

The Secretariat,
The Basel Committee on Banking Supervision,
CH-4002 Basel,
Switzerland

Via email: baselcommittee@bis.org

5 March 2012

Dear Sir / Madam

Consultation Paper: The Internal Audit Function in Banks

The Association for Financial Markets in Europe¹ ("AFME") welcomes the opportunity to comment on the consultation paper and supports the Basel Committee on Banking Supervision's (the Committee) objective of setting objective standards for the internal audit function within banks.

General Comments

AFME respectfully suggests that the recommendations in the consultation paper could be enhanced in three ways:-

Firstly, many AFME member firms undertake continuous assurance procedures rather than basing their audit work solely work on a more rigid audit cycle. Hence, AFME recommends that Principle 6, paragraph 29 should be amended to state:-

"The head of internal audit *should ensure* that all the entities and all the activities of the bank are subject to assurance procedures within an appropriate period of time based on the relative risk of the entities."

Also, AFME recommends that paragraph 49 be amended to state:-

The audit committee reviews and approves the audit plan including the assurance procedures to be utilised in achieving the appropriate coverage of the bank's activities."

Paragraph 29 of the Consultation Paper appears to require that each bank adopts an audit cycle. In contrast, paragraph 49 suggests that a bank has discretion on whether or not to adopt an audit cycle. Many AFME member firms adopt continuous assurance procedures, as noted above rather than undertaking their tasks in relation to a more rigid audit cycle as they believe that the former methodology allows them to monitor throughout a given time period any changes in risk to a bank's entities and activities and to adapt their work programme accordingly (in

¹ The Association for Financial Markets in Europe ("AFME") represents a broad array of European and global participants in the wholesale financial markets and its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME, with offices in London and Brussels, is the European regional member of the Global Financial Markets Association. For more information, visit www.afme.eu

contrast to a work schedule established by reference to an audit cycle which allows little, if any flexibility, to the work plan should risks materially change within a set period). AFME submits that the words all references to “audit cycle” be deleted, so that this methodology will be recognised in the Principles.

Secondly, AFME suggests that, whether or not, the head of internal audit operates an audit cycle, the amount of audit work conducted should be proportionate, on a risk based approach to the perceived risks. Accordingly, the following should be added to the end of the fourth sentence of paragraph 29:-

“and that the level, type and frequency of the assurance procedures should be commensurate with the risk of the particular entity or activity.”

Thirdly, AFME believes that it is important that the terms “audit” and “audited” be expressly defined. One interpretation of these terms is that the Committee expects, as per paragraph 29 above, that one or more internal auditors review an entity or activity for a period of time with an audit report being produced at the conclusion of the review. Another interpretation is that the internal auditor regularly receives and monitors management information about a particular entity or activity without actively reviewing the operation in question. Accordingly, we suggest that that the terms “audit” and “audited” be replaced with “assurance” and “assurance procedures” which encompass both reviews that results in reports *and* the continuous monitoring of the bank’s entities and activities as noted above.

The Principles

AFME submits its comments on individual Principles and their respective supporting paragraphs.

Principle 1: The final sentence of paragraph 10 appears to suggest that internal auditors may “design” internal controls. AFME suggests that it is not a primary duty of internal auditors to design internal controls, although AFME does recognise that designing such controls may be an ancillary function of an internal auditor. AFME notes that paragraph 13 states “The internal audit function should not be involved in designing.....internal control measures.” Accordingly, AFME believes that the Committee should omit any reference to the internal auditor designing internal controls in paragraph 10 in order to resolve the apparent inconsistency.

Principle 2: Paragraph 14 recommends that internal audit staff rotate periodically within the internal audit function where such rotation does not jeopardise competence and expertise. AFME notes that certain internal audit staff will have particular expertise in such matters such as prudential requirements, valuation methodologies or liquidity requirements. Accordingly, AFME recommends that the Committee recognise and state that certain internal audit staff may possess particular expertise that does not lend itself to rotating of roles within the internal function.

Principle 2: We consider that paragraph 15 which notes the independence and objectivity of the internal audit function may be undermined, inter alia, if the staff’s remuneration is *linked* to the financial performance of the bank as a whole should be deleted. We suggest it is axiomatic that, in a general sense, the remuneration of *all*

staff, including internal audit staff, is linked to the financial performance of their employer. However, we recognise that other factors will affect the remuneration of individual audit staff such as individual performance, the seniority of the person and the degree of supervision and management of staff, just as these factors are considered in the remuneration of staff across many industries in the private sector. Accordingly, we submit that the Committee deletes this particular paragraph as it feels that the paragraph gives an erroneous focus on the financial performance of a bank in setting the remuneration of its audit staff.

Principle 3: Paragraph 17 mentions outsourcing arrangements (e.g. when external experts are engaged to support the bank's internal auditors). AFME is aware that some of the world's largest banks use "guest auditors" who are staff employed within a bank's various control functions and are transferred to the internal audit function for a specific time period or for a specific project as they have particular expertise in order to assist the internal audit function. The head of internal audit ensures that the independence and objectivity of the function is not undermined by the use of "guest auditors". We suggest that it is important that the Committee state that use of "guest auditors" is permitted provided that adequate safeguards are used.

Principle 6: Paragraph 26 states the scope of the internal audit function should examine and evaluate the effectiveness of the internal control framework of the entire bank. AFME recommends that the Committee considers how an internal audit function of a particular bank should examine and evaluate the internal control framework of joint ventures between the bank in question and one or more other banks. We recommend that the Committee state, in general terms, that the heads of the internal audit function of each of the banks collectively agree, between themselves, which of their teams will conduct a review of the joint venture's activities, if appropriate, and with the conclusions of the review being shared with their counterparts from the other banks. An alternative approach would be for the review activity to be rotated between the internal audit function of each bank over a period of time, again with the results being shared with their counterparts. Another possibility is that the review could be conducted by a joint team comprising of staff seconded from the banks in question.

