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To whom it may concern,

The Basel Committee on Banking Supervision's Consultation on the 'Principles for the effective management and supervision of climate-related financial risks'

The Chartered Institute of Internal Auditors, UK and Ireland (the Chartered IIA) welcomes the opportunity to contribute our views to the Basel Committee on Banking Supervision's Consultation on the 'Principles for the effective management and supervision of climate-related financial risks'.

The Chartered IIA hosts a Banking and Financial Services Sector Advisory Panel (the BFSSAP). This group is composed of volunteers who act as a key link between us and our members in the financial services sector. The BFSSAP work with us to draft bespoke technical guidance, deliver events of interest, carry out research and inform our contribution to policy areas that are essential to supporting internal auditors operating across the banking and financial services sectors. This response was drafted with their assistance and input, all of whom commented in their own personal capacities.

In particular we would like to thank the following for their efforts: Heidi Dainton, Audit Director, OneSavings Bank (OSB Group) and incoming Secretary of the BFSSAP, and Dennis H. Kok, Head of Financial Reporting Risk Audit, HSBC.

The points made in our response are aligned with those of the European Confederation of Institutes of Internal Auditors (ECIIA) and the Global IIA.

The Chartered IIA is happy to discuss any of the comments included in the response and for our response to be published.

Your sincerely,

John Wood
Chief Executive

Chartered Institute of Internal Auditors
Wimbledon Business Centre, The Old Town Hall
4 Queen's Road, Wimbledon SW19 8YB
tel 020 7498 0101
email **info@iia.org.uk** www.iia.org.uk

Chartered Institute of Internal Auditors

About the Chartered IIA

The Chartered IIA represents around 10,000 internal audit professionals in organisations spanning all sectors of the economy, across the UK and Ireland. We are the leading voice of the profession in the UK and Ireland and are part of a global community of over 210,000 internal auditors across 190 countries. We champion the contribution internal audit makes to good corporate governance, strong risk management, and a rigorous control environment leading to the long-term success of organisations, including those in the public sector.

The role of internal audit is to provide independent assurance that risks across the organisation have been effectively identified, managed, and mitigated. Internal auditors seek to ensure that the organisations they serve remain resilient and sustainable.

We are also the authors of the 'Internal Audit Financial Services Code of Practice: Guidance on effective internal audit in the financial services sector'[1]. It is principles-based and written in the context of a company operating within the UK and Ireland regulated financial services sector.

The Code aims to enhance the overall effectiveness of internal audit, and its impact, within organisations operating in the financial services sector in the UK and Ireland. Its recommendations can be regarded as a benchmark of good practice against which organisations can assess their internal audit function.

Introduction

Climate change is arguably the most acute challenge facing our planet right now and is an issue that is quickly moving up the corporate agenda. In fact, some of the most significant impacts of climate change are widely acknowledged to be crystalising now. There is also wide acceptance that the level of impact will only increase in the coming years and that this will, in turn, affect all aspects of society and the economy. We believe it is an area where internal audit functions can add real value to the organisations they serve – within financial services, public, and private sectors.

Our response to this consultation is shaped by the pre-existing efforts to manage climate-related financial risks in the UK. The Bank of England has taken a leading role in encouraging banks and financial services to take climate-related risks more seriously, whilst also recognising that the financial risks and economic consequences of climate change matter for its mission to maintain monetary and financial stability[2].

In April 2019, the Bank of England set supervisory expectations for banks and insurers on the management of climate-related financial risks, covering governance, risk management, scenario analysis and disclosure. The Supervisory Statement SS3/19[3] sets out its expectations that firms take a strategic approach to managing climate-related financial risks.

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[1] Chartered IIA, ***Internal Audit Financial Services Code of Practice: Guidance on effective internal audit in the financial services sector***

[2] Bank of England, ***Climate Change***

[3] Bank of England, Supervisory Statement, ***SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change***

Chartered Institute of Internal Auditors
Wimbledon Business Centre, The Old Town Hall
4 Queen's Road, Wimbledon SW19 8YB
tel 020 7498 0101
email **info@iia.org.uk** www.iia.org.uk

Also in the UK, the Department for Business, Energy and Industrial Strategy (BEIS) has now introduced mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs. Coming in to force in April 2022, the new measures will require those organisations to use the Task Force on Climate-related Financial Disclosures (TCFD) framework for reporting such information.

This is the backdrop against which our response is set.

So important is climate risk to the Chartered IIA (and the internal audit profession) that over the past several years we have carried out research, delivered training, responded to consultations, and published thought leadership reports to ensure that our members and other stakeholders are fully aware of the importance of understanding, managing, and mitigating climate-related risks.

It is our role as an institute to ensure that internal audit functions are well equipped to tackle climate-related risks. And more widely, that organisations' boards and senior leadership themselves understand the key role that their internal audit functions can play in providing assurance across the organisation's climate change agenda.

In addition, we have also taken steps to reflect upon our own contribution to climate change and are looking to reduce our carbon footprint. In 2021, to ensure that we practice what we preach on climate change, we signed up to an initiative called Climate Action for Associations[4].

