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Secretariat of the Basel Committee on Banking Supervision
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By email: baselcommittee@bis.org

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To Secretariat of the Basel Committee on Banking Supervision

Comment on the Basel Committee's Consultative Document
External audits of banks

We are pleased to have the opportunity to provide feedback on the Basel Committee's consultation. We have a few limited high-level comments on what is an extremely detailed document.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of a number of institutional investors from across the world, including PNO Media (Netherlands), VicSuper of Australia, Canada's Public Sector Pension Investment Board and the UK's BBC Pension Trust, British Coal Staff Superannuation Scheme, Mineworkers Pension Scheme and Lothian Pension Fund (only those clients which have expressly given their support to this response are listed here). In all, EOS advises clients with regard to assets worth a total of $195 billion (at March 31 2013). We assist these clients to act as good owners of the companies in which they invest, and to participate in debates on public policy which will affect the value of their investments.

We take a close interest in audit matters and are supportive of the Basel committee's attention to this important area for helping ensure bank reporting is accurate and relevant. We particularly welcome the consultation's focus on the importance of dialogue between the auditor and the regulatory authorities as we believe that this is a key mechanism for helping regulators stay close to developments and so for making supervision work effectively. We further believe that the work of the auditors will be markedly enhanced by having feedback and input from regulators, who may have insights and concerns which could influence and enhance the process and progress of the audit. We regard the elements of the proposed guidance which consider the relationships between the supervisor and the auditor, and between the supervisor and the audit committee, as being the most important.

This raises the issue of the status of this guidance. We welcome the Basel Committee taking a close interest in matters of the audit of banks, but we believe that there needs to be careful consideration of how its recommendations might best be reflected into practice. While the Committee does have status in the most important

areas flagged above – the relationships between the supervisor and the auditor, and between the supervisor and the audit committee – its status in setting standards or even producing guidance in other areas is much less clear. The language of the guidance (“must”, “should”, “needs to”) tends to suggest that these are binding requirements, which may not be the right status for what should be intended as guidance. Perhaps a closer dialogue with the IAASB may be productive to determine how best to give this important material the right status alongside the ISAs. We would suggest that the right status should be sector-specific guidance; only in some limited areas will it be appropriate for there to be changes to the ISAs and their application material. We are firmly of the view that sector-specific changes to these is not appropriate, but that sector-specific material is better handled through associated guidance.

On specific paragraphs and Principles we have the following brief comments:

Paragraph 42
We do not agree that auditors should necessarily be required to comply with both international and local ethical standards. Local standard-setters should not be overridden in this way but should be left to decide what ethical standards are applicable to auditors in their jurisdiction.

Paragraph 67
We welcome the encouragement for auditors to focus on matters of remuneration, and firmly agree that this focus will assist the auditors to assess the culture of the organisation and so will provide important insights into the likely effectiveness of internal controls and risk management approaches more generally. We would, however, go further, and encourage auditors to consider matters of bank culture more generally, not just through the lens of remuneration. We would therefore welcome this paragraph being broadened significantly from the current narrow focus on pay matters, which are important but not all-important.

Paragraph 114
Rather than the proposed stipulation of the frequency with which a tender occurs, we would recommend a model whereby audit committees set a clear maximum period until the next tender occurs. This seems a simpler and more flexible approach that is more likely to be welcomed and adopted.

Principle 9
We would recommend the inclusion of the word “quality” in this principle, so that it reads “The audit committee should monitor and assess the quality and effectiveness of the external audit”. The concept of quality is of central importance, and will usually be the core of the understanding of effectiveness; but use of the term directly and drawing it more transparently to the attention of audit committees (and, indeed, bank supervisors) should drive more attention to this specifically. We hope that it will also draw attention to the IAASB’s recent good and ongoing work on audit quality.

Principle 12
We believe that it is vital that there is active two-way dialogue between the supervisor and the auditor; too often we have the impression that the information flow is only in one direction. It is clear to us that the Basel Committee agrees that there should be a fuller and two-way exchange of information, and would recommend that this be more fully reflected in the Principle itself. This might be done by extending the Principle so that it reads “..that includes appropriate active and two-way communication channels..”

We would welcome discussion of these points if any remain unclear.

Yours sincerely,

Paul Lee
Director