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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sir

The Internal Audit Function in Banks

ICAEW is pleased to respond to your request for comments on the *Internal Audit Function in Banks* consultative document issued in December 2011.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REPRESENTATION

THE INTERNAL AUDIT FUNCTION IN BANKS

Memorandum of comment submitted in March 2012 by ICAEW, in response to The Basel Committee on Banking Supervision's consultative document on *The Internal Audit Functions in Banks* published in December 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultative document *The Internal Audit Function in Banks* published in December 2011 by The Basel Committee on Banking Supervision, a copy of which is available from this link <http://www.bis.org/publ/bcbs210.pdf>.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of statutory (external) auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. This response reflects consultation with:
 - a special working group established for the purpose of responding to this consultative document comprising senior internal auditors from banks based in London, including members of the ICAEW's Internal Audit Committee; and
 - the ICAEW's Banking Committee.

SECTION 1: INTRODUCTORY COMMENTS

5. In responding to this consultative document we are also mindful of comments made by Mr Andrew Bailey (Director, UK Banks and Building Societies Division at the Financial Services Authority) in a speech he gave on 11 October 2011. Making several references to internal audit, Mr Bailey commented that:
 - it is important that internal audit functions must be active and able to push their case strongly;
 - post the financial crisis, he noted how little attention risk management and internal audit functions have attracted;
 - boards and senior management must be supported by robust and well-functioning risk and audit functions;
 - we are not in the right place today in terms of the role and influence of audit and risk functions; and
 - it is not the job of the regulator to fill the role of the audit and risk functions.
6. We believe that it is now time to help to positively address issues raised by Mr Bailey and we make reference to a number of them in this letter. In particular, to ensure that internal audit functions are robust, independent, effective and have influence there are several fundamental matters that need to be addressed such as the standing of the internal audit function, its reporting lines and the need for internal audit functions to have appropriate skills and competencies throughout the function to carry out their responsibilities.
7. Heads of Internal Audit have aspirations to develop and improve their internal audit function and the reporting of its work. Some Heads of Internal Audit wish to consider the further development of an informed view to be given annually to their audit committee. This is something we expect to work on in the future.

8. As an overall comment on the drafting of the consultative document, as noted in Sections 2.7 and 4.1 of this letter, we believe that the draft guidance generally takes an old fashioned, more traditional view of internal audit and is inconsistent when referring to internal audit and its role. We suggest that this matter is carefully considered in the final drafting process to ensure consistency of definition and language.

SECTION 2: MAJOR POINTS

2.1 The standing of internal audit in an organisation

9. The standing of a good internal audit function is absolutely crucial to the function's ability to perform an effective role. In addition to being independent and objective, internal audit has to have an authoritative standing and recognition within the organisation. Taken together, these attributes go to the heart of internal audit's credibility, effectiveness and the impact it can make. Whilst the standing of the internal audit function is clearly an important issue to regulators and to other external stakeholders (including shareholders), we also believe that the perception of internal audit by the board and management within the organisation is equally important.
10. Principle 2 of the consultative document states "... that the internal audit function has an appropriate standing within the bank, enabling internal auditors to carry out their assignments with objectivity." Principles 5 and 17 also make reference to the standing of internal audit. Whilst in the supporting text to Principle 2 there is reference to objectivity and independence, in our opinion 'standing' is much greater than independence and objectivity and we are disappointed that the matter is not further developed in any of the supporting text to Principles 2, 5 or 17.
11. We note in paragraph 88 that reference is made to 'good standing'. We believe that this is a much better word than 'appropriate' as used in Principles 2 and 17. 'Appropriate' is subjective and can be widely interpreted. We recommend that 'appropriate' is replaced with a more robust word such as 'good', or even 'authoritative', which would aid the ultimate effectiveness of internal audit by stressing the need for it to be fully empowered and to have a 'seat at the table' thus allowing its voice to be heard. We also suggest that good, sophisticated internal audit functions should have an equal standing within the organisation alongside other good key control functions such as Compliance, Finance and Risk Management.

2.2 Internal audit and its reporting lines

12. The standing of internal audit is often driven by its reporting lines. Whilst we agree with Principle 12 (the reporting line to the audit committee or the board) we are not sure this fully reflects reality in that there are often dual reporting lines; one to the audit committee (or the board) and the other to executive management.
13. Whilst some organisations will have different board structures, where internal audit has a second reporting line to executive management we suggest that it is good practice for the most senior person in the internal audit function, the Head of Internal Audit, to report to the Chief Executive Officer (CEO). In such circumstances, the internal audit function will generally have a much better standing within the organisation. Such an executive management line to the CEO would also help to remove the possibility of reduced independence if, say, the executive line is to the Finance Director or Financial Controller, the Chief Risk Officer or the Head of Compliance.

