

Introductory comments on the Basel Committee consultative document (December 2011)

IFACI (IIA France) has read the Basel Committee consultative document of December 2011 concerning the internal audit function in banks with keen interest.

While taking up the main points developed in the document published in 2001 under the title “Internal audit in banks and the supervisor’s relationship with auditors”, the IFACI notes with satisfaction that the 20 principles set out in the 2011 version are a positive response to the challenges faced by internal audits functions today and possibly tomorrow.

IFACI therefore approves the consultative document as a whole, but would like to draw attention to the following points:

1. IIA standards

The document refers to some IIA standards on several occasions and we acknowledge this. IFACI considers however that the document should recommend that internal auditors comply with the professional standards of the IIA taken as an indivisible whole.

The International Professional Practices Framework of internal auditing (IPPF) is robust and forms a consistent unit that must be applied without picking. It has proved its effectiveness and relevance over the years.

2. Independence and position of internal audit in the bank

The independence of the person in charge of internal auditing and internal auditors is essential for the function to be seen as credible in institutions. This credibility is achieved through a close relationship with the bank’s governance bodies. The Basel Committee states rightly in its introduction that “the principles set out in this document should be applied in accordance with the applicable national corporate governance structure of each country.” Indeed, two models can be envisaged: a model that establishes a stronger link between the internal audit function, the board of director or the supervisory board, and a model that establishes a closer link with the executive management.

It is up to banks to combine these two approaches, drawing from the specific advantages of each one. For instance, giving preference to a very close relationship with the audit committee to the detriment of the senior management by giving it a much more important role that it actually has may have a negative impact on the effective and efficient performance of the internal audit function. Audit committees must know how to take benefit from internal audit activities. They are doing this better and better, all the while asking questions about the level of governance without going into details that would be too operational and would involve direct reporting of the internal audit function the audit committee.

IFACI considers that it is preferable for the internal audit function to report to the senior management, and notes that there is a consensus on this point in France. It goes without saying that the internal audit function must have a regular relationship with the audit committee. This is because it is important for internal auditors to have the legitimacy and support that they need to carry out the thorough investigations required, which they can only obtain if they are close to the general management. Moreover, it is more essential for internal auditors to be perfectly familiar with the bank's business and specific characteristics, its problems, difficulties and risks and to participate with all the other employees in the bank's successes and share its failures.

Therefore, for the internal audit function to be operational in its recommendations and be accountable, it must remain an **internal function** of the company and consequently report to the executive body.

The reporting structure must be combined with close and regular relations with the audit committee, which must play a significant role:

- It is informed or consulted on questions relating to the appointment, appraisal, compensation and replacement of the head of internal audit. It is consulted beforehand in exceptional situations such as dismissal and resignation.
- It makes sure that the internal audit has the resources required for carrying out the audit plan. It inquires about the composition and professionalism of the internal audit team and ensures that the resources provided are in line with internal audit engagements. It makes sure that the turnover and compensation of internal auditors will guarantee career attractiveness and personal consideration.
- It takes cognizance of documents that formalise the organisation of the internal audit department, in particular the internal audit charter.
- It reviews the audit plan.
- It regularly receives information about the internal audit activity:
 - o Monitoring of the creation of the audit plan,
 - o Main findings of audits,
 - o Implementation of corrective actions, etc.

As an independent function, internal audit must have a well-established status as well as all the resources and information required to carry out its engagement.

3. Scope of action of internal audit

The role of internal audit is reinforced by the fact that, as the third line of defence, it remains the last control level of the internal control and risk management system, and in particular of the risk management department which also finds its role increased.

IFACI has taken note that in the consultative document, the internal audit mandate was very vast and concerned the assessment of compliance and risk management functions as well as the assessment

of governance, internal control and risk management processes. It is important that this be stated more clearly.

The internal audit function must not be perceived as a mere assessor of internal control and its mandate must not be considered as restricted to compliance.

4. Creation of a glossary

Since each term may have diverging interpretations, we think it is very advisable to create a glossary (for terms like Internal Control, Internal Control System, Internal Control Framework and Reporting functions).

The table appended contains additional comments.

