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**Comments of the EAPB on the Basel Committee's consultation on banks' internal audit function**

Dear Madam or Sir,

The European Association of Public Banks, EAPB, welcomes the opportunity to comment on the Basel Committee's consultation on banks' internal audit function. We appreciate the deliberations of the Basel Committee on Banking Supervision (BCBS) with regard to the tasks and functions of internal audit in banks and with the intention to strengthen audit inspections, the internal control process and risk management in banks. We also view positively the direct reference to the Institute of Internal Audit (IIA) and the conclusion of the BCBS that its communiqués were of a professional standard. We see this as clearly enhancing the image of the internal audit profession.

## I. General remarks

When elaborating principles on the internal audit function in banks that should be applicable globally, the following aspects should be respected:

The consultation paper shows that there is a need for harmonisation in respect of the scope of activity of all banks since this scope is fundamentally different from the regulations that apply in national regulations. Certain sections of the proposed provisions in the consultation paper are in conflict with the legally foreseen powers of senior management and the tasks of the board of directors in subsidiaries.

According to the legislation in several European countries, internal audit is an instrument of senior management, reports to it and is directly accountable to it. The board of directors is responsible for monitoring the management function undertaken by the senior management. It should be ensured that the internal audit function continues to have a clear link to only one place when it comes to discipline.


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In the case of internal audit in a group, it must be clearly distinguished between the responsibilities of the parent company and the subsidiary respectively, taking into consideration the differing national situations and cross-border cases. Requiring the parent company to centrally establish the internal audit function in a group structure goes too far. The obligation of the parent company should be to establish a group audit function which acts in addition to the internal audit functions of the subsidiaries and has a leading role within the structuring of the internal audit function of the subsidiary and the determination of their audit methods and procedures. The decisions referring to the internal audit unit of the subsidiary have to be made by the responsible bodies of the subsidiary.

Internal audit tasks are an element of risk management that is independent of processes and is clearly distinguished from operational, process-dependent activities. The requirement that control failings of one line of defense should be covered by another line of defense can mainly be fulfilled by appropriate on-going controls of the individual functions. To avoid a dilution of responsibilities, a duplication of controls, and inefficient processes within an institution, it should be clearly differentiated between all three control functions.

An intensified communication between internal audit and supervisory authorities would be welcomed. However, the senior management should always be introduced appropriately in this kind of interaction. Incorporating the expectations of the banking supervisors in a timely fashion into the audit planning process via the annual internal audit plan can be positive. However, the internal audit function's capacity to act should not be adversely affected by knowing the expectations of the banking supervisors. It should be stated clearly that the submission of sensitive information to supervisory authorities should only be made by authorized banking bodies. The internal audit function should not be seen as a tool that can be used by supervisory authorities. There is a need to clearly define reporting and responsibility lines for the internal audit function.

## II. Specific remarks on selected principles and paragraphs

### - Introduction

*Paragraph 7*

According to our interpretation, there is a need for harmonisation, among other things, in respect of the scope of activity of all banks, including those with-in banking groups, as well as for holding companies whose subsidiaries are predominantly banks. This scope of activity is fundamentally different from the regulations that apply in national regulatory law such as, in Germany for example, the relevant regulations of the KWG (German Banking Act) and the regulations of the Minimum Requirements for Risk Management (MaRisk). Certain sections of the proposed provisions in the consultation paper are in conflict with the legally foreseen



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powers of senior management and the tasks of the board of directors in (foreign) subsidiaries.

- **A. Supervisory expectations relevant to the internal audit function**

*Paragraph 12*
The BCBS indicates that the audit plan should be approved by the board of directors and not by senior management. This approach is not in tune with the legal framework in certain European countries where an approval of the audit plan by senior management (in some cases with a previous opinion of the audit committee) which is then reported to the board of directors/audit committee has proven its worth.

*Paragraph 14*
With a view to the growing complexity of the methods and processes applied in risk management and the therefore necessary specific knowledge, the EAPB deems a staff rotation as not realistic. A rotation would have a negative impact on the audit results. A comparison with the rotation among external auditors is not valid since in the case of an ongoing mandate only the head of the audit team changes but not the team itself.