14. Whilst mandating a specific executive reporting line to the CEO is not something we would advocate for inclusion in the Basel guidance, we are disappointed that the consultative document is completely silent on the reporting lines to executive management, even to the extent of excluding illustrative examples.
15. We suggest that an illustrative example be given in the text supporting Principles 12 and 17, such as in paragraph 83. For example, when regulators and others look at reporting structures, if the Head of Internal Audit does not report to the CEO on the executive line, there may be warning signs of a potential lack of standing of the internal audit function.
16. In addition to the matters referred to in paragraph 83, regulators may wish to consider some form of relative benchmarking of internal audit with some of the other key control functions within the organisation, such as Compliance, Finance and Risk Management. This could be characterised by comparable executive reporting lines and levels of expertise in addition to comparable remuneration and investment levels.

2.3 The skills and competencies of people in internal audit functions

17. We believe that it is important that the people in the internal audit function, and not only those at the top of the function, should have the skills and competencies to enable them to undertake their work effectively. Unless internal audit has credibility with, and the confidence of, the people in the function being audited, it cannot effectively audit that function. The people in internal audit should have a mix of skills and expertise to put them on a par with the people in the functions they are auditing.
18. Internal audit is often referred to as the third line of defence within an organisation, but the third line should not mean third class. It should not be, nor be seen to be, a layer down the organisation or working to a lower standard in terms of competence and capability from the functions it is auditing.
19. If regulators want internal audit to be more independent and effective then the regulator also needs to support internal audit in its ambition to be better qualified, better recognised and respected, and better engaged within their organisations with the resources to do the job.

2.4 Remuneration policy for people in internal audit functions

20. Internal audit functions are interested in, and should be incentivised to support, the long-term future of their organisation. We consider that the overall policy objective for the remuneration of staff in internal audit, as for other key control functions, should be to establish an appropriate balance between fixed and variable remuneration. For internal audit, this is to also help ensure that the overall remuneration of staff does not impair their independence and objectivity.
21. If variable remuneration is related to the performance of the bank, then this should only be based on longer-term performance, say, over three to five years. If variable remuneration is related also to the performance of the internal audit function itself, regardless of the financial results of the bank, then this could be part of short-term remuneration for staff. For internal audit staff, there should be no link between short-term remuneration and the financial performance of the bank.
22. Paragraph 15 of the consultative document states “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.”

- 23.** We suggest that an outright ban on anything linked to the financial performance of the bank as a whole, thereby prohibiting a focus on longer-term incentives, does not reflect a balanced approach. We hope that in the final drafting process, and based on our suggestions in paragraph 21 above, these distinctions can be made clearer.
- 24.** We also suggest that the final sentence of paragraph 21 be moved to paragraph 15.

2.5 The difficulty of producing guidance for widespread application

- 25.** We generally welcome initiatives by regulators and others where the objectives, actual or implied, are to:
- ‘raise the bar’ of base-level guidance;
 - increase the effectiveness of internal audit; and
 - take internal audit forward by enhancing its independence and standing within an organisation.
- 26.** We recognise the difficulties faced by the Basel Committee in trying to produce base-level guidance that can be used by regulators for banks of all sizes in jurisdictions around the world. We note the links to the Institute of Internal Auditors’ (IIA) global standards. Like the Basel guidance, the IIA’s standards are written for internal audit functions in many different industry sectors (including the public sector) around the world. As banks operate in somewhat more sophisticated environments than a number of other industry sectors, the IIA standards set a relatively low benchmark for internal audit functions in banks.
- 27.** This base-level or ‘lowest common denominator’ approach introduces a number of potential problems. For example, for the larger and more sophisticated banks, we do not believe that the Basel guidance achieves all three of the objectives noted in paragraph 25 above. Whilst the draft guidance generally includes most of the things that the large banks do already, as noted in Section 4 it uses language and concepts that are somewhat old fashioned and/or do not reflect prevailing good practices.
- 28.** By way of contrast, from the perspective of smaller banks the document may appear to have been drafted for application by the larger banks. We question whether smaller internal audit functions will be able to fully implement the guidance and thus be able to demonstrate compliance therewith to the satisfaction of a regulator.
- 29.** The Basel Committee needs to be aware of these two opposite perspectives when it provides guidance on how the final document will be interpreted and implemented.
- 30.** Generally, there is not much evidence that the draft guidance reflects the progress made in internal audit since the previous Basel guidance document was issued in 2001. Nor does it give much encouragement to the aspirations of forward looking Heads of Internal Audit in sophisticated organisations to evolve and improve their internal audit functions.
- 31.** We would not wish to see the ‘lowest common denominator approach’ conflict with, or lower the bar for current good practices nor discourage the development of aspirations to enhance practices and the effectiveness of internal audit functions in the larger and more sophisticated banks.

