The Institute of
Internal Auditors
Elevating Impact

14 February 2022

Via Online at Comment upload (bis.org)

Re: Consultative Paper on Principles for the Effective Management and Supervision of Climate-Related Financial Risks.

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

Dear Sir/Madam:

On behalf of The Institute of Internal Auditors (The IIA) and our more than 210,000 professional members worldwide, I thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (the "Committee") *Consultative Paper on Principles for the Effective Management and Supervision of Climate-Related Financial Risks*.

The IIA recognizes and values the existing acknowledgement of the Committee that vital to the corporate governance process is an independent, competent, and qualified internal audit function. Basel's principles for enhancing corporate governance and guidance for assessing the effectiveness of the internal audit function already identify and value the role of an organization's internal audit function. We also appreciate the Committee's recognition that an organization will enhance the ability of its internal audit function by having internal auditors adhere to national and international professional standards, such as those established by The IIA. <u>We encourage and support the Committee in continuing this acknowledgement in its principles of the internal audit function and the value of assurance regarding the management of climate-related financial risks.</u>

The Committee's leadership in identifying internal audit functions as integral to sound corporate governance, to reducing the risk of loss and reputational damage to banks, and to the need for management to take appropriate and timely corrective action in response to internal control weaknesses identified by internal auditors has resonated globally.

Consequently, financial institutions, investor organizations, banking regulators, and corporate governance advocates continue to take steps to ensure that boards and senior management of regulated banks establish and maintain an adequate, effective, and efficient internal control system and support an independent internal audit function to discharge duties effectively. Those recommending the role of internal audit include the Asian Development Bank, International Finance Corporation, International Monetary Fund, and Reserve Bank of India. (See detailed examples of these and more in Annex B.)

The Three Lines Model

The core components of sound corporate governance are articulated in the widely accepted Three Lines Model, updated and published by The IIA in 2020, emphasizing the need for clear roles and responsibilities toward confronting applicable risks, and the crucial importance of effective coordination, communication, and collaboration. Because of its holistic view and understanding of risks across an organization, internal audit is uniquely positioned to provide objective assurance, independent from management, on effective governance structures and systems of internal control (such as those using the *COSO Internal Controls - Integrated Framework)* that manage climate-related financial risks. This assurance, in turn, ensures complete, accurate, and reliable climate-related information, including public disclosures, on which to effectively assess risk, systemic or otherwise, and protect the safety and soundness of the financial services sector.

Basel Committee's Questions on the Proposed Principles – The IIA's Responses
The IIA's comments on the Committee's questions on the proposed principles are summarized below and detailed in Annex A. The points made in our response are aligned with those of our member affiliates in the European Confederation of Institutes of Internal Auditors (ECIIA) and the Chartered Institute of Internal Auditors, U.K and Ireland:

- Highlight the vital importance of objective internal assurance capacities to risk management frameworks.
- Update wording to reflect the 2020 update of the Three Lines Model.
- As a key player in the three lines of effective governance and risk management, internal audit should also have an adequate understanding of climate-related financial risks and should be equipped with the appropriate skills and experience to provide objective assurance, independent of management, on these risks.
- The internal audit function, as a third line role, provides the highest degree of objective assurance and the only internal assurance that is independent of management.
- Add reliability as a key attribute of quality data.
- Recommend that the three lines of the organization work together to ensure that the level of internal assurance is commensurate with the level of confidence needed by internal and external users of information, including disclosures.

Thank you for the opportunity to provide feedback to the Committee's *Consultative Paper on Principles for the Effective Management and Supervision of Climate-Related Financial Risks*. I encourage the Committee to continue to identify and recognize the value of internal assurance, independent from management, provided by an organization's internal audit function over the management and disclosure of any material risk, including those that are climate- and ESG-related. I am available to discuss our response with you at your convenience.

Sincerely,

Anthony J. Pugliese, CIA, CPA, CGMA, CITP
President and Chief Executive Officer
The Institute of Internal Auditors, Global Headquarters

Annex A

Questions on the Proposed Principles – The IIA's Responses

Question 1.
Has the Committee appropriately captured the necessary requirements for the effective management of climate-related financial risks and the related supervision? Are there any aspects that the Committee could consider further or that would benefit from additional guidance from the Committee?

IIA Comment:

- We noticed that "assurance" is not mentioned in the document and The IIA believes objective internal assurance is of vital importance to any risk management framework of any key enterprise risk, including those that are climate-related. In our below response to Question 2, we suggest where in the Principles "assurance" can be appropriately added. In addition, we suggest the word "assurance" could improve the Consultative Paper as follows: On page 6, paragraph 10, we recommend the following sentence change:
    - *The high degree of uncertainty around the timing of these risks suggests that banks should take a prudent and dynamic approach to developing their internal capacities around risk management and assurance.*
- We also appreciate the Committee's mention of the three lines of defense and would like to ensure the Committee is aware that The IIA issued a refreshed position paper in 2020 as an update to the three lines of defense, which now is called the Three Lines Model. In the below response to Question 2, we recommend where this change could be made accordingly.

