Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Remarks by Julie Dickson, Acting Superintendent
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
National Bank of Canada - Internal Audit Meeting

Montreal, Quebec
Monday, May 11, 2007

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For additional information contact:

Jason LaMontagne
Communications Specialist
Communications and Public Affairs
jason.lamontagne@osfi-bsif.gc.ca
www.osfi-bsif.gc.ca

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Introduction

Thank you for inviting me to speak to you today about the views of the Office of the Superintendent of Financial Institution's (OSFI) on a key control function at all financial institutions -- internal audit.

In fact, it is not often that OSFI is asked to speak about control functions, even though it is near and dear to our hearts. So when we get invitations like this we never refuse.

OSFI cares about control functions because of the system we have chosen in Canada to oversee financial institutions – the so-called tripartite surveillance system.

This system is referred to in many historical documents. I recently pulled one off the shelf – it was a "Study to Assess the Current Mandate and Operations of the Office of the Inspector General of Banks". The Office of the Inspector General of Banks was a predecessor agency to OSFI. The study was requested by the Honourable Barbara McDougall (Minister of State, Finance) in April 1986, and prepared by Coopers & Lybrand. Their mission was to make recommendations for the improvement to the overall system of oversight of banks in Canada.

A lot of changes have been made since then. But one thing that has not changed, because it has withstood the test of time, is Canada's tripartite surveillance system.

The first part of this tripartite system is provided within each bank by its internal audit department and other control functions.

The second part of this system is the work of the external auditors.

The third and final part is oversight provided by the regulator. OSFI has extensive powers which have been enhanced over the years, but we rely heavily on the external auditor and each bank's own inspection system or control functions, such as internal audit, risk management, compliance, senior management, and the board of directors.

The tripartite system of surveillance is also called the reliance based system. And while we do rely on the internal control functions, we also have to establish a basis for reliance on them, which is why we issue statements of our expectations and why we get very excited if we see weaknesses in any of these control functions. It is also why I welcome invitations such as the one you have extended to me, because it is an indication of your interest in ensuring that the internal audit function looks to the future and keeps pace with evolving issues.

A central theme amongst the changes of recent years is an advancement in the importance of the internal audit function.

Across the federally regulated financial sphere, OSFI has seen buy-in to the principles required of an effective internal audit. Institutions have recognized that it is not enough to merely put “Internal Audit” on someone’s nameplate and consider yourself compliant. The procedures and responsibilities behind the function must be well thought-out, documented and effective, for us to be satisfied.

Assessing Internal Audit

So what does OSFI look for in a robust internal audit function? Our supervisors use OSFI’s Internal Audit Assessment Criteria to look for the presence of certain bell-wethers that we believe are indicative of effective performance. These indicators help them in their evaluation of the internal audit function’s oversight capability.

Generally, OSFI’s assessment of internal audit takes into consideration how well the function executes its role. This includes promoting a sound control environment that mitigates risks, ensuring that control weaknesses are appropriately identified and dealt with, and providing the Board and Senior Management with reasonable assurance of the effectiveness of, and adherence to, the institution’s organizational and procedural controls.

We gain our evidence of effective performance through various means, including discussions with directors and management. This means talking to the Chief Internal Auditor (CIA), the external auditors, the heads of other oversight functions, and we are increasingly talking to the Chair of the Audit Committee on a regular basis. We also want to see how significant audit recommendations, and subsequent management responses, are addressed with the Audit Committee. And we will do a review of audit practices, reports, working papers, and follow-up documentation.

Among the more important performance indicators that we use to guide our supervisory judgement are:

How does the Board and Senior Management view internal audit? OSFI wants to get a sense of the extent to which internal audit is viewed by the Audit Committee and Senior Management as being effective in executing its mandate.

An effective internal audit function will keep Senior Management and the Board informed of material issues or trends, so they are better able to make appropriate and timely decisions. Internal audit is also expected to understand the actions being taken by management to address the issues raised.

