Chartered Institute of Internal Auditors

29 February 2012

Mr Marc Pickeur
Chairman, Accounting Task Force Audit Subgroup,
Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Mr Pickeur,

Consultation response:

Basel Committee on Banking Supervision – The internal audit function in banks, Dec 2011

Please find attached our detailed comments on the above consultation, containing the specific views of the Chartered Institute of Internal Auditors, which represents internal audit practitioners based in the UK and Ireland.

The attached comments complement and in some areas expand on the response submitted by the Institute of Internal Auditors on behalf of the global IIA community.

Our responses have been developed in consultation with members operating in the banking sector in the UK and Ireland.

In summary, we are broadly very supportive of the proposals on updated guidance. We believe these will enable internal audit to increase its value through a clearer positioning as a high profile, influential and "Trusted Adviser".

In considering the proposals, it has been easy to agree and affirm most of the principles detailed, given their close proximity to the spirit and detail of our International Standards and Code of Ethics. However, we have made a number of recommendations with the intention of improving clarity and operation of the principles to help ensure they can achieve their intended objectives within a banking environment.

The Chartered Institute of Internal Auditors also looks forward to working closely with the UK's Financial Services Authority and its successors to develop the internal audit profession within the banking and financial services sector. We hope you will find our comments constructive and we would be happy to discuss any of them in more detail.

We are content for our comments to be considered as part of the public record.

Yours sincerely,

Dr Ian Peters
Chief Executive

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Basel Committee on Banking Supervision – The internal audit function in banks, Dec 2011.

About the Chartered Institute of Internal Auditors

The Chartered Institute of Internal Auditors is the professional body for the internal audit profession in the UK and Ireland.

We have been leading the profession of internal auditing in the UK and Ireland for over 60 years. A third of our 8000 members, which includes nearly 1000 heads of internal audit, work in the financial services sector.

The Chartered Institute of Internal Auditors is affiliated to the global Institute of Internal Auditors and the *International Standards* and *Code of Ethics* unite a global community of 170,000 internal auditors in 165 countries.

Summary of key comments

The following are key features that the Chartered Institute of Internal Auditors believes must be acknowledged in the revised supervisory guidance for assessing the effectiveness of the internal audit function in banks:

- The need to ensure the independence of the internal audit function with a clear reporting line to the audit committee.
- The importance of appropriate skills and competencies in the internal audit profession.
- The need to adhere to professional standards enhanced as necessary through sector specific guidance.
- Acknowledgement of a risk based approach to internal audit rather than a restrictive cycle approach.
- The need to take adequate account of regulatory requirements whilst not preventing internal audit from performing its wider, risk based function.
- The importance of an effective relationship between internal audit and the supervisory authority which also recognises the importance of the relationship between internal audit and the board and executive management.

Detailed comments

PRINCIPLE 1 – An effective internal audit function independently and objectively evaluates the quality and effectiveness of a bank's internal control, risk management and governance processes, which assists senior management and the Board of Directors in protecting their organisation and its reputation.

1. We agree with this Principle. This supports internal audit's positioning as a "Trusted Adviser"

PRINCIPLE 2 – The bank's internal audit function must be independent of the audited activities. This requires that the internal audit function has an appropriate standing within the bank, enabling internal auditors to carry out their assignments with objectivity.

2. We agree with this Principle. The reporting line proposed in Principle 12 will reinforce this independence.

3. In order to fulfil its duties, the internal audit function should have direct communication with the board. This can be achieved through the head of internal audit's regular attendance and participation in all key governance committees, including the main board. Attendance at these meetings provides opportunities for the head of internal audit to be apprised of strategic business and operational developments, and for high-level risk, systems, procedures or control issues to be raised at an early stage. A presence at such meetings also provides an opportunity to exchange information concerning the internal audit function's plans and activities.

4. We support the recommendation relating to the rotation of internal audit staff within the function. But it should be noted that in today's risk-focused corporate environment and internal audit world, internal audit staff rarely continuously perform the same tasks, and thus the risk of familiarity impacting the internal auditor's ability to make critical judgments is small. In smaller banks, the ability to rotate staff within the internal audit function may be more difficult.

5. We note the Task Force's comments relating to the potential undermining of independence and objectivity if remuneration is linked to the financial performance of the bank as a whole.

