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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

Dear Sir/Madam,

Re: CBA¹ Comments on the Basel Committee's Consultative Document: *The internal audit function in banks*

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) document: *The internal audit function in banks* (Consultative Document).

As a general comment, we believe the Consultative Document frames a reasonable basis of principles for internal audit functions in banks, and in many cases offers expanded guidance that is helpful as compared to current guidance. In our view however, there are a number of aspects where clarification or reconsideration of the underlying basis supporting the principles is required. In particular, we respectfully submit that the supervisory expectations underlying the principles in the Consultative Document should be less prescriptive to afford the many varied institutions the ability to determine the basis of their adherence to the principles consistent with their board and company arrangements.

For your consideration, below is a summary of our key concerns. Additional detailed discussion is included in the attached.

Principle 13: '3 lines of defence' model

Paragraphs 55-59 of the Consultative Document articulate how a bank should defend itself against the risks it faces using a model called the '3 lines of defence'. In our view, it is inappropriate to recommend such a sweeping model in a consultative document designed for only one of the control functions - internal audit. It should be the responsibility of senior management and the board to define the model, consistent with their overall responsibility for the

¹The Canadian Bankers Association works on behalf of 53 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 267,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness.

system of internal control. We therefore believe that that 3 lines of defence model would be more appropriately located in a 'governance'/'risk' type document instead of the Consultative Document which merely concerns the internal audit function in banks.

Further and notwithstanding our above mentioned preference for the removal of the '3 lines of defence' model from the Consultative Document, interaction between the second and third lines is not defined although the principles indicate internal audit assessment of the effectiveness of controls in such areas. We therefore recommend revisions that:

- eliminate the requirement for a model that extends beyond internal audit; and
- reference the internal audit interaction with other control functions.

Annex 2: Responsibilities of a bank's audit committee

Given that the responsibilities of a bank's audit committee are fundamental to the governance of a bank, we question the appropriateness of including the content in Annex 2 in the Consultative Document. We believe that such content is better placed in a document that concerns 'governance' rather than the internal audit function in banks.

Despite our comments above, we are of the view that the main areas of responsibility of the audit committee listed in Annex 2 are overly prescriptive and need to be clarified or supplemented. Items which are most problematic include:

- item (n): *"reviewing the assessment by senior management of the head of the internal audit function and the key internal auditors"*; and
- item (o): *"approving, or recommending to the board for its approval, the appointment, re-appointment or removal of the head of the internal audit function and the key internal auditors"*.

Contrary to item (n), we believe that since the internal audit leader is responsible for managing staff and reviewing performance of their reports, they should have a role in determining their reviews. Practically, the audit committee would not be sufficiently familiar with the performance of key auditors to effectively assess, comment or evaluate their performance review. Further, regarding item (o), we believe that the responsibility for appointment or removal of key internal audit staff to the audit committee is unusually prescriptive and unnecessary as the board should have the ability to decide on the appropriate committee for executive appointments (e.g. human resources is a viable alternative). We therefore recommend that item (o) be revised to allow board flexibility with respect to the approval/appointment/removal of key internal auditors, thereby eliminating the need for the requirement to be within the prevue of the audit committee.

We thank you for taking our comments into consideration and would be pleased to discuss these issues further at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to be 'J. E. Smith', written in a cursive style.

CBA comments on BCBS Consultative Document – The internal audit function in banks

