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To:	Basel Committee, Service
Cc:	Aspden, John; Nik van Leuven; Richard Walker; Philip Marr
Subject:	Consultation on "the internal audit function in banks"
Date:	Friday 02, March, 2012 14:03:33

Email to Secretariat of the Basel Committee on Banking Supervision sent on behalf of Philip Marr, Director of Banking, Guernsey Financial Services Commission

Here are my comments on the consultative document the internal audit function in banks published in December 2011.

My comments are given from the perspective of a host supervisor of banks which will typically be subsidiary banks of internationally active banking groups.

1. Principle 8 states that "Each bank should have a permanent internal audit function." Paragraph 41 is clear that senior management and the board should take all necessary measures to ensure that the bank has a permanent internal audit function commensurate with size and complexity etc. Paragraph 42 acknowledges that internal audit activities may be partially or fully outsourced but quite rightly goes on to say that responsibility for those activities cannot be outsourced.

2. Principle 15 addresses outsourcing of internal audit functions. This reinforces paragraph 42 in saying that regardless of whether internal audit activities are outsourced the board of directors remains ultimately responsible for ensuring that the system of internal control and the internal audit function are adequate and operating effectively. In paragraph 63 the principle recommends that large banks and internationally active banks perform internal audit activities using their own staff. However it then says that outsourcing of internal audit activities on a limited and targeted basis can bring significant benefits. As currently drafted paragraph 63 is not helpful to host supervisors who supervise banks at the subsidiary level. The text implies that outsourcing is only outsourcing to third parties. In part this is in conflict with the first sentence of paragraph 63 which is a strong recommendation that large banks and internationally active banks use their own staff. What would be helpful and in keeping with observed practice is that the text should acknowledge the fact of intra-group outsourcing at the subsidiary level. This is where subsidiary banks make use of a central group internal audit function which use the staff of the parent bank allowing access to greater expertise but also make use of personnel who are independent of those conducting the activities which are being audited. Intra group outsourcing has the benefit at the subsidiary level (where banks are likely to be smaller than the parent), in allowing the subsidiary bank to engage experts who would not ordinarily be employed in the bank because the scale would not justify it. Furthermore it avoids the danger in a smaller organisation of directly employed internal audit staff getting too close to the local staff being audited.

3. My suggestion is that there should be reference in principles 8 and 15 to what is a commercial reality: that large groups prefer to use group audit functions (that is intra group outsourcing) which can be deployed where there is a prioritised need as part of a group audit programme using internal audit standards which are consistent across the

whole group which may also be across many jurisdictions. This acknowledgement would be helpful and would sit alongside the references to third party outsourcing. If the option of intra group outsourcing of the internal audit function is not defined or acknowledged as a satisfactory mechanism for delivering internal audit then assessors are likely to become rigid in their application of Revised Core Principle 26. In that Core Principle Essential Criterion 4 specifies that banks have an independent <u>permanent</u> and effective internal audit function. The issue is around the use of the word “permanent” since in small banks it may not be cost effective to have an independent internal audit function within the bank. If assessors apply a rigid interpretation of a “permanent” function then it ignores what is commercial international practice. The objectives of the principle are still maintained because an independent internal audit function of appropriate expertise is accessed using the intra group option. My experience is that some small banks do have an independent internal audit function at the subsidiary level but they are in the minority: the typical model is to access a group internal audit resource which operates internationally across a whole group thereby maintaining the same standards and having access to a wider knowledge base of risks and acceptable practice.

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