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Lisbon, March 19, 2012

To  
Secretariat of Basel C.B. Supervision  
Bank for Inter. Settlements  
CH 4002 BASEL  
SUISSE

**SUBJECT:** Comments over Basel Document

Dear Colleagues.

In spite of the delay in submitting to you our comments to the document "The Internal Audit Function in Banks – Consultative Document – Basel Committee", IIA Portugal is now sending his position, as attached.

We did several meetings with the majority of Internal Audit Departments of Portuguese Banks.

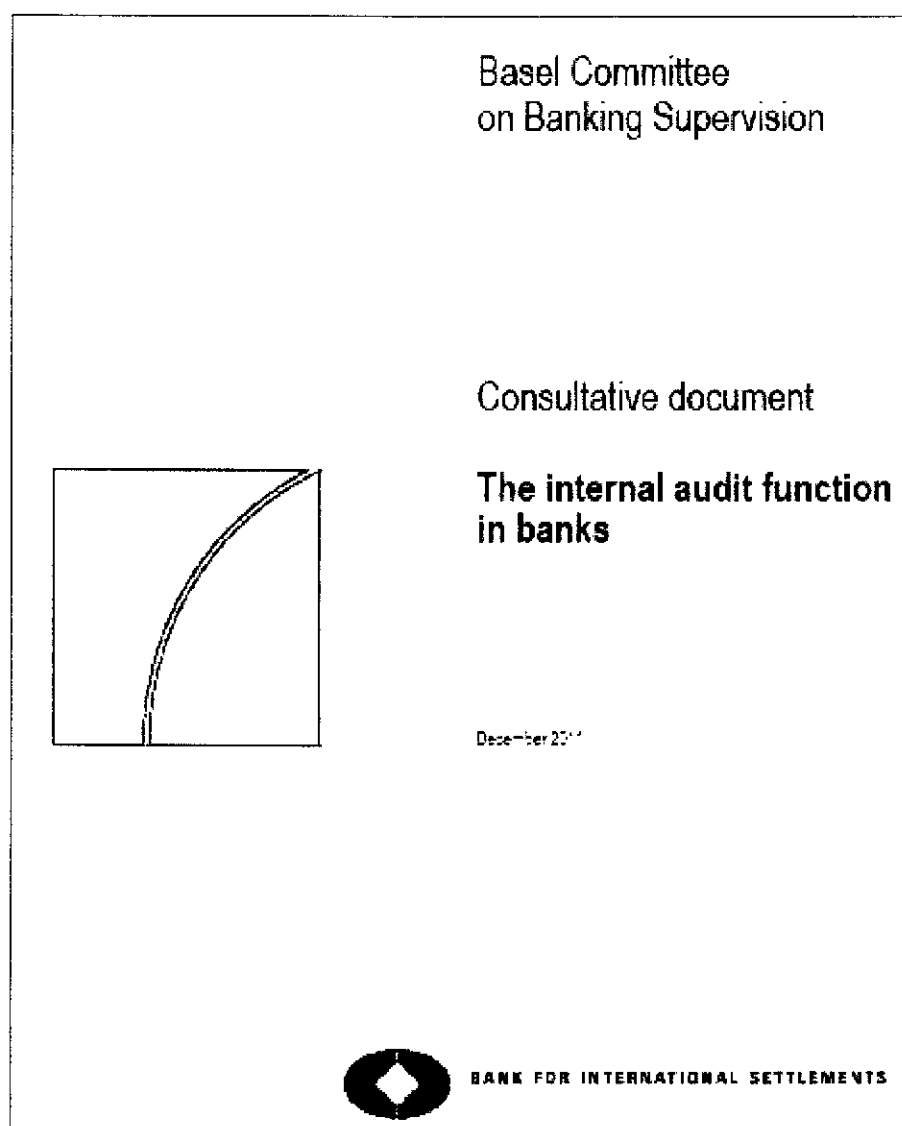
Sorry for the delay.

Best-Regards.



Maria Fátima Geada  
(President of IIA Portugal)

## ANALYSIS OF THE DOCUMENT



Lisbon, 27 January 2012

### **List of Attendees**

Acácio Diogo Morais	Banco de Portugal
Alexandra Maria Ricardo	Banco de Portugal
António Lima	Banco Espírito Santo
António Manuel Marques	Banco Português de Negócios
Eduardo Sérgio Martins	Banco de Portugal
Francisco Martins da Rocha	Banco de Portugal
Glenda Monteiro Carmo	Banco Primus
João Gouveia	Banco Popular Portugal
José Gaspar	Banco Popular Portugal
José Manuel Tinoco	Banco Português de Investimento
Kathy Tereso	Banco de Investimento Global
Luís Filipe Machado	Banco Comercial Português
Luís Romão	Banco Popular Portugal
Mariana Viegas	Banco BIC Português
Maria João Lopes	Banco Bilbao Vizcaya Argentária (Portugal)
Mário Gaspar Neves	Banco Comercial Português
Paulo Reis Vaz	Banco Português de Investimento
Vasco Tamagnini Guimarães	Banco Português de Investimento

## INTRODUCTION

Following the publication by the Basel Committee on Banking Supervision of the document “*The internal audit function in banks*”, IPAI – Instituto Português de Auditoria Interna (the Portuguese Chapter of the IIA – Institute of Internal Auditors) was challenged to organize, within the scope of the activities of the Financial Services Auditors Group, a meeting with members of Internal Audit teams in Portuguese banks.

The meeting was held on January 27, 2012 in Lisbon, and was attended by 18 members of 10 banks, between Chief Audit Executives (CAE) and other audit managers.

This document presents the main ideas shared at the meeting, arranged by the principles established in the document under analysis. The possibility of sending the conclusions of this meeting to the Basel Committee, through the ECIIA was discussed.

## **A. Supervisory expectations relevant to the internal audit function**

### **2. Key features of the internal audit function**

#### ***(a) Independence and objectivity***

**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.**

The discussion about this principle stood essentially at two levels: the standing of IA in the organizational structure of the banks, in the context of different governance models, and the remuneration of IA staff.

Based on § 5 of the Introduction, the document assumes the existence of the monistic ("one-tier") governance model.

It was generally agreed by attendees that IA should be linked to a non-executive body (except in small sized banks, where the existence of such a body is not required), ensuring the existence of independence from executive management. This will be a subject under analysis by the supervisors, when assessing the IA function, under the principles established in principles 17 to 20.

The remuneration of internal auditors, as well of other control units, is a topic of current interest at international level. The prevailing rule has been that control units – internal audit, risk management and compliance – should not have variable remuneration indexed to the financial performance.

The principle established in § 15 gathered the agreement of the attendees, which see as necessary the differentiation of compensation criteria between controls units and business management units.

#### ***(c) Professional ethics***

**Principle 4: Internal auditors should act with integrity.**

Concerning the ethical issues in the conduct of internal auditors in performing their functions, one attendee expressed the opinion that the major risk of IA is the breach of confidentiality. In this regard, another attendee said that in his bank, the CAE and other IA managers are considered by the supervisory as "regular insiders".

### **4. Scope of activity**

**Principle 6: Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function.**

The highlight in this principle was the responsibility of CAEs for the definition and presentation of the annual audit plan, expressed in § 29 and somehow already addressed in § 12. Special attention was given to the fact that the audit plan will become the sole responsibility of CAE, possibly accommodating suggestions, even from the supervisory entity, but not subject to approval of executive management.

As discussed in the analysis of Principle 14, this responsibility is not entirely clear in the case of banks with international activity, given the preponderance of parent bank in the definition of the scope of audits in subsidiaries.

**Principle 7: The internal audit function should ensure adequate coverage of regulatory matters within the audit plan.**

The attendees understanding of this principle was not consensual, specifically the provisions of § 32: "...assessing the adequacy of its capital resources...".

Some attendees were of the opinion that IA should not assess the adequacy of capital, but restricted to the evaluation of the processes and management and monitoring systems of regulatory capital indicators. The assessment of capital adequacy by IA would result, for some attendees, in overlap with responsibilities usually contracted to External Auditors.

Despite this understanding, it was consensual the idea that the requirements associated with this principle demand the strengthening of IA structures, with higher demands in what concerns the technical background of IA. Similar demands will be required to supervisory entity staff, in order to accomplish the assessment of IA function in banks.

## **5. Corporate governance considerations**

### **(b) Responsibilities of the board of directors and senior management**

**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.**

§ 47 assigns senior management the responsibility of ensuring CAE the necessary means to achieve the defined objectives, with proportionality against approve audit plans.

Attendees noted the omission in the document of the subject of the dimension of the audit teams, defending that it should go further eventually pointing to a future definition of a benchmark.

Concerning the issue of audit teams' dimension, and despite the role of banks' supervisory bodies in the scope of internal control review procedures review following Notice no. 5/2008 of Bank of Portugal, that encompasses an opinion on audit teams dimension, attendees were of the opinion that Bank of Portugal should clearly express to banks management their opinion on audits teams dimension.

### **(c) Responsibilities of the audit committee in relation to the internal audit function**

**Principle 10: The audit committee, or its equivalent, should oversee the bank's internal audit function**

Attendees expressed the view that the responsibilities of audit committees should be regulated and relevant legislation should be changed accordingly.

Considering the requirement on the existence of audit committees, namely for large and internationally active banks, attendees were of the opinion that specific rules should be established, defining qualitative and/or quantitative criteria for the mandatory existence of audit committees on small sized banks, similar to what exists concerning the IA function and the remuneration committees, in these cases with specific rules established in Notices issued by Bank of Portugal.

The of review of audit reports by Audit Committees was also brought to discussion, namely the criteria underlying the decision to submit or not a report to Audit Committees – concept of “key audit reports”, included on § 49.

**(d) Management of the internal audit department**

**Principle 11: The head of the internal audit department should be responsible for ensuring that the department complies with sound internal auditing standards and with a relevant code of ethics.**

In this principle, relevance was given to the personal accountability of CAE on the adherence to internal audit standards, including those established by the IIA.

**(f) The relationship between the internal audit, compliance and risk management functions**

**Principle 13: Internal audit should both complement and assess operational management, risk management, compliance and other control functions.**

The complementarity of control functions was the subject of discussion among attendees, with different views about the correct interpretation to be given to the word “complement”.

The standing of IA in a differentiated level against risk management and compliance functions (§ 55) was considered a progress in relation to the current reality.

Although the Notice no. 5/2008 of Bank of Portugal states that IA should audit compliance and risk management functions, no preponderance is given to IA function, unlike the direction that the document under review seems to point out.

With regard to the possible overlap between control functions, particularly between IA and Compliance, most of the attendees supported the idea that its IA responsibility to assess compliance with legal and regulatory requirements, and compliance function should not assess processes that are already implemented. The intervention of compliance functions should occur earlier, particularly in the product development and process implementation stages.

However, one attendee was of the opinion that compliance should intervene after the development or implementation stages, assessing compliance with regulations in force by performing compliance audits.

## **6. Internal audit within a group or holding company structure**

**Principle 14: The internal audit function in a group structure or holding company structure should be established centrally by the parent bank.**

Several attendees belonging to banking groups with international activities commented on the requirements established under this principle, in light of the reality of their groups.

The preponderance of the units of parent banks in the definition of the organization, the principles and the scope of performance of subsidiaries audit units, even within the legal requirements, may in the opinion of several attendees, generate potential conflicting situations. The possibility of personal accountability of a CAE in a situation of conflicting guidance from parent bank and guidance from local supervisory authority was discussed.

## **7. Outsourcing of internal audit activities**

**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 and the internal audit function are adequate and operating effectively.**

The regulation of outsourcing internal audit activities was deemed positive by attendees.

In the view of one of the attendees, the guidelines of the document point to the use of outsourcing on an exceptional basis, only acceptable on limited, focused and justified situations, with clear prevalence of the principle of internal audit performance by own resources.

It was recognized however that the use of outsourcing may be the unique rational solution, particularly in internationally active groups, due to the geographical distance of some operations, the necessary sound knowledge of specific local regulations, and, specially, when the size of the overseas units does not justify the existence a local internal audit unit.

## **B. The relationship of the supervisory authority with the internal audit function**

### **1. Benefits of enhanced communication between the supervisory authority and the internal audit function**

**Principle 16: Supervisors should have regular communication with the bank’s internal auditors to (i) discuss the risk areas identified by both parties, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank’s response to weaknesses identified.**

Attendees recognized the benefits of the strengthening of communication between supervisory authority and banks.

However, the compatibility of this principle with the independence requirements of IA function was questioned. The example of the submission of audit plan to the supervisory authority (§ 73) was pointed out.

Concerning the privileged contact of supervisory authority (in the person of the Chairman of the Audit Committee), it was highlighted that nothing was planned for the institutions in which there is no such body, as in small sized banks.

It was also noted that in some situations, the action of some attendees were of the opinion that the proposals included in the document related to the principle under discussion may question the role of IA within the banks, with the risk of IA units being seen as a vehicle of Bank of Portugal in the banks.

However, the attendees agreed that the strengthening of communication must be understood as an “intrinsic collaborative relationship” between each bank and the supervisory authority.

## **C. Supervisory assessment of the internal audit function**

### **1. Assessment of the internal audit function**

**Principle 17: Bank supervisors should regularly assess whether the internal audit function has an appropriate standing within the bank and operates according to sound principles.**

The assessment of IA function by the supervisory authority deserved extensive discussion by the attendees.

Being unanimous opinion that the IA function, like any other function in a bank, should be subject to assessment, some attendees were of the opinion that Bank of Portugal need to grant himself the adequate means in accordance with the requirements for such assessment.

Among the requirements related with Principle 17, relevance was given by attendees to the rules concerning the appointment and dismissal of CAE (§ 87).

It was also noted the inclusion in § 83, among the areas of evaluation by the supervisory authority, of the subject of the remuneration of CAE and of “key auditors”, a concept that was considered to be not completely explained in the document.

About this subject, it was considered that the inclusion of the audit plan in the Internal Control Report (Notice no. 5/2008 of Bank of Portugal, art. 25, 2 f)), is opposed to the principle of surprise in the conduction of audit actions.