2.6 Implementation of the guidance

32. Whilst the Basel document will result in global guidance, it will be the local regulators in different jurisdictions who interpret the guidance and implement it into their own assessment and grading methods. We have concerns that some regulators may have a very literal, checklist approach to the interpretation of the guidance.
33. There needs to be sufficient flexibility, balance and pragmatism by all regulators so that, on one hand, the smaller banks with fewer resources are not unfairly penalised while, on the other hand, the more advanced practices of the larger and more sophisticated banks are not dragged down to the 'lowest common denominator' base-level as a result of prescriptive interpretation. Where organisations exceed the base-level guidance, we hope that regulators will be supportive and give due credit.
34. We believe that a major test of the success of the guidance is how it is implemented. We strongly recommend that there should be as much consistency as possible in approach and gradings by all the different regulators.

2.7 The risk-based approach

35. Whilst the draft guidance makes reference to the risk-based approach, the language used in the document is inconsistent and appears to endorse more of an old fashioned 'assess everything all the time by cycles' approach. For example, whilst the risk-based approach is briefly referred to in paragraphs 8 and 59 of the draft guidance, the enduring tone of much of the consultative document appears to be generally reflected in paragraph 29 which refers to "all entities and all activities of the bank are audited at least once within an appropriate period of time (audit cycle)."
36. We are concerned that if the intention of the guidance, as drafted, is to encourage a more cyclical approach, then the guidance could be very costly to implement and it will have a negative impact on the risk-based approach and its development. Overall, we suggest that this would be detrimental to the effectiveness of internal audit departments.
37. We recommend that greater emphasis be given to the risk-based approach that covers all significant risks to the organisation wherever they arise which requires that the risks are assessed and prioritised and then audited in a timely manner.
38. In the finalised guidance, or in an accompanying document, it would be very helpful if there could be some indication as to how the guidance will be interpreted/implemented and how it links to the risk-based approach.

2.8 Communication between internal audit and regulators

39. We find the drafting of Principle 16 and its supporting paragraphs 69 to 80 to be generally a one-directional approach to communication, being the flow of information from internal audit to the regulator.
40. The references in Principle 16(1) to 'both parties' and in paragraph 74 to 'may consider sharing' need to be better balanced and with more obligation on the regulator to share relevant information with the Head of Internal Audit, unless there are good reasons for not doing so.

41. That said, we believe that two-way communication between regulators and internal audit should give due recognition to the fact that:
- internal audit must be independent of the regulator. There is strong emphasis in the consultative document on the independence of internal audit from management. We believe that this also applies to independence from the regulator. Internal audit must not be perceived to be the eyes, ears and even the hands of the regulator.
 - Heads of Internal Audit in banks in the UK feel more than a moral obligation to talk to the regulator if they think it needs to know something.
 - the first port of call for the regulator is the senior management of the bank and not internal audit.

2.9 Bias towards regulatory matters

42. Whilst banks and their internal audit functions pay close attention to what regulators require, it is important that regulators are not seen to be too self-serving with guidance that is biased toward regulatory matters to the detriment of other significant risks that are equally as important to the business of the organisation.
43. Given the origin of the document, it is perhaps unsurprising that there is a strong emphasis on regulatory matters, such as in Principle 7 and paragraphs 30 to 39. Whilst we agree with Principle 7, and do not disagree with the importance of the matters referred to in the supporting paragraphs, we suggest that the guidance needs to recognise that internal audit works from a perspective of the total risk universe of which regulatory matters form only a part. There needs to be better balance; internal audit cannot focus on regulatory risk to the detriment of other significant business risks.

SECTION 3: MATTERS FOR POTENTIAL FUTURE DEVELOPMENT

3.1 Internal reporting by Heads of Internal Audit: extending the informed view?

44. Unlike a statutory, external audit of financial statements which results in an opinion on the state of affairs of an organisation at a specific date, the much wider scope of business risks and controls that fall within the remit of internal audit present many different problems in performing the work and in its subsequent reporting.
45. We note that paragraph 28 of the draft guidance states “The internal audit function should develop an independent and informed view of the risks faced by the bank, based on the information made available to them and their own enquiries and professional competence.”
46. Many Heads of Internal Audit currently provide their audit committee with an annual, assurance report on the effectiveness of the system of controls based on the work performed in accordance with the audit plan (and approved changes thereto) that has been approved by the audit committee. Heads of Internal Audit may also indicate, using negative assurance, that internal audit is not aware of anything that is not being appropriately managed. Some Heads of Internal Audit give an ‘informed view’ on the risks and how they have been prioritised. Of course, rather like the ‘true and fair’ view from the external auditors, an ‘informed view’ should not be viewed as a guarantee nor can it be seen as a certainty. No one can be certain that everything is working at all times.
47. At the moment, practice in this area is still developing and, as part of their aspirations, some Heads of Internal Audit wish to start to consider within their organisations whether it is feasible or not to further enhance the reporting process. At this early stage in the thinking about this matter, the ultimate objective would be whether or not internal audit could provide the audit committee with a report giving an opinion or an ‘informed view’ on the effectiveness of the

overall governance, risk management and internal control framework. This has the potential to be a very substantial amount of work, but also of potential benefit to boards and audit committees.