Question 2.
Do you have any comments on the individual principles and supporting commentary?

IIA Comment: Yes, please see the following:

Principle 2:
We recommend adding the word "assurance" as noted below as an important part of risk management:

The board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risks. The board and senior management should identify responsibilities for climate-related risk management and assurance throughout the organisational structure. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

Principle 2: General paragraph 14
The internal control functions, including internal audit, should be mentioned as important players in governance that should also upskill their acumen around climate-related financial risks. Also, internal experts, not just external, may be used as well:

Banks should ensure that the board, senior management, internal control functions, and internal audit have an adequate understanding of climate-related financial risks and that they are ~~senior management~~ equipped with the appropriate skills and experience to manage these risks. Where necessary, banks should build capacity and upskill these organizational roles ~~board, and senior management~~ on climate-related topics, such as through internal workshops and training or external collaboration with expert organisations.

Principle 2, General paragraph 15,
This paragraph is another opportunity to reinforce the importance and value of assurance in risk management:

Banks should clearly define and explicitly assign roles and responsibilities associated with identifying and managing climate-related financial risks throughout the bank's organisational structure and ensure relevant functions and business units have adequate resources and expertise to effectively fulfill responsibilities regarding climate-related *financial risk management* ***and assurance****. Where dedicated climate units are set up, their responsibilities and interaction with existing governance structures should be clearly defined.*

Principle 4:

We recommend updating the reference to The IIA's newly updated Three Lines Model. We also recommend that the highest level of independence is clearly in the third line, internal audit, and reaffirm that internal auditors should adhere to standards such as those from The IIA:

> *Banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of the organization~~defence~~ to ensure sound, comprehensive and effective identification, measurement, mitigation and assurance of material climate-related financial risks. [Reference principles: BCP 26, SRP 20, SRP 30]*
>
> *17. The internal control framework should include a clear definition and assignment of climate-related responsibilities and reporting lines across the three lines ~~of defence~~.*
>
> *18. In the frontline, climate-related risk assessments may be undertaken during the client onboarding, credit application and credit review processes. Frontline staff should have sufficient awareness and understanding to identify potential climate-related financial risks.*
>
> *19. The second line ~~of defence~~, the risk function, should be responsible for undertaking separate ~~independent~~ climate-related risk assessment and monitoring, including challenging the initial assessment conducted by the frontline, while the compliance function should ensure adherence to applicable rules and regulations.*
>
> *20. The third line ~~of defence~~, the internal audit function, should provide objective assurance, independent of management, through regular reviews and assessments of the overall internal control framework and systems in the light of changes in methodology, business and risk profile, as well as in the quality of underlying data. Internal auditors should adhere to national and international professional standards, such as those established by The Institute of Internal Auditors.*

Principle 7:

We recommend reinforcing that data and reporting should be *reliable*:

> *Risk data aggregation capabilities and internal risk reporting and assurance practices should account for climate-related financial risks. Banks should seek to ensure that their internal reporting systems are capable of monitoring material climate-related financial risks and producing timely and reliable information to ensure effective board and senior management decision-making. [Reference principles: BCP 15, SRP 30, Principles for effective risk data aggregation and risk reporting]*

Principle 7:

Is about monitoring and reporting, we recommend including a reference to the use of the Three Lines Model to provide the proper level of assurance so that ESG information, including climate information, is reliable for confident decision-making. We also recommend the inclusion of language that addresses enterprise internal assurance to support the level of confidence needed.

> Proposed language as a new paragraph within Principle 7*: In order for banks to ensure internal and external reporting of climate-related financial risks are reliable for confident decision-making, the bank should ensure the three lines of the organization, including management (including second line risk and compliance functions) and the independent internal audit function (the third line), are working effectively to achieve objectives and facilitate strong governance and risk management that is commensurate with the level of confidence needed.*

Principle 12: Overall paragraph 45:

We recommend the following change*:*

> *The field of climate scenario analysis is highly dynamic, and practices are expected to evolve rapidly, especially as climate science advances. Climate scenario models, frameworks and results should be subject to challenge and regular review by a range of experts and independent functions, both internal and/or external. ~~internal and/or external experts and independent functions~~.*

Principle 13: Overall paragraph 50:
We recommend removing the word "defence" in alignment with The IIA's revised Three Lines Model.

> *Supervisors should determine that banks adequately incorporate climate-related financial risks into their corporate governance and internal controls, including adopting appropriate policies, procedures and controls across the three lines ~~of defence~~, equipping relevant functions with adequate resources and expertise for implementing business strategy and risk management frameworks, and performing regular reviews and assessments of the overall internal control framework and system.*

Principle 13: Overall paragraph 52:
We recommend adding the word "assurance" as an important part of risk management:

> *Supervisors should assess the extent to which material climate-related financial risks are included in banks' risk management frameworks and risk appetite along with appropriate processes and procedures to identify, monitor and manage such risks. This may include ensuring that banks' risk management frameworks take into account all material climate-related financial risks to which they are exposed and assessing whether banks' data aggregation capabilities and internal reporting practices can facilitate identification and reporting of climate-related risk exposures, concentrations and emerging risks as well as banks' ability to deploy a range of risk management and assurance approaches.*

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Annex B

Examples of Identification and Support for Internal Audit

As part of Section 39 of the U.S. Federal Deposit Insurance (FDI) Act requiring each Federal banking agency to establish certain safety and soundness standards, the agencies must establish operational and managerial standards relating to internal audit systems with provisions including adequate monitoring of the system of internal controls through an internal audit function, as well as independence, objectivity, and qualification of the internal audit function.

