

Room 525, 5/F., Prince's Building, Central, Hong Kong  
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035  
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室  
電話：2521 1160, 2521 1169 圖文傳真：2868 5035  
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

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By email: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Dear Sirs

**Consultative Document on The Internal Audit Function in Banks**

We refer to the above Consultative Document published by the Basel Committee on Banking Supervision (BCBS) in December 2011. The principles set out in the Consultative Document are generally aligned with the standards followed by the internal audit functions (INA) of the members of the Hong Kong Association of Banks (HKAB). On behalf of our members, we would like to provide our specific comments and requests for clarifications as follows:

- **Paragraph 10**

This paragraph states “*internal auditors should not assume management responsibility when providing consulting services or design and/ or implement internal controls.*”

We should be grateful for more guidance on how much consulting or the extent internal auditors should be involved.

- **Paragraph 14**

This paragraph recommends rotations “*within the internal audit function*”. This might be extended to recommend rotation within the wider bank. Banks may aim to rotate staff between INA and the businesses and other functions of the bank whilst remaining cognizant of the issues of avoidance of conflict cited in Paragraph 21.

- **Paragraph 15**

This paragraph indicates that the independence of INA may be undermined by remuneration linked to the performance of the areas audited. However,

Chairman The Hongkong and Shanghai Banking Corporation Ltd  
Vice Chairmen Bank of China (Hong Kong) Ltd  
Standard Chartered Bank (Hong Kong) Ltd  
Secretary Ronie Mak

主席 香港上海匯豐銀行有限公司  
副主席 中國銀行（香港）有限公司  
渣打銀行（香港）有限公司  
秘書 麥依敏

as many banks pay discretionary bonuses to audit staff, further clarification of regulatory expectations would be beneficial on whether the guidance relates to senior or all audit staff and whether the concerns of the Consultation Document are limited to variable pay, having due regard to the practicality of retaining talented internal audit staff.

- **Paragraphs 16 to 18**

These paragraphs state the importance of professional competence and due professional care. We would be grateful for further clarification on the skill sets that may be particularly relevant in the future for internal auditors, including qualification and experience levels for Heads of Internal Audit and key audit positions.

- **Paragraph 21**

This paragraph refers to a “cooling off” period during which internally recruited auditors should not engage in auditing activities in areas for which they had previous responsibility. Periodically, banks may use short term secondees (“guest auditors”) from the business who can provide additional expertise and insight. The required separation could be achieved for “guest auditors” by ensuring that they would not be responsible for directly auditing the part of the business for which they were responsible. For example, a “guest auditor” might be brought in from one geographic region to assist with the audit of the same function in another geographic region. Or in the case of the audit of a head office function, a “guest auditor” from that function might be used to provide specialised knowledge of that function but would not lead the audit. We would suggest that this be suitably clarified.

- **Paragraphs 23-25**

In practical terms, a charter contains the key elements of audit policy. It would be helpful if a properly structured and approved policy framework could also be recognized as a suitable alternative to a charter.

- **Paragraph 26**

As one general observation, the Consultative Document does duly recognize that all areas are within the scope of an INA’s responsibilities (e.g. Paragraph 26). However, whilst noting Paragraph 59, perhaps there is not due reference to the importance of a risk based approach and the importance of focusing on key risks. Paragraph 26 also states that the scope of internal audit activities should include examination and evaluation of the effectiveness of the internal control framework of the entire bank, including assignment of responsibility and accountability within the bank and appropriate processes to follow up on audit findings and recommendations. This may imply that Internal Audit should also review the proper

functioning of the Board and Audit Committee which the unit reports into. If so, given the lack of independence, such a review may be better led by an external party in which Internal Audit might participate and this could be linked to paragraph 43.

- **Paragraph 27**

This paragraph states that INA should monitor compliance with laws and regulations. Whilst the requirement is understandable, in many organizations, the Compliance function is primarily responsible for this task. INA should seek to discharge this responsibility, where appropriate, through reviewing the Compliance function including their monitoring capability and effectiveness. As such we suggest that this be linked to paragraphs 37 - 39.

- **Paragraph 29**

This paragraph covers the audit planning cycle and refers to an annual audit plan and the need for the plan to be reviewed at least annually. The Consultative Document does not make clear whether the annual audit plan has to include a detailed audit plan for the full year. For the avoidance of doubt, we would propose that whilst the audit plan will be reviewed and updated at least annually, the period for which specific audit plans are made may be less than one year. This is consistent with ongoing, real time assessment of where key risks lie. This is also relevant to paragraph 73 which requires that any variances to the annual audit plan have to be explained to the relevant supervisor.

Further, Paragraph 29 goes on to state that, "*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)*". Reference is also made to Paragraph 26 which refers to "*the effectiveness of the internal control framework of the entire bank*". We would suggest that wording 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 "cycle" can be construed as contrary to the spirit of such an approach. To repeat, the responsibility of INA should be to ensure that all key areas are subject to appropriate coverage according to the risk profile.