Annex

In complement of our general comment letter, our opinion is detailed on the following paragraphs:

On paragraph 5, we agree with the position but we want to add that whatever the management structure of internal audit function:

1. Internal Audit needs to be supervised on a well-defined and transparent way.
2. This supervision must be effective and actually work.
3. And, in particular, cover the management of the people.

These principles are the prerequisites to the actual independence of the internal audit function. If there are not actually and adequately addressed, internal audit may be weakened and therefore neglected.

On paragraph 42, when the internal audit activity is carried out by an external service provider, the Chief Audit Executive, in the organization, is responsible for the efficiency of the contract and the quality of internal audit activity. He reports to senior management and the Board for internal audit activity. If internal audit activity is fully outsourced, the organization must be watchful about risks to independence and objectivity.

On Principle 12, IFACI's position is that the internal audit function should report to senior management. A consensus of opinion should be established in France on this point. Furthermore, there should be a regular relationship between the internal audit function and the audit committee.

We suggest also some rewriting (highlighted in bold) for the following paragraphs ::

- Principle 1: An effective internal audit function independently and objectively evaluates the quality and effectiveness of **bank's governance, risk management and internal control**, which assists senior management and the Board of Directors in protecting their organisation and its reputation.
- Paragraph 15 : The independence and objectivity of the internal audit function **should not** be undermined **by incentives to the staff exclusively** linked to the financial performance of the business line or region for which they exercise internal audit responsibilities.
- Principle 4 : Internal auditors should act with integrity, **objectivity, confidentiality and competency**.
- Paragraph 23: The charter should be drawn up and reviewed periodically by the head of internal audit and approved **by the CEO** or the board of directors. It should be available to all internal and external stakeholders of the organisation.
- Paragraph 24 : At a minimum, an internal audit charter should establish:
 - The internal audit function's position, its authority, its responsibility **within the Bank** and its relations with other control functions;
- Paragraph 27 : We recommend to add a new paragraph :

The internal audit function should evaluate:

 - **governance, risk management;**

- Paragraph 31 : A bank's system of risk management supports and reflects its adherence to regulatory provisions and safe and sound banking practices. Therefore, internal audit should include in its scope **the assessment of** following aspects of risk management:
 - the approval **process** and maintenance of risk models including verification of the consistency, timeliness, independence and reliability of data sources used in such models.
- Paragraph 32: Banks are subject to the global regulatory framework for capital and liquidity as approved by the Committee and implemented in national regulation. This framework contains measures to strengthen regulatory capital and global liquidity. The scope of internal audit should include **assessing** all provisions of this regulatory framework and in particular the bank's system for identifying and measuring its regulatory capital and assessing the adequacy of its capital resources in relation to the bank's risk exposures and established minimum ratios.
- Principle 9: The bank's board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate, effective and efficient internal control framework and internal audit function **guaranteed by an external review**.
- Paragraph 53 : The Internal audit function is accountable to **the senior management and to the board** on all matters related to the performance of its mandate as described in the internal audit charter
- Paragraph 54: Senior management is responsible for implementing and maintaining an adequate and effective internal control framework. Therefore the internal audit function should **inform the senior management** 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 or its Audit Committee **of the status of critical findings that have (yet) not** been rectified by senior management.
- Principle 13: Internal audit should both **add value** and assess operational management, risk management, compliance and other control functions.
- Paragraph 58: The risk management function facilitates and monitors the implementation of effective risk management practices by operational management. It assists operational management in defining risk exposures and reporting through the organisation. The compliance function monitors the risk of non-compliance with laws, regulations and standards. These functions are also control functions which ensure that policies and procedures with regard to risk-taking are enforced. Other monitoring functions may include **finance**, human resources and the legal department.
- Principle 14: The internal audit function in a group structure or holding company structure should be established and **organized** centrally by the parent bank.
- Principle 15: Regardless of whether internal audit activities are outsourced, the board of directors remains ultimately responsible for ensuring that the system of internal control **including risk management system**, and the internal audit function are adequate and operating effectively.
- Paragraph 90: The audit committee and board of directors should not conclude that the internal audit function is functioning well solely because the supervisory authority has not identified weaknesses. **Indeed the audit committee's assessment and the quality assurance**

and improvement program, including the external assessment required by the IIA Standards, of the internal audit function are critical components of the supervisory review process.