The German Federal Financial Services Supervisory Authority, *Bundesanstalt für Finanzdienstleistungsaufsicht,* (BaFin) "Guidance Notice on Dealing with Sustainability Risks," notes in *Section 5.10 Internal audit function*: "Internal audit should also address the appropriate handling of sustainability risks as part of their audit activities. In particular, this should include an assessment of the appropriateness and effectiveness of the revised rules for the organisational and operational structure, risk management and the specific functions as defined by Risk and the key functions as defined by the VAG. Section 30 of the VAG (Article 47 of the S II Framework Directive) relates to the internal audit function which includes an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance."

The European Central Bank's (EBA) "Management and Supervision of ESG Risks for Credit Institutions and Investment Firms" EBA/REP/2021/18 – notes: 222. "The independent internal audit function, among other tasks, reviews the internal governance arrangements, processes and mechanisms to ascertain that they are sound and effective, that they are implemented and that they are being consistently applied throughout the organisation. Assuming that all relevant aspects of ESG factors and ESG risks are incorporated into the institution's governance and organisational arrangements, the internal audit function would capture these under the existing processes, including by effectively communicating with all parties involved in the integration of ESG risks into its activities."

The Reserve Bank of India, under the Guidance Note on Risk-Based Internal Audit, requires banks to put in place a risk based internal audit (RBIA) system as part of their internal control framework that relies on a well-defined policy for internal audit, functional independence with sufficient standing and authority within the bank, effective channels of communication, adequate audit resources with sufficient professional competence, among others. Banks are encouraged to adopt the international internal audit standards, like those issued by the Basel Committee on Banking Supervision (BCBS) and The Institute of Internal Auditors (IIA).

The Asian Development Bank's "Opportunities for Internal Audit Capacity Development" (August 25, 2015) issued to member countries stated that "building and developing internal audit activities in the developing member countries could reinforce the counterparts' capacity to ensure that funds from ADB loans, grants, and technical assistance are used effectively, with economy, and for the intended purposes."

In the International Monetary Fund's "Protecting IMF Resources - Safeguards Assessments of Central Banks" issued on March 25, 2020, the IMF calls on all central banks to have an internal audit mechanism that defines the internal audit function's role to evaluate the effectiveness of risk management, control, and governance processes within a central bank. The IMF assesses whether internal audit has sufficient capacity and organizational independence to fulfill this mandate. Assessments also review compliance with international standards. The IMF also calls for a system of internal controls. These are to include sound governance practices and policies and procedures are necessary to safeguard a central bank's assets and manage its risks. Assessments focus on oversight by the bank's board and audit committee, and the controls in foreign exchange management, accounting, banking, currency and vault operations, and the reporting of monetary data to the IMF.

International Finance Corporation's (IFC), a member of the World Bank Group, corporate governance progression matrix includes the internal audit function in the six key corporate governance parameters. The recently published IFC ESG Guidebook recommends tasking internal audit with assessing the soundness of the company's management system. The IFS ESG

Guidebook also recommends that the set of disclosures includes internal audit responsibilities and reporting lines, as well as the governance and independence of the function.

The International Corporate Governance Network's (ICGN) "Global Governance Principles" (2021) states in Principle 8.1: "Internal audit: The board should oversee the establishment and maintenance of an effective system of internal control to properly manage risk which should be measured against internationally accepted standards of internal audit and tested annually for its adequacy. Companies should have a dedicated internal audit function with clearly defined oversight and reporting structures. Where such a function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the system of internal controls has been obtained."

In "ISO 37000 Governance of organizations — Guidance" (2021), the global standard recommends internal audit function in the Oversight Principle. The standard is intended for stakeholders involved in, or impacted by, the organization and its governance. The primary focus of the standard is to promote good governance (the "G" of "ESG"). However, ISO 37000 also requires directors to use their authority to enhance their organizations' environmental ("E") and social ("S") performance.

The 2022 Ceres Guidance for Engaging on Climate Risk Governance and Voting on Directors, which outlines its guidance based on TCFD "governance," recommended disclosures and the net-zero company benchmark. This guidance provides details on topics that investors and proxy advisory firms may want to consider to inform their company engagements and decisions on whether to support the election of directors responsible for climate change risk oversight. Included in this guidance is that audit committees should direct the company's internal audit department to include in their respective work scopes sufficient testing of the impacts of climate change risk on the company's operations.