



1 March 2012

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

Dear Sir / Madam

**Re: Consultative document: The internal audit function in banks**

As a bank within the South African environment, Nedbank is required to first comply with all local regulatory requirements. In the drafting of these comments, the following was taken into account (in order of precedence):

1. The Banks Act, 1990 (as amended)
2. Companies Act, 2008 (as amended)
3. King Code of Governance Principles (King III)
4. Company policies and Charters

Where this consultative document requests for something to be done that is contrary to legislation, the legislation must take precedence. During our review, we noted that there was one instance of where the consultative document required more than local legislation (this was not considered to be of concern in our business as the business is currently compliant with the requirement in the consultative document). Refer to the comment on **"Responsibilities of a bank's audit committee"** in the attached document.

In addition to this International Standards for the Professional Practice of Internal Auditing were taken into account.

The attached document also details any instances where, we believe, the drafting of the consultative document needs attention. Refer to comments and recommendations in the attached document.

In addition to the attachments we would like to draw your attention to the fact that the language used in the consultative documents tends to be loose and words are used interchangeably: monitoring,



**NEDBANK**  
GROUP

**GROUP INTERNAL AUDIT**

135 Rivonia Road Sandown 2146  
P O Box 1144 Johannesburg 2000 South Africa  
Tel +27 (0)11 294 4444 Fax +27 (0)11 295 1111 [www.nedbank.co.za](http://www.nedbank.co.za)

Nedbank Group Limited Reg No 1966/010630/06

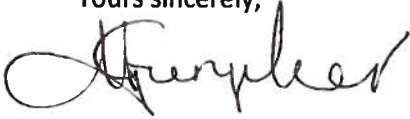
Directors: Dr RJ Khoza (Chairman) MWT Brown (Chief Executive) TA Boardman TCP Chikane GW Dempster (Chief Operating Officer)  
MA Enus-Brey Prof B de L Figaji DI Hope (New Zealand) A de VC Knott-Craig WE Lucas-Bull PM Makwana NP Mnxasana RK Morathi (Chief Financial Officer)  
JK Netshitenzhe JVF Roberts (British) GT Serobe MI Wyman (British)  
Company Secretary: GS Nienaber

We subscribe to the Code of Banking Practice of The Banking Association South Africa and, for unresolved disputes, support resolution through the Ombudsman for Banking Services. We are an authorised financial services provider. We are a registered credit provider in terms of the National Credit Act (NCR Reg No NCRCP16).

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reviewing and overseeing. We would recommend that words be defined to assist in the understanding and interpretation of the document.

Yours sincerely,



**Glynis Hunziker**  
**Chief Internal Auditor**  
**Nedbank Limited**

Per email:

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

cc: [SARB-BANKSUP@resbank.co.za](mailto:SARB-BANKSUP@resbank.co.za)

Ref	Basel requirement	Comment
	<p><b>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 in protecting their organisation and its reputation.</b></p> <p><b>1. The internal audit function</b></p>	
8	<p>The internal audit function plays a crucial role in the ongoing maintenance and assessment of a bank's internal control, risk management and governance – areas in which supervisory authorities have a keen interest. Furthermore, both internal auditors and supervisors use risk based approaches to determine their respective work plans and actions.</p> <p>While internal auditors and supervisors each have a different mandate and are responsible for their own judgments and assessments, they may identify the same or similar/related risks.</p>	<p>The use of the word “maintenance” in the sentence “The internal audit function plays a crucial role in the ongoing maintenance and assessment of a bank's internal control, risk management and governance – areas in which supervisory authorities have a keen interest” is incorrect.</p> <p>An internal audit function should not be involved in the maintenance of a bank's internal control, risk management and governance.</p> <p>There should be clear delineation between management responsibility – being maintenance and internal audit responsibility – being assessment of the control environment.</p> <p>Should internal audit be involved in both maintenance and assessment this would have an adverse impact on the requirement that internal audit be independent.</p> <p>Recommend that “maintenance and” be removed from the sentence.</p>
	<p><b>2. Key features of the internal audit function</b></p> <p><b>(a) Independence and objectivity<sup>3</sup></b></p> <p><b>Principle 2: The bank's internal audit function must be independent of the audited activities. This requires that the internal audit function has an appropriate standing within the bank, enabling internal auditors to carry out their assignments with objectivity.</b> <sup>3</sup> Both 'independence' and 'objectivity' have a specific meaning in an internal audit environment. The Glossary of The Institute of Internal Auditors refers to independence as the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. Objectivity is referred to in the Glossary as an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgement on</p>	<p>This principle states that the internal audit function should have “an appropriate standing within the bank”, but the use of the word “appropriate” is open to interpretation and as such this principle is not clear.</p> <p>Recommend that this principle be changed to reflect that internal audit should have executive level standing (and have the capability to operate at this level) and have free and unfettered access to the board.</p>