CBA Members' Comments and Requests for Clarification
OVERALL COMMENTS
<ul style="list-style-type: none"> ▪ Could the Basel Committee clarify the timeline for the implementation of the expectations set forth in this Consultative Document?
Supervisory expectations relevant to the internal audit function
<p>A. The internal audit function (Principle 1)</p> <ul style="list-style-type: none"> ▪ Paragraphs 8 & 9: Paragraph 9 indicates the role of internal audit in improving the effectiveness of processes whereas in paragraph 8, reference is to the assessment of a bank's internal control, risk management and governance – absent the reference to “processes”, thereby potentially implying an expansion of the mandate beyond assessing the effectiveness of controls. We recommend that “process” be inserted in paragraph 8 for consistency and certainty.
<p>B. Key features of the internal audit function (Principles 2, 3 & 4)</p> <ul style="list-style-type: none"> ▪ Principle 2: <ul style="list-style-type: none"> • In practice, internal audit generally has dual reporting lines, functionally to the audit committee and administratively to the CEO or another high ranking officer. Therefore, could the Basel Committee incorporate reference to both reporting lines in support of the principle of independence. • We suggest deleting the word “<i>standing</i>” and replacing it with “<i>stature and authority</i>” as this more clearly aligns to independency and objectivity requirements of an internal audit function. “<i>Standing</i>” may not be a clear concept in all jurisdictions. ▪ Paragraph 12: Internal audit's access to the board and senior management is also a key element in ensuring its independence and as such, we believe that it should be added (we note that it was mentioned in the 2001 version of the guidance). ▪ Paragraph 14: “<i>It is therefore recommended, whenever practicable and without jeopardizing competence and expertise, that the internal audit staff rotate periodically within the internal audit function</i>”. The paragraph is unusually proscriptive as it delves into the basis of resource management by the internal audit leader. While the intention of ensuring objectivity is appropriate, the basis may not be as staff rotations are but one means of addressing the matter. Further, staff rotations can be a particularly challenging process with potentially significant negative implications for the individuals and the audited IA practice's business/control areas. We therefore recommend a revision to paragraph 14 to require that the internal audit head have suitable arrangements in place to ensure objectivity of personnel (which is consistent with the overall principle) and that such arrangements be reviewed periodically with the audit committee. ▪ Paragraph 15: Paragraph 15 states that the basis of remuneration can undermine independence and objectivity if compensation is linked to financial performance of a group or the bank as a whole. While an argument may be made for remuneration of an auditor not to be linked

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solely to the business line for which they are responsible, there are sound arguments for not prohibiting a linkage to performance of the bank (including ability to move staff among units and other compatible areas that may be hindered by a differentiated compensation process specific to internal audit). The proposed approach is also very restrictive as to the use of any enterprise level variable or performance based compensation (e.g. use of deferred share units, etc). The implication might be that all compensation would have to be base salary. We therefore recommend that this paragraph be revised to require that the internal audit head ensure that the basis of compensation be consistent with the independence and objectivity of the function and that the basis be reviewed with senior management and the audit committee.

- Paragraph 17: When outsourcing is used, it is stipulated that *"it is the responsibility of the head of internal audit... to ensure adequate transfer of knowledge"*. Since transfer of knowledge is not always feasible or even contemplated in outsourcing arrangements, we believe that the Basel Committee should qualify this text by adding *"whenever practical"*. Doing so will also ensure consistency with paragraph 65 (Outsourcing of internal audit activities) which states that: *"The head of internal audit should ensure that, whenever practical, the relevant knowledge input from an expert is assimilated into the organization"*.

Paragraph 21: We recommend the deletion of the remainder of the paragraph after the first sentence of paragraph 21 (i.e. keep: *"The head of the internal audit function and all internal auditors should avoid conflicts of interest"*). We believe this sentence articulates the principle and that the remainder of the paragraph is unnecessary and overly prescriptive.

C. The internal audit charter (Principle 5)

- Principle 5: We recommend that *"purpose, standing and authority"* be replaced with *"purpose, authority and responsibility"*. This is clearer and in line with the Institute of International Auditors Standard 1000.
- Paragraph 24: As a general comment, the appropriateness of the elements noted in paragraph 24 could vary according to specific situations. We believe that the document should deal with principles rather than trying to outline specificities that ensure that arrangements made by the internal audit committee are consistent with and meet the committee's general obligation to remain objective. More specifically:
 - the third bullet relates to Section A.2. Section A.2 comments on remuneration. We do not believe that this should be included in the charter; and
 - bullets 5 (concerning criteria for outsourcing engagements) and 6 (concerning terms and conditions for advisory services) need to be rephrased since a charter usually does not get to this level of detail. As previously mentioned, we believe that the charter should be principle-based.

D. Scope of activity (Principle 6 & 7)

- Principle 6: *"Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function"*. We assume that this does not include the board and board committees.