*Paragraph 15*
The BCBS acts on the assumption that the independence and the objectivity of the internal audit function could be undermined if the remuneration of employees is linked to the profitability of company units or business divisions that the internal audit function is responsible for auditing. The same applies in relation to the profitability of the bank as a whole. The EAPB considers this latter assessment of the BCBS not appear to be realistic and in conflict with national ordinances pertaining to remuneration in institutions.

*Paragraph 17*
The BCBS considers that the entire internal audit department should have the necessary qualifications to audit all fields in which the bank is active. The EAPB would like to note that the agreement to outsource internal audit services is done in order to buy external expertise, which may not be kept within the department because of the size of the audit or because certain fields are not relevant very often. As for the requirement of an adequate transfer of knowledge from external experts to the internal audit function, it is our understanding that in the case of a new task in the audit cycle the internal audit department may use external expertise. Otherwise the concept of outsourcing would be weakened to the disadvantage of banks. Finally, it should be clearly stated that “outsourcing” in the sense of this paragraph should be within the meaning of the “purchase of audit services” as a support-function for the existing internal audit department. In this respect, paragraph 17 needs to be put in line with paragraph 65 which suggests the “transfer of knowledge” or “knowledge input” taking place by way of co-sourcing.


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*Paragraph 23*
In the view of the BCBS, the audit charter should not be approved by the senior management, but rather by the board of directors. This view is not in tune with certain national regulations and therefore problematic. Equally, the audit charter is to be made available to all internal and external eligible persons and interest groups. In the absence of further clarification, we cannot understand why external interest groups, such as trade unions or finance authorities, should have access to the audit charter. The establishment of the purpose and responsibilities of the internal audit process within the bank provide no added value for this external group in terms of assessing the bank's risk management, or its financial position, assets and liabilities and profits and losses.

*Paragraph 24 (also paragraph 65)*
Close cooperation with external audit and exchange of knowledge is always a challenge. In practice external auditors tend to rely on internal audit reports, while internal audit does not receive information from external auditors. The knowledge transfer is one way. It would be useful for the BCBS to define or clarify reasonable expectations from external auditors.

*Paragraph 25*
The BCBS suggests allowing the internal audit to examine each activity or unit and giving it access to all recordings, files, data and material owned by the bank. We would like to draw attention to the fact that the internal audit may only act on legal ground and within a legally permitted frame such as law governing data protection or collective labour law. Depending on the case, this might lead to restrictions concerning the access to data and information.

*Paragraph 29*
The BCBS is of the view that the audit plan is based on a risk assessment that includes input and contributions from both the senior management and the board of directors. The EAPB would appreciate further clarification of what is meant by 'input' from the board of directors. Furthermore, there is an incoherence regarding the audit cycle in paragraphs 29, 49 and Annex 2 point h. According to paragraph 29, internal audit must establish an audit cycle. In paragraph 49 and annex 2 however, the BCBS states "audit cycle (if any)". We believe that the words 'if any' should be removed.

*Paragraph 30*
The EAPB supports principle 7, particularly as formatted in paragraph 30, according to which the internal audit function will ensure that regulatory matters are appropriately covered in the audit plan. In this context, we propose that the detailed regulations referred to in other parts of the consultation paper are dispensed with.


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*Paragraph 31*
For reasons of clarification, the EAPB notes that the last bullet point refers to the auditing of the approval and maintenance of risk models and not that internal audit is responsible for approval and maintenance of risk models.

*Paragraph 43*
According to the BCBS the board of directors should review the effectiveness and efficiency of the internal controls at least once a year. The EAPB believes that a review once per year, e. g., as an essential part of the annual audit at the end of the year, is sufficient.

*Paragraphs 48 to 50*
The BCBS is currently undergoing a paradigm shift, at least for a good part of continental European banks, in that it no longer sees the internal audit function as an instrument for senior management, but rather as an instrument for the board of directors. The legal framework that the BCBS prefers for the interaction of the individual functions and bodies of a financial institution corresponds with the board of directors according to the Anglo-American system which is equipped with more operational competencies. The requirements contained in the consultation paper – particularly annex 2 – assume that the board of directors or audit committee is very close as regards content to the operational processes in the company and also to the audit processes. This is not the case in many places. However, closeness in terms of content is a basic requirement for the proper illustration of audit conclusions.