Ref	Basel requirement audit matters to others.	Comment
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.	<p>This statement includes "linked to the financial performance of ... or the financial performance of the bank as a whole". Practically remuneration will always be linked to the performance of the bank as a whole, to do otherwise would be counterintuitive.</p> <p>Recommend that the link to the financial performance of the bank as a whole is deleted and a statement regarding remuneration not providing an incentive for internal auditors to act contrary to attribute and objectives of internal audit and the IIA codes of conduct.</p>
	<b>3. The internal audit charter</b>	
	<b>Principle 5: Each bank should have an internal audit charter that articulates the purpose, standing and authority of the internal audit function within the bank.</b>	
24	<p>At a minimum, an internal audit charter should establish:</p> <ul style="list-style-type: none"> <li>• The internal audit function's position within the bank, its authority, its responsibility and its relations with other control functions;</li> <li>• The purpose and scope of the internal audit function;</li> <li>• The key features described above under Section A.2, Key features of the internal audit function;</li> <li>• The obligation of the internal auditors to communicate the results of their engagements and a description of how and to whom this should be done (reporting line);</li> <li>• The criteria for when and how the internal audit function may outsource some of its engagements to external experts;</li> <li>• The terms and conditions according to which the internal audit function can be called upon to provide consulting or advisory services or to carry out other special tasks;</li> <li>• The responsibility and accountability of the head of internal audit;</li> <li>• A requirement to comply with sound internal auditing standards;</li> <li>• Procedures for the coordination of the internal audit function with the statutory or external auditor</li> </ul>	<p>This statement includes "The terms and conditions according to which the internal audit function can be called upon to provide consulting or advisory services or to carry out other special tasks".</p> <p>A charter is a policy document and should not include processes.</p> <p>Terms and conditions are items that are addressed in a process and not in a policy.</p> <p>Recommend that this wording is removed as a requirement of the charter and rather considered in terms of processes that the committee would expect the internal audit function to have addressed.</p>