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- Paragraph 29: We believe that the sentence: "*The head of internal audit should ensure that all entities and all activities of the bank are audited at least once within an appropriate period of time (audit cycle).*" is not practical since there are activities of the bank that may never get audited due to their relatively low importance or low risk. We believe that the text should be revised to impose a more general obligation on the head of internal audit to identify, on the basis of risk, key activities that ought to be audited.
- Paragraph 39: "*The audit of the compliance function should include an assessment of how effectively it fulfills its responsibilities.*" This specific statement is only made about Compliance and is inconsistent with the mandate and principles noted in the introductory paragraphs of the Consultative Document. We request that this statement be deleted.

E. Corporate governance considerations (Principle 8 & 9)

- Principle 9: Under Institute of International Auditors Standard 1000, the internal audit charter establishes the internal audit function's purpose, authority & responsibility, and the final approval of the charter resides with the Board. By appending the internal audit function to Principle 9, this seems to place the responsibility for the function with management, and seems misaligned to Principle 10 and Principle 12. We therefore suggest deleting reference to internal audit in this section as this is covered in Principle 10.
- Paragraph 41: Paragraph 41 elaborates on a permanent audit function while paragraph 42 introduces the potential for full outsourcing. This seems contradictory. We recommend that the Basel Committee clarify its intention in this regard. There should be some flexibility in selecting an appropriate model, but in any event it is a basis that should be approved by the audit committee.
- Paragraph 45: We believe that this paragraph should stipulate that senior management should also ensure that internal audit receives full support and cooperation in the conduct of its work.
- Paragraph 49: The wording: "*The audit committee reviews and approves the audit plan and, if any, the audit cycle*" implies that there is no need to have an audit cycle. This is inconsistent with paragraph 29 which stipulates that "*the head of internal audit should ensure that all entities and activities of the bank are audited at least once within an appropriate period of time (audit cycle)*".
- Paragraph 52: This paragraph states that individuals who are the head of internal audit should "*always have observed the law*". This may be an unreasonable expectation due to the broad application of the term "law" (e.g. would a parking offence mean that one has not observed the law for the purposes of the Consultative Document?). We suggest that this paragraph be deleted. In the alternative, the paragraph should be revised so that only criminal offences are observed.
- Paragraph 54: The last sentence of this paragraph is not clear as it appears to indicate that all open findings (versus significant findings) should have ongoing status updates to the board. We suggest adding "*significant*" as follows: "*the status of significant findings that...*", so that information is presented in a way that is usable for the board.
- Paragraph 58: Control functions and monitoring functions appear to be used interchangeably in this paragraph (as well as elsewhere in the consultation document). Their use should be harmonized. Further, examples provided of such functions should include the Finance function

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which usually controls financial information integrity and also performs operational controls over financial budgets and capital.

The relationship of the supervisory authority with the internal audit function

A. Benefits of enhanced communication between the supervisory authority and the internal audit function

- In a number of paragraphs there is a reference to "*enhanced communication*" without indicating what this includes. We recommend removing "*enhanced*" or ask the Basel Committee for clarification as to the basis of such communications.

Supervisory assessment of the internal audit function

A. Assessment of the internal audit function (Principle 17)

- Principle 17: In order to align to changes suggested to Principle 2, we recommend replacing "*standing*" with "*stature and authority*".
- Paragraph 73: "*In this respect, the audit committee's chair would be the appropriate person to be contacted by the supervisors.*" This sentence suggests that the supervisors, as a normal course, would contact the audit chair for discussion on the audit plan. We recommend that this paragraph be amended so that the primary discussion would be with the head of the internal audit function and only if further assessment by the regulator was needed would they discuss with the audit chair (i.e. on an exception basis).
- Paragraph 83: "*The remuneration structure of the head of the internal audit function and the key internal auditors*". We believe that it is impractical to expect the audit committee to approve compensation for "key internal auditors".

Annex 1 Internal audit function's communication channels

- We note that Annex1 does not describe a bank within a group structure whereby there is not only the local board and an audit committee, but also a head office audit unit. The Basel Committee may wish to consider this sort of arrangement.