International Banking Federation

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

2nd March 2012

baselcommittee@bis.org

Dear Sirs/Madam,

Re: BIS Consultative Document on The internal Audit Function in Banks (December 2011)

The International Banking Federation ('IBFed') is the representative body for national and international banking federations from leading financial nations around the world. Its membership includes the American Bankers Association, the Australian Bankers' Association, the Canadian Bankers Association, the European Banking Federation, the Japanese Bankers' Association, the China Banking Association, the Indian Banks' Association, the Korean Federation of Banks, the Association of Russian Banks and the Banking Association South Africa. This worldwide reach enables the Federation to function as the key international forum for considering legislative, regulatory and other issues of interest to the banking industry and to our customers.

The Federation welcomes the opportunity to comment on your consultative document on The internal audit function in banks (the 'Consultative Document') issued by the Basel Committee on Banking Supervision (the 'Basel Committee') in December 2011, which revises the document Internal Audit in Banks and the Supervisor's Relationship with Auditors (the '2001 Document') issued by the Basel Committee in 2001. Please find set out below our general remarks, as well as comments directed towards specific aspects of the Consultative Document.

General Remarks

The Federation considers a bank's internal audit function to be a key tool, among others, for monitoring the adequacy and effectiveness of the bank's risk management controls and internal control systems. The Federation also believes that strong risk management is critical to the safety and soundness of banks, and the financial sector generally.

However, the Federation recognizes that having an internal audit function is not a requisite of internal control[1]. Therefore, the Federation is concerned about several specific areas where the

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[1] This is consistent with paragraph 389 of the Committee of Sponsoring Organizations' (COSO) December 2011 draft for public exposure of *Internal Control – Integrated Framework*.

Consultative Document puts forward highly prescriptive requirements. This level of granularity risks undermining the role of national supervisors and bank management to determine the internal bank processes. For example, the Consultative Documents sets specific requirements in several areas where it is primarily the role of bank management to make key decisions regarding bank operations and employees, including:

In respect of bank operations:

- Bank level organization of audit function
- Development of bank policies and procedures
- Timing and responsibility for audit reports
- Content of audit reports
- Use of third-party vendors & consultants

In respect of bank employees:

- Integrity of audit staff
- Personal character of audit staff, particular the chief auditor
- Employee remuneration
- Employee scheduling and portfolio
- Job description of audit staff
- "Standing" and respect for audit staff within the organization
- Hiring and dismissal of audit staff

In respect of the relationship between supervisor and bank:

- Detailed outline of discussion topics
- Who should initiative the conversation/contact

A related concern is that the Consultative Document is rather strongly worded relative to the 2001 Document. This change in tone makes it appear that the Consultative Document is intended by the Basel Committee to act as a rule rather than guidance, which would be a departure from previous practice by the Basel Committee.

In order to address these concerns, the Federation is of the view that the Consultative Document should be revised to be more principles-based and flexible, rather than prescriptive. This would provide local supervisors and different institutions with the ability to determine how to, respectively, modify the principles or adhere to them in a way that is consistent with local law requirements, the practices of the bank's board, the bank's general business management practices, etc. Further, given that the Basel Committee's recommendations are focussed on "large internationally active banks", and the general support for risk-based processes and controls, we believe that the Basel Committee should focus more on key risks and emphasize the importance of a risk-based approach to supervision of internal audit.

In our specific comments below, we have noted further details regarding certain proposed measures in the Consultative Document that we believe are overly prescriptive, but there are several additional areas where we consider the discretion of the national supervisor needs to be clarified.

It is the longstanding view of the Federation that regulatory requirements should take into account the nature, scale and complexity of the firms to which they are applied. Thus, we believe that the expectations to be met by complex, globally active financial institutions will be higher than those directed at banks with a limited focus and a simple business model. Generally, smaller banks and those banks with less risky profiles that should not be subject to the same risk management parameters as large banks and those banks with relatively riskier profiles. However, the Consultative Document's focus on "large and international banks" with broad application to "all banks" does not sufficiently take into account the many differences in asset size, business model,

charter type, and cost effectiveness. We have been strong supporters of the Basel Committee's express commitment to the principle of proportionality inherent in Pillar 2 of the Basel Accord and therefore recommend changing the Consultative Document to allow national supervisors to evaluate how internal risk should operate, which institutions should be required to comply with internal audit requirements and make appropriate recommendations for smaller and less riskier banks.

