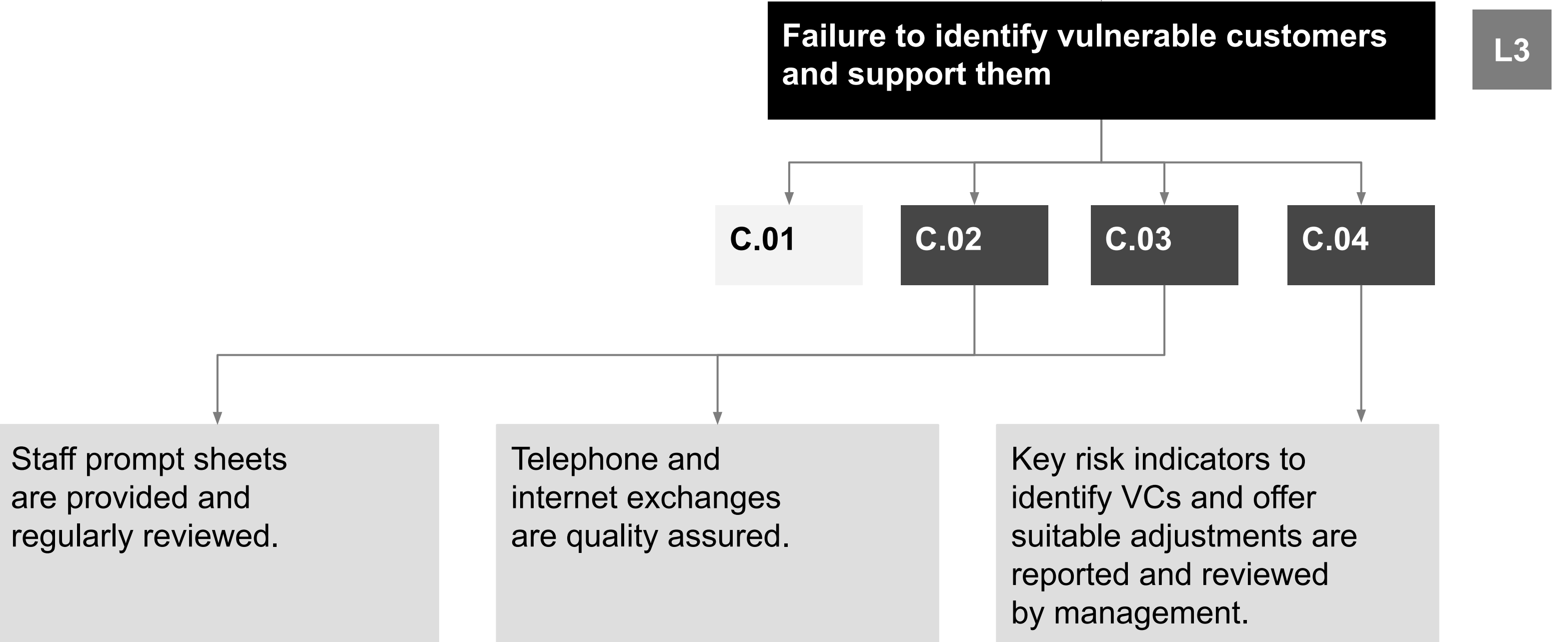
- The residual likelihood of the risk occurring through provision and review of prompts and oversight of performance via KRIs and quality assurance.
- The residual impact of the risk through QA testing of calls where any vulnerable customers missed can be re-contacted if required. Additionally the presence of controls demonstrates to the FCA that the business is taking reasonable measures to identify VCs.

Visual representation – Risk of regulatory non-compliance

Step 1 - Principal risk is identified.

Step 2 - Disaggregate principal risk into material components.

Step 3 - Identify relevant controls that mitigate material risk to a tolerable level.



Practical example – Motor finance credit risk

This example is based on an a real-life scenario from a motor finance business, highlighting how a risk-based approach to identifying material controls can be carried out in practice. The risks and controls contained here are illustrative only and have been simplified for the purposes of the example. We would anticipate that, for example, controls would be specified with a greater degree of precision than what follows.

Context and principal risk – Potential for financial loss resulting from a borrower's failure to repay a loan or meet contractual obligations

Credit risk for a motor finance company refers to the potential for financial loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Given the nature of the motor finance business and given it operates on the basis of credit, this risk is considered fundamentally material as managing it effectively is critical to ensure financial stability and sustainable profitability. The risk will depend on a number of factors such as borrower creditworthiness, collateral value (e.g. the motor vehicle's worth), economic conditions and others. The organisation has assessed the potential inherent impact as material, given the possibility of a number of those factors to result in higher than anticipated defaults and therefore losses. The next step for the business is to identify the components of that principal risk it believes are most material so as to define and apply material controls. This example focuses in on a single risk component of the principal credit risk.

Risk disaggregation

Level 2 risk

The risk that the value of the collateral is not sufficient to cover the outstanding debt in the event of default is a material component of the principal risk. This includes market value fluctuations and well as legal matters impacting the market value. The business considers that given the main component on which finance is provided is the value of the collateral and the risk that the value is not sufficient to cover the outstanding debt in the event of default. It considers the impact of the risk crystallising to be high as the if the losses incurred are outside the estimated available capital this will create liquidity problems for the organisation which will stop it from meetings its own obligations.

Level 3 risk

The organisation has further analysed the contributors to the collateral risk as valuation risk, concentration risk, condition and maintenance risk among others. Valuation risk was deemed to be the most significant component as if the valuation of the underlying collateral, in most instances the motor vehicle, the motor finance itself will carry a higher credit risk from the beginning. The potential impact of the risk crystallising is as analysed under level 2 risk.

Having identified the material components of the principal risk, the business must now identify what it considers to be its most important controls over those components, ie. its material controls.

Controls identification

The organisation has identified the following controls against the risk:

C.01 – Annual review of credit risk management framework – criteria, eligibility etc for collateral.
The CRM can assist by setting the framework for comprehensive risk assessment and accurate valuation of the collateral through the guidelines and further policies included which provide the landscape in which the organisation operates in terms of providing finance. The annual review of the framework ensures it remains up to date and any updates in the policies and procedures is included to ensure continuous improvement.

C.02 – Initial vehicle validation checks – HPI and valuation information and reviews are necessary requirements prior to approving the financing. This is important information that will feed into the risk scoping and will influence the final decision to be made. Reviewing to ensure accuracy and completeness is a crucial component of the process.

C.03 – Approval limits/delegated authority structures for reviewing/approving loans ensures that an appropriate authority is making the relevant decision for approving the finance to be issued to the lender on the basis of the risk scoring of the financing agreement and level or responsibility of the individual.

C.04 – Monitoring activities (Collateral management)
– During the loan's cycle there are essential monitoring activities that are carried out including periodic revaluation to identify significant drops in the collateral value early allowing for proactive measures to be taken.

Rationale

The business considers the combination of controls C01, C.02 and C.04 to be material as they are the ones they would rely on to sufficiently mitigate the material risk within the risk appetite limits.

- The residual risk after the initial vehicle validation check with the combination of the monitoring activities is acceptable for the organisation
- There is a framework that governs all transactions which is reviewed and signed off, covers the risk at a higher level and in aggregate.

Practical example – Motor finance credit risk (continued)

Step 1 - Principal risk is identified.

Step 2 - Disaggregate principal risk into imaterial components.

Step 3 - Identify relevant controls that mitigate material risk to a tolerable level.

L1 — Potential for financial loss resulting from a borrower's failure to repay a loan or meet contractual obligations

L2
- Risk a
- Risk b
- Risk c
- Risk d: The value of the collateral is not sufficient to cover the outstanding debt in the event of default.

L3 — Failure to accurately assess the valuation of collateral

- C.01
- C.02
- C.03
- C.04

Annual review of the credit risk management framework.

Initial vehicle validation checks.

Monitoring activities.

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