



HIGHER SCHOOL OF ECONOMICS

National Research University

(Moscow, Russia)

<http://www.hse.ru/en/>

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Basel Committee on Banking Supervision

Email: baselcommittee@bis.org

Dear Sirs,

**Basel Committee on Banking Supervision Consultative Document
Bank's Internal Audit Function**

On behalf of the National Research University Higher School of Economics (HSE), and particularly the International Laboratory of Decision Choice and Analysis and the Laboratory of the Banking Institute we would like to thank Basel Committee on Banking Supervision for the opportunity to deliver our opinion on the Consultation Document 'Bank's Internal Audit Function' [further on - *BCBS210*] published by the Basel Committee on Banking Supervision on December 2, 2011 at <http://www.bis.org/publ/bcbs210.htm>.

The comments are presented in three parts:

- (a) 'General Comments' refer to the overall issues related to capital disclosure;
- (b) 'Paragraph-wise Comments' correspond to the particular paragraphs that attracted our attention.

We hope our comments would be of use for deriving financial stability-oriented identification and regulation principles with respect to organization of internal audit functions in banks.

In case of further questions, please, do not hesitate to get in touch through email (dhm-econ@hse.ru), telephone (+7.495.621.13.42, ext. 2006) or fax (+7.495.772.95.90, ext. 2101).

Dr. H. Penikas

Lecturer

Economics Department

Key Comments

1. The document describes the overview of the principles of internal audit functions for Banks. It is necessary to determine analogous principles of internal audit for all types of financial institutes and cross-institutes activities (especially with respect to the BIS consultative document “Principles for the supervision of financial conglomerates”, cf. <http://www.bis.org/publ/joint27.htm>).
2. We propose to develop framework of the principles of internal audit functions on the basis of business-process framework. This “bottom-up” type of developing the principles usually gives more functional model completeness of framework and it will be more useful for developing the future foundation for an internal audit and risk management systems.
3. We propose to establish the financial certification organization, whose aim will be to develop specific recommendations on the basis of specific local regulations, and professional certification of auditors for financial institutions. Also, this will ensure more widespread knowledge of the Principles of experts in the banking sector (cf. paragraph-wise comment No. 3 below for more detail).
4. We propose to discuss the combination of the internal audit department and outsourcing of internal audit activities to create a lower cost of the procedure without loss of quality for internal audit functions.
5. We pay special attention to the fact that the existing risk management system (like “Palantir” or “i2 Analyst Notebook”), which are used for the internal audit activity now, de facto represent only one "line of defense" (in terms of paragraph 56), which reduces their overall effectiveness. Thus recommendations for (or requirements to) software used are welcomed.
6. We propose to justify the implementation of the principles of internal audit activities in the form of an integrated IT system of internal audit. The purpose of creating an integrated IT system of internal audit is a decision support system for the corporate governance and the senior management as an ongoing analysis of operations at the operational level.

Paragraph-wise Comments

1. **Page 4, Principle 2, paragraph 12 “On the basis of the audit plan established by the head of the internal audit function”**

It is proposed to add “*yearly*” for the audit plan to be sure all functions are internally audited throughout each year.

2. **Page 5, Principle 2, paragraph 14 “the internal audit staff rotate periodically within the internal audit function”**

Though it is really important to rotate staff to avoid loss of objectivity, the minimal time devoted to auditing specific area or function is proposed to be equal to half-year. Otherwise local regulator might have the power to establish the minimum time because too fast rotation would similarly bring poor results.

3. Page 5, Principle 3, paragraph 16 “Professional competence depends on the auditor’s capacity to collect and understand information, to examine and evaluate audit evidence and to communicate with the stakeholders of the internal audit function.”

We propose to add additional paragraph stating “Professional competence of senior internal auditors and the Heads of Internal Audit is to be certified at local or world-wide levels by local regulator and the Institute of Internal Auditors, respectively. It would provide the basis for using ‘best practices’ at all credit institutions leading to decrease in systemic risk.” For example, Central Bank of Russia has the attestation procedure for *external* auditors for credit institutions. The equivalent attestation stating the *professional competence criteria* is welcomed to be introduced for *internal* auditors for the countries following BCBS guidelines.

4. Page 7, Principle 6, Paragraph 29 “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.”

It is welcomed to define “risk profile”.

In case risk-weighted assets (RWAs) are meant under risk profile, then the complexity of auditing the function and the respective budget need not quickly change when RWAs change. RWAs might drastically change because of one large exposure taken/exempted or because of shift in risk-factor volatility. In these cases the complexity of auditing the business segment does not change a lot (i.e. to the same extent as RWAs changed).

Otherwise, if the operational criterion is meant under risk-profile, then indeed the increase in number of operations/staff leads to rise in complexity of auditing and sometimes exponentially faster because of joint risk-realisation effects.

We would recommend using the operational criteria for the term ‘risk-profile’.

5. Page 8, principle 7, paragraph 36 “It may also include public disclosures intended to facilitate transparency and market discipline such as the Pillar 3 disclosures and the reporting of regulatory matters in the bank’s public reports.”

It is proposed to add “in case no other unit is responsible for the same reporting (e.g. ones according to Pillar III)”. The rationale for the proposal is that the person is able to well report or well check other person reporting. If there happen errors in similar reports, another person with objective and independent view is to be hired to audit the routes of errors.

6. Page 9, principle 9, paragraph 43 “the board of directors should review the performance of the internal audit function”

It is advised to explicitly limit the performance review by qualitative criteria as quantitative standards might provide bias in internal auditors’ behavior. As an example, low number of problems or risks outlined might come as a result of poor auditors’ work or favourable market environment. As another example having found many errors or risks might indeed be achieved at the price of all the business really stopped working having led to rise in systemic risk (it comes from the stylized fact that small, but non-significant number of errors accompanies normal business performance).

7. Page 11, principle 13, paragraph 55 “Each of these control functions, along with the bank’s operational management, constitutes a line of defense against the risks the entity faces”

It would be of use if from the ‘best practice’ point of view it was described the place of all three lines of defense in the process of risk strategic planning (if it is only risk-management at the second line to respond for it, imbalances might arise at line 1 and 3 that were unfamiliar with the planned risk areas and risk amounts).

8. Page 12, principle 15, paragraph 63 “It is recommended that large banks and internationally active banks perform internal audit activities using their own staff.”

It is welcomed to define the term of “large” and “internationally active” banks, i.e. to state the category includes or is not limited to the ones in SIFI group. Alternatively, the point is to be left at the local regulator discretion to define the size threshold.

9. Page 14, principle 16, paragraph 77 “Contingency planning;”

We propose to clarify whether the category includes only recovery plans, or resolution plans, or both.

10. Page 17, Annex 1 “Core Principles for Effective Banking Supervision, October 2006”

It is proposed to update the link to the document as follows “Core Principles for Effective Banking Supervision, xxx 2012” having in mind the final version that is to come after the comments receipt on the BCBS Paper No. 213 (<http://www.bis.org/publ/bcbs213.htm>).

Research Team

Lvov Nikolay – PhD Student, nikolay.lvov@gmail.com

Penikas Henry – Senior Lecturer, penikas@gmail.com