6. Remuneration structures should be designed to ensure that independence is not compromised. Decisions on internal audit remuneration should therefore rest with the audit committee. Their decisions on remuneration must also reflect the need for internal audit functions to be able to attract the right skills with appropriate knowledge of complex products.

7. **Recommendation:**

   I. The Task Force should confirm and support the principle of audit function attendance at key governance committees.

   II. The guidance should stress the need for remuneration structures to be designed to ensure that internal audit independence is not compromised, and that remuneration structures are effective in attracting the right skills and knowledge into internal audit functions. (Paragraph 15).

PRINCIPLE 3 – Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank's internal audit function.

8. Internal auditing is a distinct, specialist profession. All internal audit practitioners should hold specialist professional internal audit qualifications and commit to ongoing professional development, as important indicators of their professional competence. In the UK and Ireland, the IIA's Diploma and Advanced Diploma have been designed and accredited as high quality professional qualifications for internal auditors. Similarly, our global qualification (Certified Internal Auditor – CIA) denotes a level of professional standard and training. These qualifications may be combined with others (for example, chartered accountancy qualifications) to ensure that practitioners have an appropriate mix of skills and competencies, including those specific to the internal audit profession.

9. **Recommendation:**

III. Establish a Principle that internal auditors in banks should be able to demonstrate their knowledge of and practical experience in the technical complexities of the banking arena and the competencies required.
IV. Internal audit practitioners should hold relevant and specialist internal audit qualifications and commit to continuing professional development.

PRINCIPLE 4 – Internal auditors should act with integrity.

10. We agree with this Principle.

PRINCIPLE 5 – Each bank should have an internal audit charter that articulates the purpose, standing and authority of the internal audit function within the bank.

11. We agree with this principle.

PRINCIPLE 6 – Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function.

12. We agree with this Principle but with some important considerations.

13. Paragraph 29. Whilst we agree that the audit plan should be reviewed and updated at least annually, the period for which specific audit plans are made may be less that one year. This is consistent with ongoing, real time assessment of where key risks lie, which is a basic tenet of the Risk Based Internal Audit approach.

14. The Risk Based Internal Audit approach (RBIA) is based on an organisation's own risk management framework and seeks at every stage to reinforce the responsibilities of management and the board for managing risk.

15. The basic tenet of RBIA is that audit planning is driven by the organisations' risk environment and informed by its risk register and the need for objective assurance regarding the management of those risks. RBIA is not about auditing risks but about auditing the management of risk, with an appropriate prioritisation of risks within the organisation. RBIA is a dynamic and flexible approach which ensures that emerging risks are identified and incorporated into the audit plan as required.

16. We would suggest that this principle should stress the importance of a risk based audit framework which ensures the risks of the organisation are properly assessed and prioritised with audit coverage being scheduled on a flexible basis to provide timely assurance that risks are being managed. The role of the Audit Committee is then to satisfy itself that the approach / methodology in place is appropriate for the organisation, properly implemented and that they are informed as necessary on plans and outcomes. The requirement of a fixed "cycle" can be construed as contrary to the spirit of such an approach.

17. **Recommendation:**

Remove the reference to the 'audit cycle' and stress the importance of a Risk Based Internal Audit framework.

PRINCIPLE 7 – The internal audit function should ensure adequate coverage of regulatory matters within the audit plan.

18. We agree with this principle but with some important considerations.

19. Whilst a shift of internal audit emphasis towards regulatory matters may be necessary, it is important that this does not result in too great a focus of internal audit work onto regulatory areas at the expense of other areas of risk within the business. This could be a particular concern if the supervisory authority's focus on operational risk took resources away from adequate coverage of strategic risk.

20. A disproportionate focus on regulatory risks could also result in boards and executive management gaining a perception that internal audit is an extension of the regulator. This would not benefit internal audit's relationship with executive and non executive management.

21. **Recommendation:**

The requirement for adequate regulatory coverage should not be at the expense of a risk based framework. This may be counterproductive.

PRINCIPLE 8 – Each bank should have a permanent internal audit function.

22. We agree with this principle.

PRINCIPLE 9 – The bank's board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate, effective and efficient internal audit control framework and internal audit function.

23. We agree with this principle. This is an important statement of the board's responsibility in relation to internal audit, which helps to create an effective context for internal audit.