Ref	Basel requirement	Comment
	<b>4. Scope of activity</b>	
	<b>Principle 6: Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function.</b>	<p>This principle and supporting paragraphs (26 to 29) focus on internal control.</p> <p>Internal audit should focus on: internal control, risk management and governance processes.</p> <p>Recommend that principle and supporting paragraphs are redrafted to include risk management and governance processes.</p>
29	The head of internal audit is responsible for establishing an annual internal audit plan that can be part of a multi-year plan. The plan should be based on a risk assessment (including input from senior management and the board) and should be updated at least annually. 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). The board's approval of the audit plan implies that an appropriate budget will be available to support the internal audit function's activities. The budget should be sufficiently flexible to adapt to variations in the internal audit plan in response to changes in the bank's risk profile.	<p>This paragraph talks about "a multi-year plan" and "... should ensure that all entities and all activities of the bank are audited at least once within an appropriate period of time..."</p> <p>"a multi-year plan" can be read to imply that this is a good / advisable practice, but in reality a plan needs to be built in a manner that allows for fast change in the event of a change in risk profile.</p> <p>"... should ensure that all entities and all activities of the bank are audited at least once within an appropriate period of time..." this statement is inconsistent with the requirement for a risk based approach.</p> <p>Recommend that both of these statements are removed from this paragraph.</p>
	<b>Principle 7: The internal audit function should ensure adequate coverage of regulatory matters within the audit plan.</b>	<p>This principle highlights regulatory risk when in reality internal audit should focus on all significant risks to the bank.</p>
30	Internal audit should have appropriate capability regarding regulatory matters and undertake regular reviews of such areas. These include policies, processes and governance measures established in response to various regulatory principles, rules and guidance established by the relevant authorities. In particular, the internal audit function of a bank should have the capacity to review key risk management functions, regulatory capital adequacy and liquidity control functions, regulatory reporting functions and regulatory compliance functions.	<p>Recommend that this principle be re-worded to cover all significant risks.</p> <p>This statement could result in a misinterpretation such that all other significant risks are excluded from internal audit work.</p> <p>Recommend that this statement is re-worded such that the misinterpretation cannot take place.</p>



Ref	Basel requirement	Comment
	<b>(a) Risk management</b>	
31	<p>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 following aspects of risk management:</p> <ul style="list-style-type: none"> <li>the organisation and mandates of the risk management functions including market, credit, liquidity, interest rate, operational, and legal risks;</li> <li>the adequacy of risk management systems and processes for identifying, measuring, assessing, controlling, responding to, and reporting on all the risks resulting from the bank's activities;</li> <li>the integrity of the risk management information systems, including the accuracy, reliability and completeness of the data used; and</li> <li>the approval and maintenance of risk models including verification of the consistency, timeliness, independence and reliability of data sources used in such models.</li> </ul>	<p>This statement could result in a misinterpretation such that all other significant risks are excluded from internal audit work.</p> <p>Recommend that this statement is re-worded such that the misinterpretation cannot take place.</p>
	<b>(b) Capital adequacy and liquidity</b>	
32	<p>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 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.</p>	<p>This statement could result in a misinterpretation such that all other significant risks are excluded from internal audit work.</p> <p>In addition, this paragraph requires that internal audit staff have a level of knowledge and understanding that is comparable with experts in the business. This may result in an internal audit function being put under pressure from a remuneration and knowledge perspective.</p> <p>Recommend that this statement is re-worded such that the misinterpretation cannot take place.</p> <p>Recommend that this paragraph makes the allowance for this work to be performed by an external assurance provider who may be in a better position regarding staff with the level of knowledge and experience.</p>
33	<p>Internal audit should review management's process for stress testing its capital levels, taking into account the frequency of such exercises, their purpose (e.g., internal monitoring vs. regulator imposed), the</p>	<p>This statement could result in a misinterpretation such that all other significant risks are excluded from internal audit work.</p> <p>In addition, this paragraph requires that internal audit staff have a level of</p>

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	reasonableness of scenarios and the underlying assumptions employed, and the reliability of the processes used.	<p>knowledge and understanding that is comparable with experts in the business. This may result in an internal audit function being put under pressure from a remuneration and knowledge perspective.</p> <p>Recommend that this statement is re-worded such that the misinterpretation cannot take place.</p> <p>Recommend that this paragraph makes the allowance for this work to be performed by an external assurance provider who may be in a better position regarding staff with the level of knowledge and experience.</p>
34	Additionally, the bank's systems and processes for measuring and monitoring its liquidity positions in relation to its risk profile, external environment, and minimum regulatory requirements, should fall within the audit universe.	<p>This statement could result in a misinterpretation such that all other significant risks are excluded from internal audit work.</p> <p>In addition, this paragraph requires that internal audit staff have a level of knowledge and understanding that is comparable with experts in the business. This may result in an internal audit function being put under pressure from a remuneration and knowledge perspective.</p> <p>Recommend that this statement is re-worded such that the misinterpretation cannot take place.</p> <p>Recommend that this paragraph makes the allowance for this work to be performed by an external assurance provider who may be in a better position regarding staff with the level of knowledge and experience.</p>
	<b>5. Corporate governance considerations</b>	
	<b>(b) Responsibilities of the board of directors and senior management</b>	
	<b>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.</b>	<p>This principle focuses on internal control.</p> <p>The board of directors should focus on: internal control, risk management and governance processes.</p> <p>Recommend that principle and supporting paragraphs are redrafted to include risk management and governance processes.</p>
46	Senior management should be accountable for ensuring that timely and appropriate actions are taken on all internal audit findings and recommendations.	<p>This paragraph refers to "recommendations". Practically internal audit functions tend to facilitate management putting in place a management action that addresses an unmitigated risk. Recommendations from</p>