Principle 6: Paragraph 27 states that the internal audit function should evaluate the "effectiveness and efficiency of operations". AFME respectfully suggests that evaluating the *efficiency* of operations is not within the remit of the internal audit function. It is the proper role of a bank's management to evaluate the efficiency of its operations. Accordingly, AFME recommends that any references to the evaluation of the efficiency of an internal control system be deleted. (Please also see our comments on paragraph 59). Additionally, in order to avoid confusion over the use of "operations", which, in many banks refers to various back office functions, AFME suggests that "operations" is replaced with "activities".

Principle 7: Paragraph 30 advises that internal audit should conduct regular "reviews" of areas dealing with regulatory matters. AFME suggests that "reviews" is replaced by "assurance procedures" as the former term might be interpreted by some to mean an audit with an output of a report that include recommendations for improvement.

Principle 7: Paragraph 32 advises that “The scope of internal audit should include assessing all provisions of this regulatory framework.....”, which contemplate an assessment of the adequacy of the bank’s system for assessing its capital resources. AFME suggests that the Committee makes it clear that it is not within the remit of internal audit to assess the ability of the bank to fund its activities and the remit of internal audit is confined to evaluating the bank’s *system* for assessing its own capital resources.

Principle 7: Paragraph 37 advises that the activities of the compliance function should be subject to periodic review by the internal audit function. AFME - in analysing the nine paragraphs supporting Principle 7 notes - “periodic review” is only mentioned in relation to the compliance and not in relation to risk management, capital adequacy and liquidity and regulatory and internal reporting, thus causing uncertainty about what is required. In order to avoid any possible misinterpretation of the term “periodic review”, we suggest that the term “regular review” is used, subject to our comment made in relation to paragraph 30.

Principle 8: Paragraph 41 requires each bank to have its own permanent internal audit function. AFME is aware that some banking groups operate their internal audit function on a group basis and utilise the internal audit group function as a group function rather than, as the Principle envisages, requiring each bank within a banking group to have its own permanent and dedicated internal audit function. It is important that the Committee recognises and states that the group arrangements described above are acceptable provided all banking activities within the group fall within the scope of the evaluation of the group internal audit function.

Principle 9: Paragraph 45 advises senior management to inform the internal audit function of various matters at any early stage. AFME suggests to the Committee that a member of the internal audit function be invited to sit, as an observer, on all bank committees, boards, working groups, etc. Such participation would assist greatly in the flow of information to the internal audit function.

Principle 11: Paragraph 52 advises that the head of the internal audit function should ensure that the internal audit staff are persons of integrity. AFME would like to advise the Committee that most banks adopt procedures to ascertain the integrity of all staff in any position that could be deemed to be sensitive. Accordingly, AFME does not believe that additional particular measures to be adopted for internal audit would provide any benefit. Furthermore, it is extremely difficult, if not impossible, for any bank to *ensure* that its staff are persons of integrity at a given point in time. A bank can only take reasonable measures, particularly in light of each employee’s data protection rights and a right to a private life, to ascertain whether an individual staff member is a person of integrity at a particular moment.

Principle 13: Paragraph 59 again mentions the role of internal audit in assessing or evaluating the efficiency of the internal control system. We refer to our earlier comments on paragraph 27.

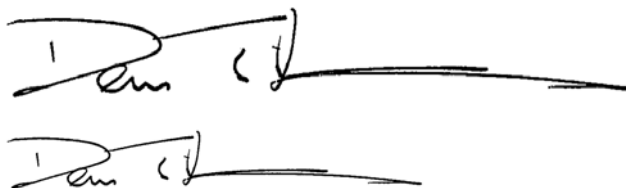
Principle 14: Paragraph 60 discusses the role of the internal audit function within a group and each of its various components. AFME would welcome guidance on how the internal audit function should manage the difference in expectations of supervisors, where they exist, particularly between the expectations of the lead

supervisor of a group and the expectations of a local supervisor for a branch or subsidiary. It is possible that confusion may arise between this Principle and Principle 8 which calls for each bank to have its own internal audit function. AFME would welcome clarification that a group of companies that has many banking subsidiaries may establish and operate the internal audit function as a group function, which will audit banking subsidiaries from time to time.

Principle 15: AFME would suggest that the second sentence of paragraph 65 is superfluous.

Principle 16: AFME cautions the Committee about the bullets in paragraphs 77 and 79 as they may lead to supervisors engaging with internal audit exclusively on these matters to the exclusion of other matters which may deserve the attention of the parties, such as disaster recovery planning and testing, the suitability of particular accounting policies adopted by the bank, sales practices for retail customers and compliance with sanctions legislation. AFME recommends, therefore, that the Committee advises that each supervisor communicates with the internal function the particular matters of interest to the supervisor of the bank in question and not only rely exclusively on the items in paragraphs 77 and 79.

I trust that the Committee will find this submission by AFME to be of assistance in its deliberations. Please do not hesitate to contact me should you require any further information.

The image shows two handwritten signatures in black ink. The top signature is a stylized, cursive script that appears to read 'Denis O'Connor'. The bottom signature is a similar but slightly different cursive script, also appearing to read 'Denis O'Connor'. Both signatures are followed by a horizontal line.

Denis O'Connor
Managing Director
Association for Financial Markets in Europe