When reviewing the draft principle, we ask the BCBS to take the following aspects into consideration:
The stronger interaction of the internal audit function with the committees of the bank, but also with the external interest groups of the institution, would commit additional resources. The scope of reporting for the distinctly higher number of those receiving the reports, including the discussions that would necessarily follow, would mean that significantly more staff time would be required. If staff numbers stayed the same, this would lead to a reduction in the resources available for the original audit services. It is furthermore doubtful if the responsible senior manager can continue to be able to have an open discussion with the head of internal audit if he can be made liable for his comments towards the board of directors. The senior management would also not be able to ask the internal audit function to scrutinize specific occurrences and situations. Furthermore we ask the BCBS to clarify how it will distinguish between the functions and the tasks of the external auditor and internal audit. According to the deliberations of the BCBS, the board of directors would mandate both, external and internal audit, in the future.


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*Paragraph 53*
According to this paragraph, the internal audit function is accountable to the board of directors and its audit committee in all matters that relate to performance in accordance with the internal audit charter. According to principle 12, the internal audit function should report to the audit committee or the board of directors and inform senior management of its conclusions at the same time.
According to the legislation of certain countries, however, internal audit is an instrument of senior management, reports to it and is directly accountable to it. The roles and responsibilities of senior management are also arranged accordingly into diverse company-specific regulations relating to internal audit. In a similar fashion, the management of a public share company often has to take appropriate measures, in particular to establish a monitoring system for the early recognition of developments that endanger the continued existence of the company. Thus, the personal and objective responsibility for the design and work of the internal audit function always lies with the senior management of an organisation. In particular, the board of directors is responsible for monitoring the management function undertaken by the senior management.
It should be ensured that the internal audit function continues to have a clear link to only one place when it comes to discipline – which, to the prevailing number of our members, should be the senior management. In the final analysis, the sharing of disciplinary competencies between the executive and the supervisory body or audit committee makes for a lack of clarity in terms of the execution of disciplinary authority. The responsibilities of the audit committee for internal audit detailed in annex 2 lit. (b) to (o) should consequently be borne by the senior management of the institution.

*Paragraph 54*
According to the proposal, the head of internal audit is required to report towards the board of directors or the audit committee on the status of those findings that the senior management has not rectified yet. We suggest limiting this reporting obligation in the sense of an escalation procedure which will only be put into practice, if severe deficiencies against members of the senior management have been discovered and the senior management does not follow its own reporting requirements.

*Paragraphs 55 + 56*
Our understanding of the complementary function of internal audit is that internal audit tasks are an element of risk management that is independent of processes and is clearly distinguished from operational, process-dependent activities. This relates to the requirement stated in paragraph 56 that control failings of one line of defence should, as a basic principle, be covered by another line of defence. In our view, this requirement can mainly be fulfilled by appropriate on-going controls of the individual functions. However, the regulation could, in fact, result in a dilution of responsibilities as well as duplication of controls, and thus, in inefficient processes within an institution. It should be clearly


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distinguished between all three control functions (see also below our answer to paragraph 58).

*Paragraph 58*
As we understand it, the compliance function described here follows an Anglo-American model. This monitors, in general terms, the risks of non-compliance with statutory regulations. The compliance function tasks rewritten in paragraph 58 also obviously include money laundering, fraud prevention and data protection. This business oriented design of the compliance function is currently the subject of intensive discussion in relation to the implementation of organisational development in some countries. It is important for the BCBS to appropriately distinguish between the existing control functions such as risk management, compliance and internal audit.

*Principle 14*
It is of utmost importance that this principle distinguishes clearly between the responsibilities of the parent company and the subsidiary respectively, taking into consideration the differing national situations and cross-border cases.

The EAPB is of the opinion that the requirement laid down in paragraph 60 is too far-reaching in requiring the parent company to centrally establish the internal audit function in a group structure. The obligation of the parent company (senior management) should be instead, to establish a group audit function which acts in addition to the internal audit functions of the subsidiaries (complementary audits; joint audits) and has a leading (coordinating) role within the structuring of the internal audit function of the subsidiary and the determination of their audit methods and procedures. The decisions referring to the internal audit unit of the subsidiary have to be made by the responsible bodies of the subsidiary. Insofar, it has clearly to be distinguished between the group-wide responsibility of the senior management of the parent company for the introduction of a group-risk-management (group standards, etc.) and the responsibilities of the management of the subsidiary.

Centrally establishing the internal audit function by the parent bank would have different consequences for the national banking sectors in Europe. While it can be an effective tool for a group, it might also signify a risk for those national banking sectors where a large amount of foreign ownership is involved. In such cases, a centrally established internal audit function would act in the best interest of the group and not the particular bank, which might cause problems for the individual bank and potentially for the national banking sector.

Finally, we would like to point out that certain current national regulations leave it to the parent bank to decide whether it is efficient to centrally establish internal audit group-wide or individually in each member of the group.


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*Paragraph 62*
Here, the BCBS states that all activities, including outsourced activities and all units in the group, come under the overall responsibility of the internal audit function. One could read the regulation as meaning that the parent company's internal audit function is obligated to audit all activities and processes, as well as entities of the group within a given time period, irrespective of any audit activities carried out in parallel by the internal audit function in the subsidiary. The group audit can also refer to and take into consideration the audit results of the internal audits of group companies. Independently of this, the group audit within the context of risk management at the group level must operate in addition to the internal audits of group companies.

*Principle 15, paragraph 65*
The banking law of certain countries, for example in Poland, does not approve the outsourcing of the internal audit function. The BCBS should acknowledge this, as principle 15 in its current wording may be viewed as supporting the outsourcing of the internal audit function. Furthermore, while the term outsourcing is used here, the situation described in paragraph 65 would be co-sourcing.

- **B. The relationship of the supervisory authority with the internal audit function**

*Paragraph 67*
In the view of the BCBS, the bank regulator should be in a position to scrutinise the work of internal auditors in their continuous monitoring process, including by way of on-site monitoring. The regulation of on-site monitoring should not lead to an intensification of regular special audits of the internal audit function by banking supervisors. We are of the opinion that on-site inspections should not go beyond the scope which is usual today.

*Principle 16*
The EAPB welcomes the intention to intensify the communication between internal audit and supervisory authorities. However, the senior management (as the in our view responsible body that internal audit reports to) should always be introduced appropriately in this kind of interaction. Moreover, such an interaction must be organized in a way that there is no over-stretched additional workload created for the internal audit function.
We see it as a positive factor if the expectations of the banking supervisors can be incorporated in a timely fashion into the audit planning process via the annual internal audit plan. In the process, however, the internal audit function's capacity to act should not be adversely affected by knowing the expectations of the banking supervisors. This could come about, for example, in that the expectations of the banking supervisors could produce conflicts in the handling of the audit in technical terms, as well as in respect of capacity. An


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implicit audit coercion could hinder the risk-oriented auditing of all the institution's activities and processes in a given audit cycle.
It should be stated clearly that the submission of sensitive information to supervisory authorities should only be made by authorized banking bodies. The internal audit function should not be seen as a tool that can be used by supervisory authorities. There is a need to clearly define reporting and responsibility lines for the internal audit function. The internal audit function should not report directly to the supervisory authority about any risk areas, risk mitigation measures or bank's responses to identified weaknesses.
Finally, it should also be taken into consideration that the interaction will have a direct impact on the evaluation of the internal audit function as stated within principle 17.

*Paragraph 73*
According to paragraph 73, where there is a divergence from the audit plan, the banking supervisor is expected to develop an understanding of the circumstances that led to this. Supervisors are also expected to be able to discuss the audit plan for the coming year in order to ascertain which of the risk areas can be appropriately covered. In practice, paragraph 73 might lead to a situation where risk planning is done based on the supervisory authority's and not the bank's own risk analysis, which would not be a good solution.

The paragraph presents some points that require clarification:
It is not clear at which point and in which time sequence the audit plan for the following year should be discussed with the supervisors. There is not sufficient time between drafting and approval by senior management. We understand that the BCBS suggests that the discussion regarding divergences from the current audit plan and the audit plan for the following year should be between the banking supervisors and the audit committee's chair (senior management?), and not the head of internal audit. Due to the fact that details can primarily be passed on by the "author" of the audit plan, there are good reasons why the discussion on such items should always be conducted by the banking supervisors with the head of internal audit. We believe that formal clarification is required to the effect that not every inconsequential divergence from the audit plan has to be discussed with the banking supervisors. The agenda items of a periodic meeting with the banking supervisors should focus much more on essential audit-related matters. Furthermore, our understanding of the discussion of the following year's audit plan is that there is no need to coordinate the draft version of the audit plan with the banking supervisors or to get advance approval by them.

*Paragraphs 75 to 80*
The EAPB considers the possible discussion points between the supervisors and internal auditors addressed in this paragraph as being extensive. In order to fulfil its duties, the internal audit function does not need to have and continuously evaluate information to the same extent as operational controlling, accountancy or group management functions. In addition, our view is that many of the elements addressed under paragraphs 77, 78 and 79


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concern either the senior management of the institution, the annual accounts auditor or the compliance function.

- **C. Supervisory assessment of the internal audit function**

*Paragraphs 82 to 87*
According to the BCBS, the banking supervisors should regularly assess whether the internal audit function has an appropriate standing within the bank and operates according to sound principles. In doing so, the banking supervisors should develop a grading system in order to carry out the assessment. The audit committee or its equivalent and the internal audit function should also develop and apply their own tools for assessment of the audit function. Within this context, the EAPB would point out that, in some countries, the annual accounts auditor carries out a regular assessment of the internal audit function as part of the final accounts audit. We would ask the Basel Committee to incorporate such relevant audits by the annual account auditor in its guidelines. The development of one's own tools should also be dependent on the size, the type and the scope of the business activity, as well as the degree to which the institution is networked.

Finally we would like to point out that, based on the requirements of the IIA, certain national trade associations have set up an own quality assessment on which the internal audit function has to report to senior management or, where required, to the board of directors/audit committee at least once a year. We suggest that such certified quality assessment should be respected.

*Paragraph 87*
In the view of the BCBS, the appointment and replacement of the head of the internal audit function is relevant to the supervisory assessment of the bank. Therefore, the banking supervisors should be informed in both cases of the process itself and the circumstances leading to it. Also, the banking supervisory authorities should be permitted to arrange a meeting with the former head of internal audit.

The EAPB is of the opinion that the BCBS should not continue its deliberations concerning the contacts between supervisory authorities and former heads of internal audit. If a former head remains being employed by the bank, he is restricted by his employment status and cannot be required by labour law to make statements that could be disadvantageous for him. If a former head is not employed by the bank anymore, it should not be possible to oblige him to meet the banking supervisors.

*Principle 19*
According to this principle, the supervisory authority shall consider the effects of its assessment of the internal audit on its assessment of the bank's risk profile as well as on its



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own supervisory activity. In our opinion, this perception causes too much of an emphasis on the internal audit's function in comparison with other elements of the risk management system.

*Paragraph 94*

The BCBS is considering the publication of supervisory actions taken in response to deficiencies in the internal audit. In our opinion, banking supervision has sufficient opportunity to exert influence on the management as well as on the board to remedy such deficiencies. Therefore, we do not support the idea of publication.

Finally, we like to note that the BCBS is leaving it open when and whether the procedure shall come into effect and if so, how long the transitional period for implementation by the institutions shall be. We understand that the intention behind this approach is to first receive feedback on the content and to decide subsequently how to proceed.

Should you have additional questions or comments, please do not hesitate to contact us.

The EAPB organises a committee on internal audit on a regular basis which gathers the heads of internal audit of the EAPB members. The committee is at your disposal for an exchange of views.

Kind regards,

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EAPB

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