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		internal audit can result in actions that are not practical, not cost effective etc, the business is in a better position to propose a management action.  Recommend that “recommendations” is replaced with “management actions”.
	<i>(e) Reporting lines of the internal audit function</i>	
	<b>Principle 12: The internal audit function should report to the audit committee or the board of directors and should inform senior management about its findings.</b>	
54	Senior management is responsible for implementing and maintaining an adequate and effective internal control framework. Therefore the internal audit function should inform senior management of 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, the status of findings that have not (yet) been rectified by senior management.	The final sentence of this paragraph “The head of the internal audit function should report to the board, or its audit committee, the status of findings that have not (yet) been rectified by senior management” may result in too much detail being reported. Where a method requires that issues / findings are allocated different levels of significance based on the impact, of the unmitigated risk, on the business. This paragraph may result in less material items being reported on and diluting the focus on the more material issues.  Recommend that the paragraph be updated to allow for the escalation of significant / material issues.
	<i>(f) The relationship between the internal audit, compliance and risk management functions</i>	
	<b>Principle 13: Internal audit should both complement and assess operational management, risk management, compliance and other control functions.</b>	This principle could be interpreted as requiring a performance evaluation of management.  Recommend that the principle is re-worded to avoid misinterpretation.
56	Control failings by one line of defence should, in principle, be detected by another line of defence. However, responsibility for internal control does not transfer from one line to another.	This paragraph could be read to require that first line of defence (operational management) highlight control failings within third line of defence (internal audit).  Recommend that the paragraph is re-worded to avoid the above.
	<b>Annex 2</b>	



Ref	Basel requirement	Comment
	<b>Responsibilities of a bank's audit committee</b>	
	<p>The audit committee is a specialised committee within the board of directors.</p> <p>As such, it prepares the work of and reports to the board of directors in specific areas for which it has designated responsibility. The board of directors assumes final responsibility.</p> <p>The main areas of responsibility of the audit committee are listed below by broad categories.</p> <p>The list provides a summary of sound practices for the audit committee of a bank. This list may vary according to local regulations and practices. For example, the responsibilities of an audit committee may be assumed directly by the board of directors in some banks or in some countries.</p>	<p>This paragraph states "the audit committee is a specialised committee within the board of directors". Neither the Banks Act nor the Companies Act require that the audit committee be a board committee, but rather that the committee is made up of board members.</p> <p>Recommend that given the fact that local legislation will take precedence, the paragraph is updated to require that the audit committee is made up of board members.</p>
(k)	<p><b>Internal audit</b></p> <p>reviewing discoveries of fraud and violations of laws and regulations as raised by the head of the internal audit function;</p>	<p>This paragraph implies that internal audit can audit to find fraud. Due to the ever changing nature of fraud, the approach to the identification of fraud is active rather than proactive. Within a bank specific responsibility for the identification and investigation is given to a forensic area.</p> <p>Recommend that this paragraph be changed to such that the responsibility for fraud identification and reporting sit with a forensic function and not internal audit.</p>