



FEDERATION  
BANCAIRE  
FRANCAISE

*Banking supervision  
And Accounting issues Unit  
The Director*

Paris, March 2<sup>nd</sup> 2012

**French Banking Federation comments on the Basel Committee Consultation Paper on the internal audit function in banks (BCBS 210)**

Dear Sir,

The French Banking Federation (FBF) is the professional body representing the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 450 commercial and cooperative banks. FBF member banks have 40,000 permanent branches in France. They employ 400,000 people, and service 60 million clients.

The FBF supports the objective of ensuring a strong internal control framework within banking organisations and appreciate the opportunity to comment the proposed principles.

The consultative paper of the BCBS on the internal audit function in banks proposes a very demanding and challenging framework from an operational and governance standpoint. We support many of the proposed principles. Indeed, most of them are consistent with the existing French regulation on internal control.

However, others appear to be non-appropriate on three main grounds:

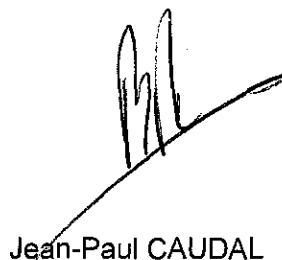
- A confusing corporate governance definition
- The reporting line of the internal audit function
- The lack of organizational flexibility.

You will find in the annex attached our detailed comments and suggested changes on the issues raised the consultative document.

**Mr Xavier-Yves ZANOTA  
Secretariat of the Basel Committee  
on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland**

We thank you for the consideration of our remarks and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

A handwritten signature in black ink, consisting of stylized, overlapping loops and a long, sweeping horizontal stroke extending to the right.

Jean-Paul CAUDAL

p/o Bernard PIERRE

### **A) Confusing corporate governance definition**

§ 5 of the introduction rightly restates the complexity and variety of firms' governing structures and makes clear that the recommendations must be interpreted in light of the national legislation. However, the recommendations themselves play on the ambiguities arising from this diversity of situations varying from the so-called one tier to two-tier governing body, which does not help building a responsibility based system. As adopted in other instances, we strongly suggest referring to the governing body in its supervisory function or to its executive function in order to clarify the intent of the BCBS. The absence of any specification would then simply mean that national regulation may choose the most adequate solution in light of the country legislative and cultural environment.

In a two-tier model, as it exists in France, the board of directors is separated from the executive management. In our opinion, this organisation enhances the management efficiency and its control. The separation of functions between the chairman of the board of directors and the chief executive officer is a good practice but shall not be imposed as the company model in itself ensures a counter power mechanism. It can indeed consolidate the efficiency of corporate governance. On the one hand, the Chairman can dedicate much of his attention to the proper and efficient organization of the Board without any conflict of interest. Particularly, he is in position to make sure that the CEO informs in a timely, reliably and clear manner the board of any significant event that could affect the life of the company. The Board can then exercise fully and efficiently its supervisory function. On the other hand, the CEO is fully responsible of all the company's operations and clearly accountable for its performance. With the possible help of deputies, he performs the executive function.

The perception of this issue may be different in companies operating within a one-tier legal framework. According to such model, there is only one board of directors, in charge of executive and non executive functions. In such case, a strict separation of functions between the chairman of the board of directors and the chief executive officer may be considered as important to ensure an efficient counter power.

### **B) Reporting line**

The internal audit function as well as all the other functions contributing to the bank's internal control should not be split between the different bodies governing the firm. They must clearly report to the executive function and provide through it the material or the testimony needed by the supervisory function. Any other organization where the supervisory and the executive functions may be perceived being in competition would inevitably lead to conflicting situations. Actually, the internal control functions would be weakened by a direct reporting to the supervisory function. Their authority is intimately linked to their close relationship with the executive function; a supervisory function reporting would be a delusion turning these functions into marginal and box ticking roles.

The most important matter is the independence of the internal audit function towards the activities and persons audited. Thus, the audit function should report to the executive function but can also alarm the board in its supervisory function if necessary.

### **C) Lack of organizational flexibility**

In light of the legislative and cultural diversity across the world, the proposed paper should avoid going beyond the principles and presuming as adequate any particular kind of governance organization. The consultative paper proposes very prescriptive requirements that are directed at the micro-level of management and processes of the bank. This level of granularity is not appropriate for a BCBS recommendation. For examples:

- The supervisory function of the governing body may have set up different committees to address its duties. There is no doubt that one of them should oversee the internal audit examining and assessing work. However this committee may also have some other responsibilities including the oversight of all the internal control functions; it may or may not be the addressee of the external audit opinion. It may be called the audit committee or otherwise.
- The auditor remuneration policy is certainly a significant point provided that the recommendation remains principle based. We may understand that the compensation of auditors should not be mainly driven by the performance of the business line under his surveillance; we believe on the other hand that eliminating any reference to the global performance of the bank is highly questionable.
- The "3 lines of defense" concept does not fit in a paper directed at defining the role of the internal audit. There is no reason to believe that this internal control framework is the best practice and could be blessed in passing. Moreover this passive notion is probably inadequate for internal control functions that are requested to be pro-active and close to the decision making process.
- The internal audit multi-year plan should certainly have a very wide scope. However "the assessment of the adequacy of the capital resources in relation to the bank's risk exposure and established minimum ratios" is much more an on-going operational responsibility of both the risk and finance function, even though the internal audit may express an opinion on the quality of process in the course of its audit plan.
- The requested expertise of auditors is clearly one of the most critical responsibilities of the head of the internal audit. Getting it through participation in the external expert's work is just an example among others that cannot be construed as an expected recommendation in line with the nature of the paper.
- We would expect that the supervisors would primarily discuss general risk mitigation measures with the executive and risk management. Auditors may have a view and opinion on some of these measures but they are not actively engaged in the decision making process.