48. We hope to start a project on this matter later in the year and if the results of our work indicate that such a report to the audit committee is feasible, then we will be happy to share the results with the relevant regulator in the UK and with the Basel Committee. This is a matter for the future and not a suggestion for inclusion in the 2012 Basel guidance.
49. Overall, for the purposes of this guidance, we suggest that it should not discourage Heads of Internal Audit from giving a broader view to their audit committee if they so wish.

SECTION 4: COMMENTS ON DRAFTING: SPECIFIC PRINCIPLES OR PARAGRAPHS

4.1 Overall comment: the language used in the document

50. We note that the consultative document generally takes an old fashioned, more traditional view of internal audit, for example referring to audit cycles.
51. The draft guidance is inconsistent in referring to internal audit and its role in:
- internal control; or
 - internal control and risk management and governance processes.
- We believe it is the latter, but we suggest that the ordering should be “governance processes, risk management and internal control”.
52. Overall, there is a need for consistency of definition and language.

4.2 Specific principles and paragraphs

Principle	Para	Comment
1	9 and 10	We suggest that Basel check with the IIA whether it will be revising its definition, particularly whether the word ‘consulting’ will be removed or changed.
4	-	We believe that internal auditors ‘must’ act with integrity (not ‘should’ act with integrity).
4	21	We suggest that a ‘cooling off’ period should be six months plus additional safeguards. Pragmatically a twelve month period is too long for people coming to work permanently in the internal audit function as opposed to ‘guest auditors’ for specialist, short-term assignments who are there in an advisory capacity that are brought in from a part of the business for that purpose.
5	24	A charter should be a high-level document. We suggest that the level of detail in the proposed wording is somewhat excessive. It is suggested that the bullets which deal with (i) criteria, (ii) terms and (iii) conditions and procedures are three things that should not be in the charter. They could be included by internal audit functions in their own detailed operating procedures.
6	26	We suggest that the scope should be amended to the effectiveness of the governance processes, risk management and internal control framework.

6	27	<p>The language of paragraph 27 gives a somewhat dated view of internal control and internal audit, based on the old 1992 COSO internal control model. As noted elsewhere in this letter, it is also skewed with an over-emphasis on compliance matters (law and regulations including any requirements from the supervisor). In banks, much of this detailed work falls to the Compliance function.</p> <p>We suggest that careful consideration be given to removing paragraph 27 or that it is substantially reworded to indicate that these matters are illustrative and are for consideration by the audit committee which may also wish to add additional matters that are based on risk and reflect a more modern approach.</p>
	29	<p>We comment elsewhere on this paragraph and its unfeasibility and old fashioned approach. We strongly recommend that the sentence dealing with cyclicalities be deleted. 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).</p>
7	-	See our comments in Section 2.9, 'Bias towards regulatory matters'.
8		We have a concern that there is potentially conflicting guidance between Principles 8 and 14. Our comments are noted under Principle 14 below.
13	55	We suggest that the first line be amended from 'operational management' to 'the management of operations'. The latter is wider than the people involved and includes the processes.
13	59	We suggest that the words the 'adequacy of design and effectiveness of operation' should replace 'assess the efficiency and effectiveness of the design and operation of internal control'.
14		Whilst Principle 14 states that the internal audit function in a group should be established centrally by the parent bank, Principle 8 appears to conflict when it states <u>each</u> bank should have a permanent internal audit function. Some clarification is needed as to how these two Principles interact. We assume that where a parent bank has established an internal audit function that works across its subsidiaries, then this will cover both Principles 8 and 14 unless the parent company's board deems that some subsidiaries should have their own internal audit functions.
16	Et seq	See our comments in Section 2.8 'Communication between internal audit and regulators'. The wording need to be more balanced and should not have the appearance of being a one-way dialogue.
16	73	Pragmatically, we suggest that supervisors should obtain an 'understanding of the circumstances which led to <u>significant</u> changes' in the audit plan.
16	73	We suggest that rather than contact the Audit Committee Chairman in the first instance, regulators should initially speak to the Head of Internal Audit with the right of escalation via executive management to the Audit Committee Chairman if the matter cannot be satisfactorily resolved with the Head of Internal Audit.

Annex		We note that some lines are missing in the diagram. For example, the line from external audit and senior management, and from the supervisor to the board and senior management.
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