Specific Comments

Supervisory expectations relevant to internal audit functions

Introduction: Paragraph 2 states that the Committee's *Principles for Enhancing Corporate Governance* "requires" that banks have an internal audit function. To be more consistent with the language of that document, we recommend that this wording be changed to state that "The Committee's *Principles for Enhancing Corporate Governance* includes as part of its principles for good corporate governance, the inclusion of an internal audit function.

Paragraph 4 of the Consultative Document "encourages bank internal auditors to comply with and contribute to the development of national and international professional standards, such as …". We are concerned that the Basel Committee is imposing a requirement on all internal auditors to "contribute to the development of national and international professional standards". Standards are generally developed by dedicated task or work groups, who then receive comments on such drafts and modify accordingly. We believe it is unreasonable for employers, professional representative bodies or individual internal auditors to have this general obligation placed on them, especially as it is coming from an external prudential standard setter. We recommend that all references in the Consultative Document to this particular requirement be removed. If the Basel Committee chooses to retain references to standards, we believe that it is important that any standards set out in the Consultative Document be aligned and consistent with the standards and definitions issued by The Institute of Internal Auditors with respect to, for example, the periodic review of the internal audit function by the audit committee or the board of directors.

Principle 1: Paragraph 9 discusses the role of internal audit in improving the effectiveness of processes. In contrast, paragraph 8 references the assessment of a bank's internal control, risk management and governance absent a reference to "processes". This potentially implies an expansion of the mandate beyond assessing the effectiveness of controls. We therefore recommend that "process" be inserted in paragraph 8 for consistency and certainty.

Principle 2: Paragraph 14 recommends that "whenever practicable and without jeopardizing competence and expertise" that internal audit shall rotate staff periodically. The paragraph is unusually prescriptive in that it delves into the basis of resource management by the internal audit leader. We support the goals of internal audit objectivity and independence. However, we believe that mandatory staff rotation is just one means of reaching these goals. Further, staff rotations can be a particularly challenging process with potentially significant negative implications for the individuals and the audited internal audit practice's business/control areas.

In addition, paragraph 15 comments that the basis of remuneration can undermine independence and objectivity if compensation is linked to financial performance of a group or the bank as a whole. While an argument may be made for remuneration of an auditor not to be linked solely to the business line for which they are responsible, there are sound arguments for not prohibiting a linkage to audit performance of the bank (including ability to move staff among units and other compatible areas that may be hindered by a differentiated compensation process specific to internal audit). We recommend that paragraph 14 be revised to require that the internal audit head have suitable arrangements in place to ensure objectivity of personnel (which is consistent with the overall principle) and that such arrangements be reviewed periodically with the chief executive officer and the audit committee. Paragraph 15 should also be revised to require that the internal

audit head evaluate, also within the internal audit function's quality assurance process, the basis of compensation for internal audit staff for consistency with the independence and objectivity of the function, and that the basis be reviewed with senior management and the audit committee. We note in this regard that the IIA Standards have a QA process that should address independence and objectivity.

Principle 6: We believe that the Consultative Document should not mandate that the purpose of internal audit to assess the "efficiency" of operations. This task should be left to the senior management of the bank, except where it is required of the internal audit function pursuant to other legal requirements or standards applicable in one or more particular jurisdictions. Internal audit can, however, assess the effectiveness of operations, and we recommend that this principle be modified accordingly.

Principle 8: Paragraph 41 elaborates on a permanent audit function while paragraph 42 introduces potential for full outsourcing – these concepts seem contradictory. The Consultative Document should clarify intentions in this regard. There should be some flexibility in selecting an appropriate model but, in any event, it is a basis that should be approved by the audit committee.

Principle 10: In order to accommodate differences in local law and individual bank practices, we recommend modifying the first line of paragraph 49 to state the following: "The audit committee reviews and the board, senior management or the audit committee approve the audit plan and, if any, the audit cycle." (modification underlined).