Does Internal Audit proactively communicate with the Audit Committee? An effective internal audit function cannot be reactive. It must be proactive to the extent that it should regularly engage the Audit Committee to ensure appropriate resources and a robust work plan are available.

An effective internal audit function will approach the Audit Committee if it believes its resources are inadequate for the proper execution of its mandate, or when the audit plan needs to be changed because of new ventures, divestitures or a change in the institution's strategic direction.

Likewise, if Internal Audit does not feel it has the expertise available to perform a specific task to the expected level of performance, it is incumbent on the function to engage with the Audit committee and seek out that expertise, even if it is on a temporary basis.

Also, internal audit should not hesitate to escalate material issues to the Audit Committee, either with or without Senior Management's approval. A promise by management to address an issue is not sufficient, actions are what matter and it is those actions that the internal audit group must pursue to fruition.

Information provided to the Audit Committee should identify the issues, their effect on the control environment, actions (or lack of action) taken by management, and the potential effect on the institution if remedial action is not forthcoming. We would also expect Internal Audit to comment on the appropriateness of management's timelines if they are a concern.

Does Internal Audit identify things that could materially affect an institution? It is critical that the internal audit function perform a review of the objectives, strategies, events and initiatives that could materially impact the institution, in order to ensure risk management and control practices continue to be appropriate and effective. This also allows Internal Audit to better plan their audit work and allocate sufficient resources.

Internal audit must play a key role in the major new initiatives approval process, while not jeopardizing their independence. Prior to launch of a new material product or system, or an acquisition etc, we would expect sector management to sign off as well as the control functions (audit, risk management, compliance). Internal audit should provide its opinion on whether management has identified the key risks inherent in the initiative, and whether the extent and rigour of the controls to be put in place to manage the risks are appropriate.

To what extent does Internal Audit proactively seek information to develop/refine audit plans? OSFI wants to see that internal audit actively seeks information from risk management, the appointed actuary, compliance officers, external auditors, OSFI, or other relevant sources to corroborate or enhance its risk assessment and to ensure areas of weakness are considered in its audit plan.

To round out its views, an effective internal audit function will meet with management of the business lines as well as with the individuals having actuarial, risk management and compliance oversight responsibilities. Their objective should be to understand the nature of each business, the key risk exposures and related controls, and different views on areas of concern or weakness noted through their management or oversight activities.

This input can be considered in the context of a risk assessment, audit findings and changes within the institution and its operating environment. Using all of this information, the internal auditor can create a robust audit plan, setting out the priority, timing and resources required for the auditing schedule.

Also, it is not a bad decision to have the Chief Internal Auditor, or a senior member of the audit group, be a regular attendee of various senior management committee meetings, even as an observer. This provides the Auditor with an excellent source of information for audit planning purposes.

Is Internal Audit's job done when the audit is finished, or does it follow up on issues and to what extent does it effect change? Internal audit must proactively follow-up and report on significant issues to ensure timely resolution. And it must demonstrate it can effect necessary changes in the operations of the institution in response to the material weaknesses identified.

I cannot stress enough the importance of follow-up and escalation. Issues that are left outstanding without resolution can, when they eventually come to the attention of senior management, the Audit Committee, or the Board, cast a very unfavourable light on the internal audit function. Worse, unresolved problems can lead to a much larger risk exposure for the institution.

While the role of internal audit is to audit to existing policies, if internal audit sees that policies are weak and not achieving the right result, they need to speak up.

Some internal audit departments will argue that that is not part of their mandate, but we believe that it is. Internal audit should never merely audit to a bad policy, or expect that management will do something about it. Internal audit should add value to the control function, and act to bring poor or inadequate policies to light.

Does Internal Audit see the big picture in its audit findings? Internal audit must consider the pervasiveness and significance of its findings, both at the individual significant activity level, as well as across the institution.

We have seen situations where internal audit identified numerous instances of similar technology-related findings across a number of activities, each of which, taken individually, would seem inconsequential. However, taken together, the systemic nature of the problem exposed the institution to significant operational risk. Internal audit cannot be done in silos; you must always be cognizant of the bigger picture.

Does Internal Audit write a clear report, and differentiate its findings? Or is it hard to tell exactly what they are saying and what is material? When the auditing is done and the findings presented, OSFI will look at the extent to which internal audit differentiates between audit findings affecting safety and soundness, from those affecting operating efficiency, and the manner in which these are communicated and followed-up.

Equal weight should not be given to all findings. The significance of the activity must be weighed when findings are presented so as to give an accurate report on the status of the institution's controls. Also, an internal audit report that is unclear as to where the real dangers lie could result in an inappropriate allocation of resources leading to a delay in the resolution of, or even the exacerbation of, the issue.

Does Internal Audit have a system whereby a critical eye can be cast on its own work? This is one of the essential elements in OSFI's Internal Audit Assessment Criteria. You could have best of class audit systems, methodologies and procedures in place, but it is the consistency of application that is central to successful oversight by internal audit. There is a need to ensure that internal audit is as efficient as possible by putting in place an internal audit quality assurance mechanism.

What types of individuals staff the internal audit function? Up and comers? Or others? Is there enough rotation and retention? Is it seen as a positive step in a career? The financial services sector can change quickly in today's increasingly fast paced world. For the internal audit function, this sets a high standard. Understanding how and why changes in the marketplace and the organization are occurring, and how those changes will impact the institution, is of vital importance to the internal audit group if it wants to be effective.

This effectiveness is often reliant on the skill-sets of the individuals in the audit function. To address this, an organization should have in place a culture of continuous training. Skill must be retained and developed in several key areas, including advanced risk management techniques, experience in detecting fraud, expertise in quantitative analysis expertise, market risk management modelling techniques, and credit risk management models, amongst others.

OSFI is concerned when we see substantial turnover in an institution's internal audit group. When this happens it is not only OSFI that should have concerns, the institution should take note as well. Rapid turnover, especially at the more senior levels, is a sign that the audit department is losing critical sources of knowledge, and that the department's stature within the institution may be decreasing in importance. At the other extreme, we are also concerned when we see no movement out of Internal Audit into the business. It is a fine balance between rotation and retention.

We recognize that there exists in many institutions a pressure to become more efficient, and it is part of doing business. But we will always cast a critical eye to cuts that are directed at control processes.

Is Internal Audit ahead of the curve or behind the curve and in the dark?
I have spoken to how important it is for internal audit to make its concerns known to senior management, but the information exchange between internal audit and management must work both ways. When management changes the strategic direction of the institution, it is vital that internal audit be made aware of the new course, and that they understand how the changes will impact their risk prioritizations.

In the past, OSFI has seen how shortcomings in this area have affected an organization. We have seen institutions change their target market, but not change their policies to reflect the risk in the new product. As a consequence, internal audit continued to audit to out of date policies. Only after a period of time did they recognize that the company was presenting a new product, with new risk. A delay like this can mean that a lot of business gets put on the books, before recognition happens and countermeasures are put in place.

When material events like these occur, OSFI will review the role internal audit played in an attempt to understand where the failures may have occurred. While sometimes painful, these situations can be helpful in that they assist OSFI when attempting to ascertain the effectiveness of an institution's internal audit group, and the relationship between the group and management. We ask ourselves, did the audit function not push hard enough? Or did management keep internal audit in the dark?

This two-way communication also applies to discussion around policy. As I mentioned earlier, if internal audit sees that policies are not achieving the right result, they need to speak up.

Does internal audit have clout? As I mentioned earlier, the internal audit function has steadily increased its level of importance in the last few years. And there may have been a time when the reporting lines of the internal audit function were not a matter of great concern, as long as the function existed within an organization.

Today that is no longer the case.