#### **Suggested changes:**

- In most instances, "the governing body in its supervisory function" should be substituted to "board of directors".
- In all instances, "the governing body in its executive function" should be substituted to "senior management".
- **Page 3 - 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~~ the governing body in its executive function and, ultimately the governing body in its supervisory function, in protecting their organization and its reputation."
- **Page 5 - Principle 2 - §15**: "The independence and objectivity of the internal audit function may be undermined if the staff's remuneration is linked to the financial performance of the business line for which they exercise internal audit responsibilities ~~or to the financial performance of the bank as a whole~~".
- **Page 6 – Principle 5 - §23**: "The charter should be [...] and approved by ~~the board of directors~~ the governing body in its executive function and reviewed by the governing body in its supervisory function."

- **Page 7 – Principle 6 - §29:** The head of internal audit [...] within an appropriate period of time (audit cycle). The ~~board's~~ approval of the audit plan by the governing body in its executive function implies that an appropriate budget will be available to support the internal audit function's activities. The approved audit plan is reviewed by the governing body in its supervisory function or its concerned committee.
- **Page 8 – Principle 7 - §32:** "The scope of the internal audit should include all provisions of this regulatory framework and in particular the bank's system for identifying and measuring its required regulatory capital and ~~assessing the adequacy of its capital resources in relation to the bank's risk exposures and established minimum ratios.~~"
- **Page 9 - Principle 9:** "The bank's board of directors governing body in its supervisory function has the ultimate responsibility for ensuring that ~~senior management~~ the governing body in its executive function establishes and maintains an adequate, effective and efficient internal control framework, and including the internal audit function."
- **Page 9 - Principle 9 - §43:** "At least once a year, the ~~board of directors~~ governing body in its supervisory function should review the effectiveness and efficiency of the internal control framework based, in part, on information provided by the internal audit function. Moreover, as part of their oversight responsibilities, ~~the board of directors~~ should review the performance of the internal audit function. ~~From time to time, the board of directors should consider commissioning an independent review of the internal audit function.~~"
- **Page 10 - Principle 12 -** The internal audit function should report to the ~~audit committee or the board of directors~~ governing body in its executive function and should inform senior management him about its findings. The head of internal audit should provide the audit committee or the governing body in its supervisory function with information taken from the one prepared for the use of the governing body in its executive function.
- **Page 10 - Principle 12 - §53:** "The Internal audit function is accountable to the ~~board and its governing body in its executive function and makes report of its major observations to the ad-hoc~~ audit committee governing body in its supervisory function on all matters related to the performance of its mandate as described in the internal audit charter." (Annex 2 should be modified accordingly).
- **Page 10 - Principle 12 - §54** "~~Senior management~~ The governing body in its executive function is responsible for implementing and maintaining an adequate and effective internal control framework. Therefore the internal audit function should ~~inform senior management~~ provide the governing body in its executive function with all significant findings so that corrective actions can be taken. Subsequently, the internal audit function should follow up on the outcome of these corrective measures. The head of the internal audit function should report to the ~~board~~ governing body in its executive function and ultimately inform the governing body in its supervisory function or its Audit ad hoc committee of the status of critical findings that have not (yet) been rectified by senior management.
- **Page 11 - Principle 13 -§55 to 59** should be reconsidered in order to take into account our comments on page 2 of this response.
- **Page 12 - Principle 7-** "governing body" should replace "board of directors". § 65 should be deleted.

- **Page 13 - 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 gather their opinion on the risk mitigation measures taken by the bank, and (iii) monitor the bank's response to weaknesses identified"
- **Page 16 - Principle 18 -:** "*Supervisors should formally report all weaknesses identified in the internal audit function to the ~~board of directors~~ the governing body in its executive function with information to the supervisory function, and require remedial actions.*"

**Page 16 - Principle 18 - §88.** « When the supervisory authority concludes that a bank's internal audit function is inadequate or ineffective, it should require the ~~board of directors~~ governing body in its executive function to develop an appropriate remedial plan that will restore the internal audit function to good standing on a timely basis. The supervisory authority should inform the governing body in its supervisory function of its request. The plan should be communicated in writing to the supervisory authority for review, and to the supervisory function or its audit committee for information and oversight. When the supervisor is not satisfied, it should require changes or additional measures to be included in the plan. The supervisor should monitor the implementation of the plan ».

**Page 16 - Principle 18 - §90.** "The audit ad-hoc committee and ~~board of directors~~ hence the supervisory function should not conclude that the internal audit function is functioning well solely because the supervisory authority has not identified weaknesses. The supervisory review process is not a substitute for the executive function's assessment and the audit committee's review of this assessment or ~~an external assessment~~ of the internal audit function.