Principle 13: Paragraphs 55-59 of the Consultative Document articulate how a bank should defend itself against the risks it faces using a model called the '3 lines of defence'. In our view, it is inappropriate to recommend such a sweeping model in a consultative document designed for only one of the control functions - internal audit. It should be the responsibility of senior management and the board to define the model, consistent with their overall responsibility for the system of internal control. We therefore believe that that 3 lines of defence model would be more appropriately located in a 'governance'/'risk' type document instead of the Consultative Document which merely concerns the internal audit function in banks.

Further and notwithstanding our above mentioned preference for the removal of the '3 lines of defence' model from the Consultative Document, interaction between the second and third lines is not defined although the principles indicate internal audit assessment of the effectiveness of controls in such areas. We therefore recommend revisions that:

- eliminate the requirement for a model that extends beyond internal audit; and
- reference the internal audit interaction with other control functions.

Principle 16: This principle requires the supervisor to engage the internal auditors to "understand the risk mitigation measures taken by the bank" – presumably in relation to the "risk areas identified by both parties". We would have expected that the supervisors would primarily engage the banks' risk management executives, rather than internal auditors, on general risk mitigation measures.

As we see it, the internal audit function acts on behalf of senior management and the audit committee with the aim of ensuring the effectiveness and adequacy of risk management controls and internal control systems. It follows, therefore, that the internal audit function should also report first and foremost to senior management and the audit committee. We have serious reservations about the idea of internal auditors reporting their findings and recommendations to supervisory authorities directly (paragraphs 71 and 72). In our view, the first port of call for supervisors should be senior management, which should also be responsible for coordinating all enquiries and reports.

We would agree, however, that subsequent regular exchanges of information and discussions between supervisors and internal auditors may well make good sense. To maximize the efficiency of such exchanges, representatives from the business units concerned should also attend discussions of findings and corrective action.

Also in relation to Principle 16, at paragraph 77, it is noted that "internal audit is well placed to provide the supervisor with insight on the institution's business model including risks in the institution's business activities, processes and functions…". In our view, this requirement is misplaced, and supervisors should engage the business and risk management executives for such insight. However, we agree that internal audit may well provide insight on "the adequacy on the control and oversight of these risks …". We recommend that this section be modified accordingly.

Furthermore, it is not, in our view, within the responsibility of the internal audit function to make judgements about specific results of risk measurement or accounting figures. This is the task of the risk management and accounting staff. The internal audit function is primarily involved in evaluating the appropriateness of processes and controls in these areas. We would therefore like to suggest amending paragraph 78 to read as follows: "To the extent that accounting data drives certain regulatory measures or is included in regulatory reporting, supervisors should seek to understand and benefit from work performed by internal audit on processes and controls relating to: […]".

The relationship of the supervisory authority with the internal audit function

We note that, in a number of paragraphs, there is reference to "enhanced communication" without an indication of what that includes. We recommend removing the references to "enhanced" or, alternatively, request clarification as to the nature of such communications.

Annex 2: Responsibilities of a bank's audit committee

As a general comment, we respectfully question the appropriateness of including the Annex in the Consultative Document as it concerns governance matters rather than the internal audit function at which the Consultative Document is directed. The Annex sets out responsibilities in paragraphs (m), (n) and (o) regarding remuneration and performance of the internal audit head and key internal auditors. This seems unusually prescriptive given that: (1) the board of directors should have the ability to decide on the appropriate committee for executive appointments (for example, the human resources committee is a viable and reasonable alternative); and (2) the internal audit leader who is responsible for managing staff and reviewing performance of their reports should determine reviews. Practically speaking, the audit committee would not be sufficiently familiar with the performance of "key" auditors to effectively assess, comment on or evaluate their performance review. We note also in this regard that the term "key" is not defined and could be interpreted more expansively than intended. We recommend that the Consultative Document be revised to allow the board of directors greater flexibility with respect to the approval/appointment/removal of "key" internal auditors.

In conclusion, we thank you again for the opportunity to comment on the Consultative Document.

Yours faithfully,

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Managing Director, IBFed

Nathalie Clark
Chairman, IBFed Accounting Working Group