- **Paragraphs 30 – 39**

These paragraphs all sit under *Principle 7: The internal audit function should ensure adequate coverage of regulatory matters within the audit*

*plan*. These sections provide greater direction in terms of what is required to be audited in relation to regulatory matters than the direction appears elsewhere in the document for other areas of risk. Whilst perhaps understandable given the context for the proposed revisions of the 2001 document, and some shift of emphasis may be desirable, this may have the effect of overly skewing the focus of audit work onto regulatory areas rather than the broader range of risks (of which regulatory risk is a part) within the business.

- **Paragraph 38**

This paragraph states compliance laws, rules and standards include primary legislation, rules and standards issued by legislators and supervisors, market conventions, codes of practice promoted by industry associations, and internal codes of conduct applicable to the staff members of the bank. Instead of “market conventions”, we suggest that banks should comply with “market best practices”, as there may be control loopholes in market conventions.

- **Paragraph 43**

This paragraph refers to the board of directors’ responsibilities for reviewing the performance of the INA. Further clarification is required regarding the importance of Internal Audit being subjected to stringent quality assurance reviews, both internally and externally, on a regular basis.

- **Paragraph 47**

This paragraph states that “*Senior management should ensure that the head of internal audit has available the necessary resources, financial and otherwise, to carry out his or her duties commensurate with the approved annual audit plan.*” According to Principle 10, the audit committee “*should oversee the bank’s internal audit function*”. As such, we suggest that the audit committee should also be an appropriate party to ensure that the head of internal audit has available the necessary resources, financial and otherwise, to carry out his or her duties commensurate with the approved annual audit plan.

- **Paragraph 52**

This paragraph states that “*The audit committee should ensure that the head of the internal audit function is a person of integrity. This means that he or she will be able to perform his or her work with honesty, diligence, and responsibility. It also implies that these persons always have observed the law and have not been knowingly a party to any illegal activity. The head of internal audit should also ensure that the internal audit staff are persons of integrity.*” The term “a party to any illegal activity” may be too generalized as certain offences (e.g. illegal parking) may not impair the

honesty, diligence and integrity of the person. Such standards should apply to all staff working in banks and not only to internal audit staff.

- **Paragraph 54**

This paragraph refers to INA's responsibility to follow-up on implementation of its recommendations. It would be helpful if this paragraph made clear that the primary responsibility for monitoring and reporting on the implementation of INA recommendations lies with management rather than INA (subject to INA being in a position to highlight any discrepancies in the reported data).

- **Paragraph 56**

This paragraph indicates that responsibility for internal control does not transfer from one line to another and we are fully supportive of the principle that the first line should not be dependent on the second line checking in ensuring appropriate control of risk, and so on for the second and third line. However, it may be appropriate for "superior" lines to place reliance on the work of others e.g. INA 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 and this principle should also be recognized.

- **Paragraph 59**

This paragraph states that *"The internal audit function employs a risk-based approach to assess the efficiency and effectiveness of the design and operation of internal control and periodically provides assurance to senior management and the board of directors."*

Internal audit would normally primarily focus on the *"Adequacy of design and effectiveness of operations"* and therefore the above wording may require further review.

- **Paragraph 73**

This paragraph requires supervisors to understand reasons for changes in audit plans. This may be an overly prescriptive requirement and should supervisors wish to understand reasons for changes in plans they would always be entitled so to do. A requirement might prove to be both time consuming and a distraction from more significant matters.

- **Paragraph 74**

This paragraph indicates that supervisory authorities may consider sharing relevant information with INA. 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 INA to "develop an

informed and independent view of the risks faced by the Bank" supports this approach.

- **Annex 1**

This sets out all linkages for INA but also includes some linkages for non-INA areas e.g. External Audit to Board. Whilst the paper states that not all non-INA communication channels are depicted, we suggest depicting some of the important ones, particularly the one between senior management and the board and audit committee which is currently excluded in the diagram.

- **Annex 2**

According to paragraph 44, "*senior management is responsible for developing an internal control framework that identifies, measures, monitors and controls all risks faced by the bank*", and according to paragraph 49, "*The audit committee ... ensures that senior management is taking necessary and timely corrective actions to address control weaknesses, compliance issues with policies, laws and regulations and other concerns identified and reported by the internal audit function.*"

In this regard, the responsibility of the audit committee in relation to "*control weaknesses, non-compliance with policies, laws and regulations and other problems identified by internal auditors and external auditors*" should have been covered in paragraph (z). The responsibility stated in Paragraph (aa) should only be applicable to the senior management as the audit committee should not be "addressing" issues, rather they should only be ensuring the senior management are addressing issues.

We hope you would find the above comments useful. If you have any questions, please do not hesitate to contact us.

Yours faithfully



Ronie Mak  
Secretary

c.c. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority