UBS

UBS AG
Postfach
8098 Zürich
Tel. +41-44-234 11 11

Group Internal Audit
Audit Standards & Governance

Jean-Claude Rochat
GE3A-RVJ
Max-Höggerstrasse 81
8048 Zurich
Tel. +41-44-238 2779
jean-claude.rochat@ubs.com

www.ubs.com

By e-mail
Public
Secretariat of the
Basel Committee on Banking Supervision
Bank for International Settlements
4002 Basel

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Comments to the Consultative document "The internal audit function in banks"

Dear Sirs,

On behalf of Group Internal Audit of UBS AG, we are pleased to enclose our remarks on the captioned consultative document the Basel Committee on Banking Supervision issued for comments on 2 December 2011.

We very much appreciate and support the efforts of the Basel Committee to strengthen the overall effectiveness of the internal audit functions within banks. We also trust that our contribution will be helpful to the Committee to adequately position and calibrate this important goal.

Yours sincerely

UBS AG

Jean-Claude Rochat	Markus Baumann
Managing Director	Managing Director

Enclosure

GIA Responses to the Basel Committee on Banking Supervision consultative document
The internal audit function in banks

1. Introduction

Group Internal Audit (GIA) is pleased to have the opportunity to comment on the consultative document issued by the Basel Committee on setting minimal standards for the internal audit function in banks.

2. Overall comments

We are pleased that the Basel Committee has taken the time to review and to update the 2001 guidance paper *Internal audit in banks and the supervisor's relationship with auditors*, in order to address the unique challenges that internal audit units established within the financial services industry are facing. By updating the document, the Basel Committee should aim to:

(i) Create a document that would assist the Board of Directors, the executive management and the Heads of Internal Audit at implementing an effective internal audit function, and

(ii) By basing on existing standards applicable to the internal audit profession, creating a differentiated set of principles and expectations responding to specific needs arising from individual institutional risk profiles, sizes, business activities and regulatory environment. This should also be reflective of the professional challenges faced by internal audit functions of larger and more internationally integrated institutions, respectively.

Such a document would provide a source of inspiration for shaping the future of internal auditing over the coming decade.

We acknowledge that the Basel Committee has based its work on valuable sources; however, some of these are outdated, which we find to be contrasting with the aims described above. This is the case for example for the COSO's *Internal Control – An Integrated Framework* which was also the basis for the 2001 predecessor document. Unfortunately, the proposal adopts a "one-size-fits-all" approach that may not be suitable for smaller organizations and may not provide sufficient insight for larger ones to represent a credible and universally acknowledged reference for setting a new environment in the internal auditing profession in the banking industry.

As a further note, while the Basel Committee endorses a risk-based approach for internal auditing, the principles outlined and the interpretative paragraphs attached to them, are somewhat conflicting when addressing such areas as audit cycles and an overemphasis on regulatory risk compared to other sources of risk. In this context, leveraging to a greater extent the internal audit function for regulatory purposes bears the risk of blurring management's responsibilities.

3. Missing guidance

The various waves of crises which have rocked the financial services community over the last few years have exposed shortcomings in the design and operating effectiveness of the assurance providers, commonly described through the "lines of defense" terminology (cf. paragraph 55; see separate comment later in this document). The guidance document from the Basel Committee could incorporate lessons learned from these events as indicated below to strengthen overall the role of the function; areas that would benefit to be emphasized include:

(i) Reinforcing the principle of **professional skepticism**, to challenge routine and tunnel views, at all levels of the organization, i.e. from process-level to management, including limits and authorities, up to senior management and the board itself.

(ii) While the role of internal audit is not primarily to uncover **fraud**, internal audit should be vested with the skills and professional competence to interpret signs potentially indicative of fraud. Internal audit functions operating in the financial industry should be especially aware of the risk associated with individual or collusive cases of fraud and be trained more thoroughly than other internal audit professionals in this respect.

(iii) Internal auditing should not be perceived as a static discipline but rather one that can and should evolve dynamically by assessing, critically evaluating and constantly striving to improve its own processes with a view to increase its effectiveness. A major source of inspiration is to **learn lessons** from identified internal or external deficiencies. In this respect, supervisors could also be vested with a transmission role, thereby providing tailored support and guidance adapted to the requirements of the supervised institutions.

(iv) An important number of institutions are active **internationally or globally**. These institutions are confronted to challenges of their own, such as cross-border activities related to their operating model; further, different legal structures need to be established in the various jurisdictions. While the document addresses the issue of internal audit within a group or holding company structure (principle 6 and interpretative paragraphs 60 to 62) these do not sufficiently capture the essence of the potential conflicts that can emerge from these situations. It would be good if the Basel Committee would address such issues, for example with respect to conflicting requirements between local (host) regulators and home regulators in terms of the audit resourcing, audit planning, audit execution and audit reporting, in addition to the construction of local (sub-) Charters. The Basel Committee could also issue guidance on the establishment and coordination of supervisory work within an international **supervisory college**. The new document would then contribute to standardizing requirements in the various jurisdictions and establishing a more even playing field for institutions to adhere to.

4. Individual comments

#	The internal audit function in banks – Consultative document, December 2011	Comments
A. Supervisory expectations relevant to the internal audit function		
1. The internal audit function		
1	§6 states: "For large banks and internationally active banks, an audit committee (or its equivalent) is typically responsible for providing oversight of the bank's internal auditors."	In our opinion, the paragraph should state: "For large banks and internationally active banks, an audit or other committee (e.g. risk committee or ~~its~~ an equivalent) is typically responsible for providing oversight of the bank's internal auditors."
2	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 organization and its reputation.	The introduction of a new assessment over qualitative aspects should be supported by a corresponding guidance as to its intended nature. Further, the last part of the sentence on the responsibility of the board should be modified as follows: "in discharging their legal and statutory responsibilities" "[…[senior management and the Board of Directors in ~~protecting their organization and its reputation~~ discharging their legal and statutory responsibilities."

#	The internal audit function in banks – Consultative document, December 2011	Comments
2. Key features of the internal audit function		
3	§ 13 "[…] should not prevent senior management from requesting input from internal audit […]".	§ 13 "[…] should not prevent senior management from ~~requesting~~ soliciting input from internal audit […]".
4	§ 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."	Long-term incentives should not per se be detrimental to the independence and to the objectivity of the internal audit function. Instead, the guidance should seek to strike a balance between fixed and variable compensation, whereas the fixed portion should be commensurate with functions of equal standing within assurance providers (e.g. risk control, financial control, compliance, legal). While we agree that short term incentives aligned to business performance should be discouraged, we support and would advocate that internal audit is eligible for variable incentives that align it with the long term performance of the organization. Last sentence of §21 should fit here.
5	Principle 3: Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank's internal audit function.	We are supporting the concept of knowledge transfer from external "subject matter experts" and believe that this should include elements of "challenge" (see separate section on "Missing guidance" above, specifically on professional skepticism"). Overall, the skill-set and competence of internal audit, as a group, should be commensurate with the areas and functions to be audited, thereby facilitating the sufficiency of challenge.
3. The internal audit charter		
6	Principle 5: Each bank should have an internal audit charter tat articulates the purpose, standing and authority of the internal audit function within the bank.	The proposal appears overly prescriptive, so elements relating to the criteria for outsourcing should not be part of the Charter. As mentioned above, general aspects addressed by the IIA's Standards could be left out, to include mainly divergences, specialties or more advanced level of expectation.
4. Scope of activity		
7	Principle 6: Every activity (including outsourced activities) and every entity of the bank should fall within the scope of the internal audit function.	§ 27 lists matters that should be evaluated by internal audit; this should be refined. In particular, "efficiency of operations" is far too prominent. The ideal structure should be top-down along the lines: Strategy ➔ governance processes ➔ risk (management and control) ➔ internal control framework ➔ reliability of information ➔ compliance with laws, regulations, statutes and internal directives ➔ safeguarding of assets (including segregation)
8	Principle 7: The internal audit function should ensure adequate coverage of regulatory matters within the audit plan.	This is actually a sub-set of Principle 6. Regulatory risk is part of the overall risk landscape. Overall, the guidance should better be reflective of a risk-based approach, where resources are devoted in priority in those areas that bear the highest risks. Sub-section "(a) Risk management" should differentiate between risk management and risk control.
5. Corporate governance considerations		
9	§41 states: "[…] a permanent internal audit function commensurate with its size, the nature of its operations and the complexity of its organization."	This should be amended as follows: "[…] a permanent internal audit function commensurate with ~~its size, the nature of its operations and the complexity of its organization~~ the risks taken, the complexity of its businesses and organization, as well as the nature of its operations."
10	§49 states: "The audit committee reviews and approves the audit plan and, if any, the audit cycle."	Reference to the audit cycle should be removed. This should be included in the Charter.
11	§52 states: "The audit committee should ensure that the head of the internal audit function is a person of integrity. This means that he or she will be able to perform his or her work with honesty, diligence, and responsibility. It also implies that these persons always have observed the law and have not been knowingly a party to any illegal activity. […]"	This description is unnecessarily blunt. This should merely refer to: "The audit committee should ensure that the head of the internal audit function satisfies higher criteria of personal integrity and objectivity as well as professional competence. ~~is a person of integrity. This means that he or she will be able to perform his or her work with honesty, diligence, and responsibility. It also implies that these persons always have observed the law and have not been knowingly a party to any illegal activity~~ […]"

#	The internal audit function in banks – Consultative document, December 2011	Comments
12	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.	The principle should be strengthened on the follow-up part. Also, §54 requires the head of the internal audit function to report to the board, or its audit committee, the status of findings that have not (yet) been rectified by senior management. This places the emphasis at the wrong place. Internal audit should report on the status of exceptions, i.e. incorrectly closed actions, repeat actions, past due actions, extended actions. Further, the document should include the concept of "*integrated assurance*" with other assurance providers.
13	Principle 13: Internal audit should both complement and assess operational management, risk management, compliance and other control functions.	We agree with the principle which refers to the convergence of views / lines of defense. In this context, lines of defense should not be perceived in a hierarchical sense, but be on an equal footing considering the skill-set, compensation and investment level to other assurance providers (see also above). Further, with respect to the 1st line of defense, the term used "operational management" may be confusing and the line between 1st and 2nd blurred. A good definition should be included in a glossary. §59 should be included in Principle 6, after §29.
6. Internal audit within a group or holding company structure		
14	Principle 14: The internal audit function in a group or holding company structure should be established centrally by the parent bank.	We agree with the principle. However, may need to be expanded to better reflect the challenges multinational institutions are facing and specifically referring to the "group view" (see separate section on "Missing guidance" above, specifically on international and globally active firms). It may also include guidance on the support of local internal audit teams by the group team as well as the issue of resource allocation and sharing. Further, reference should be made to the fact that Charter at subsidiary level would be conceived as being a sub-set of the Charter at group or parent level and the set-up accepted by the local supervisors.
7. Outsourcing of internal audit activities		
15	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.	We support that knowledge transfer should take place. However, should be mindful not to be too prescriptive, as not to instill a false level of confidence in staff who may feel having been instructed by the external service provider (consider limitations in scope but also in industry developments, and time decay).
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		
16	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.	According to this, supervisors shall receive the same level of information as the Audit Committee; this might prove to be excessive.
17	2. Potential topics for discussion between supervisors and internal audit	Valuable list of topics for discussion. However, should not be the basis for establishing a "second-guessing" of management. The list will also be expandable depending on future developments. It is therefore questionable whether it should be this detailed.
C. Supervisory assessment of the internal audit function		
1. Assessment of the internal audit function		
18	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.	§84 suggests establishing a grading system for the internal audit function. We question whether this is in fact necessary. It would yield benefits, should the principles and measurement tools be identical in all jurisdictions.

#	The internal audit function in banks – Consultative document, December 2011	Comments
2. Actions to be undertaken by the supervisory authority		
19	§90 states: "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. The supervisory review process is not a substitute for the audit committee's assessment of or an external assessment of the internal audit function"	This appears to be unnecessary and should be dropped. Alternatively, it would need rephrasing.

Zurich, 2 March 2012 / JCR