PRINCIPLE 10 – The audit committee, or its equivalent, should oversee the bank's internal audit function.

24. We agree with this principle, which reinforces internal audit's independence from executive management.

PRINCIPLE 11 – The head of the internal audit department should be responsible for ensuring that the department complies with sound internal auditing standards and with a relevant code of ethics.

25. We agree with this Principle. Members of the Institute of Internal Auditors are bound by its International Standards for the best practice of internal audit and Code of Ethics, which form part of an International Professional Practices Framework (IPPF). It may be appropriate to build on the IIA's International Standards with more specific guidance in sectors such as banking.

26. **Recommendation:**

The Principles should exemplify the IIA's IPPF as an appropriate set of "sound internal audit standards" and an "appropriate code of ethics", for internal auditors in all financial institutions.

PRINCIPLE 12 – The internal audit function should report to the audit committee or the board of directors and should inform senior management about its findings.

27. We agree with this Principle.

PRINCIPLE 13 – Internal audit should both complement and assess operational management, risk management, compliance and other control functions.

28. Paragraph 56 indicates that responsibility for internal control does not transfer from one line of defence to another in the Three Lines of Defence model. We support the principle that the first line should not be dependent on the second line of defence in checking and ensuring appropriate control of risk, and so on for the second and third lines.

29. However, it may be appropriate for 'higher order' lines of defence to place some limited reliance on the work of subordinate lines of defence. For example, Internal Audit may determine that it is appropriate to place some reliance on work done by the operational risk function or the credit review function in the second line of defence.

30. **Recommendation:**

This Principle should allow for limited reliance on the work of subordinate lines of defence in the Three Lines of Defence model.

PRINCIPLE 14 – The internal audit function in a group structure or holding company structure should be established centrally by the parent bank.

31. We agree with this principle. This gives boards sufficient flexibility to determine how the internal audit function should be managed and operated within a group structure.

32. **Recommendation:**

This Principle should make it clearer that in a group structure, it is not a requirement for separately incorporated entities to maintain their own audit function unless the board of directors and senior management of the parent deem this necessary.

PRINCIPLE 15 – Regardless of whether internal audit activities are outsourced, the board of directors remain ultimately responsible for ensuring that the system of internal control and the internal audit function are adequate and operating effectively.

33. We agree with this principle.

PRINCIPLE 16 – Supervisors should have regular communication with the bank's internal auditors to (i) discuss the risk areas identified by both parties, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank's response to weaknesses identified.

34. We agree with this Principle. But we note that paragraph 73 requires supervisors to understand the reasons for any divergence from audit plans. It is important that it is clear that "divergence" means any significant change.

35. An interpretation of this principle which results in constant dialogue on changes might prove to be both time consuming and a distraction from more significant matters.

36. Paragraph 74 indicates that supervisory authorities may consider sharing relevant information with Internal Audit. A more directive approach, which would require sharing unless there was a pressing

reason not to share, would be welcomed. The requirement in Paragraph 28 for Internal Audit to "develop an informed and independent view of the risks faced by the Bank" supports this approach.

37. **Recommendation:**

I. Clarify the definition of "divergent" so that it is clear the focus is on significant shifts from the audit plan.

II. Make the supervisor's obligation to share relevant information with internal audit clearer.

PRINCIPLE 17 - Bank supervisors should regularly assess whether the internal audit function has an appropriate standing within the bank and operates according to sound principles.

38. We agree with this Principle. See also comments on Principle 2.

PRINCIPLE 18 - Supervisors should formally report all weaknesses identified in the internal audit function to the board of directors and require remedial actions.

PRINCIPLE 19 – The supervisory authority should consider the impact of its assessment of the internal audit function on its assessment of the bank's risk profile and on its own supervisory work.

PRINCIPLE 20 – The supervisory authority should be prepared to take informal or formal supervisory actions requiring senior management or the board to remedy any identified deficiencies related to the internal audit function within a specified timeframe and to provide the supervisor with periodic written progress reports.

39. We agree with principles 18-20. These Principles clearly and appropriately underline the importance of the internal audit function to the effective management of risk, strong internal control and good corporate governance. This should support the supervisors drive to ensure appropriate standing of internal audit within banks.