OSFI believes the internal audit function should report to the senior levels in the institution, the Chief of Internal Audit should have enough seniority and power to effect real change, and that the internal audit function should maintain its independence from the core business. In this area, substance matters significantly more than form. The ideal solution would be to have internal audit report directly to the audit committee; however, the current powers and tools of the CIA, including the veto of the audit committee on the hiring/firing of the CIA, direct access to the audit committee, and audit committee approval of internal audit resources, ensures an appropriate level of independence to the function.

We have seen reporting lines which we were not comfortable with, where we did not think the reporting was being done to the appropriate level, or was not independent, and we made our concerns known so that changes could be made.

When the proper reporting lines are put in place and information is making its way from internal audit to the proper level of management, when deficiencies are noted, senior management is then better able to take quick action. This is important because we want to see evidence that management is taking real action on internal audit's findings. Not just eventual action (which we see much more often than non-action) but timely and responsive action that will have the effect of changing the flagged behaviours.

Having internal audit report to the appropriate level of management is important when an issue needs to be addressed. The speed of resolution is often linked to the amount of time it takes for management to become aware, and the subsequent weight they put behind solving it.

It is also important to note that we would love to see all flagged issues solved in a short time span, but we also understand that internal audit recommendations can take time to put in place. Solutions, especially technology solutions, can certainly take time, but it is important that compensatory controls be put in place in the interim. It is incumbent on internal audit to follow up on such items, even suggest interim measures, rather than waiting for management to implement the perfect solution.

Is Internal Audit ready for Basel? The implementation date of Basel II is fast approaching. In about 150 days the culmination of a lot of work done by the international community, OSFI, and the institutions will be put into effect.

There is an important role for internal audit to play in the Basel process. The Basel Accord states:

Internal audit or an equally independent function must review at least annually the bank's rating system and its operations, including the operations of the credit function and the estimation of PDs, LGDs and EADs. Areas of review include adherence to all applicable minimum requirements. Internal audit must document its findings.

Internal Audit will be expected to play a role in reporting to the Board and senior management on the effectiveness of the institution's internal controls designed to ensure adherence to all Internal Ratings Based (IRB) minimum requirements. This role is critical in assisting senior management in fulfilling its responsibilities with respect to IRB requirements.

Internal Audit will also be called on to confirm that an institution's system of controls over rating systems and their internal estimates are effective. As part of its review of control mechanisms, Internal Audit will evaluate the depth, scope, and quality of credit risk control's work and conduct testing to ensure that their conclusions are well founded.

In preparation for IRB approval, Internal Audit activities should include, but not be limited to:

- A review of processes with respect to the initial mapping exercise of the IRB minimum requirements to the audit programs;
- A review of the detailed two- or three-year audit plan that would indicate the activities that would be reviewed annually and the activities that would be covered on some pre-determined cycle in order to assess the adherence to IRB minimum requirements;
- A review of the audit scope and assessment of the design and effectiveness of the internal controls intended to ensure adherence to all IRB minimum requirements;
- A review of reports related to the credit risk control units charged with the responsibility for the design, selection, implementation and validation of the institution's rating systems. Internal Audit work should include a review of the effectiveness of the internal controls to ensure independence of credit risk control units;
- An assessment of the adequacy of resources and skills required to perform the new Basel framework audit work; and
- Details of any Internal Audit work that would be outsourced to another, equally independent, function or external audit.

Closing

These are some of the important areas that OSFI considers when undertaking a review of the internal audit function, but they are not the be-all of success. The role of internal audit has evolved greatly in the past few years, and will continue to evolve into a more dynamic process, becoming more proactive and more forward looking -- whereas in the past its role was more to find out what had happened, as opposed to what could happen.

I appreciate your inviting me to come and talk to you today, and for being able to touch on what we at OSFI see as contributing to an effective internal audit.

There are several key areas that make up a successful institution; chief among those is the internal audit function. Your advice, thoroughness and diligence go a long way towards protecting both depositors and your institution, and assists OSFI in maintaining confidence in the safety and soundness of Canada's financial system.

Thank you.