The Chartered IIA's work on climate change

Harnessing internal audit against climate change risk: A guide for audit committees and directors[5]

In advance of the COP26 climate summit in Glasgow we partnered with BSI to publish a guide with the intention to motivate senior leaders to make demands of and fully harness their internal audit teams in respect of climate change preparedness. In addition, we wanted to encourage internal audit professionals to be leaders in this space, stepping up to show their value and worth to the organisations they serve.

Organisations' preparedness for climate change: an internal audit perspective[6]

In November 2020 we published a report in partnership with The Climate Group[7], based on our own research to better understand how Chief Audit Executives (CAEs) were addressing climate change and environmental sustainability risks in their organisations. Having established that climate change is a dynamic risk that is quickly moving up the agenda, the research then identified what internal audit functions were doing in this area. Of the CAEs surveyed, almost half (47%) indicated they have discussed climate change with their audit committee, 35% with their risk committee, and 22% have done so with their board. It is with executive management that CAEs seem to have had the most engagement on this topic (64%). A large majority, (83%) of those surveyed believed there should be a universally agreed framework to report climate-related information.

[4] **Climate Action for Associations**
[5] The Chartered IIA, ***Harnessing internal audit against climate change risk: A guide for audit committees and directors***
[6] The Chartered IIA, ***Organisations' preparedness for climate change: an internal audit perspective***
[7] **The Climate group**

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Risk in Focus[8]

Risk in Focus is an annual thought leadership research project analysing the top risks faced by organisations across Europe. It is an essential tool for audit committees and a barometer of what CAEs and others perceive as their organisations' risk priorities. The latest edition, Risk in Focus 2022[9], found that *climate change and environmental sustainability* is seen as a top five risk by as many as 31% of CAEs, representing an increase of more than 40% on last year's survey when 22% of CAEs said the same. This means that in the space of two years, the topic had gone from a talking point to a principal item on risk maps and corporate risk registers.

Following the results of Risk in Focus 2021, we worked with a number of other European countries' institutes of internal auditors to produce a related document, '*Practical guidance on climate change and environmental sustainability*'.[10]

Technical guidance

In addition to the above reports, we also have available to our members a wealth of technical guidance to enable them to audit climate-related risks. For example, 'Auditing climate data and reporting'[11], which focuses on auditing both external and internal climate-related reporting and the data underlying such reports. Another piece of technical guidance is on 'Climate financial risk auditing'[12] which addresses some of the main sources of financial risk in relation to climate change.

A full list of climate-related technical guidance is available on the Chartered IIA's website[13].

Q1. 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?

We are in support of the Committee's work to examine the extent to which climate-related financial risks can be addressed within the Basel framework. We are also broadly supportive of the principles outlined in the consultative document. They take a comprehensive and holistic approach.

The Committee should continue in future to build on the principles and take additional steps. For example, by producing practical guidance to ensure that any strengthening of regulation, supervision, and practices of banks worldwide is accompanied by additional support to bring any new proposals into practice.

[8] **Risk in Focus Homepage**
[9] The Chartered IIA, ***Risk in Focus 2022***
[10] Risk in Focus 2021, ***Practical guidance on climate change and environmental sustainability***
[11] The Chartered IIA, Technical Guidance, ***Auditing climate data and reporting***
[12] The Chartered IIA, Technical Guidance, ***Climate financial risk auditing***
[13] The Chartered IIA, Resources, ***Technical Guidance***

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The principles outlined are relatively high-level, which is understandable if the Committee is going to be successful in maintaining sufficient flexibility given the degree of heterogeneity and evolving practices in this area. It is right that the principles are drafted in a way that intends to accommodate a diverse range of banking systems and are intended to be applied on a proportionate basis depending on the size, complexity, and risk profile of the bank or banking sector for which the authority is responsible (para. 6).

However, high-level principles do not necessarily translate and trickle down into identifiable changes in behaviour and practice 'on the ground'. In some places, the Committee should go further to strengthen, or expand upon, some of the principles made. This would lead to increased real-world impact. At present, the document's analytical approach is valuable but will not necessarily 'move the dial'.

One of the reasons that we believe that additional further steps should be taken to build upon the principles (e.g. through further work and guidance in the future) is that not all banks and supervisors will be equally well-served by high-level principles. The levels of maturity will vary widely across the sector. Organisations would benefit from additional support and direction, and the Committee is well-placed to take a leading role in ensuring that none are left behind.

Q2. Do you have any comments on the individual principles and supporting commentary?

We have made comments on some of the individual principles and suggested wording to strengthen those principles especially in relation to the role and value of internal audit.

Of particular relevance is ensuring that the organisation receives appropriate assurance around both regulatory requirements and the processes the organisation has put in place to mitigate climate risk. Therefore, there needs to be clarity around who the assurance providers are. The three lines model is essential at outlining where in an organisation these responsibilities sit.

Internal audit uses the three lines model[14] as a tool to clearly sets out the expectations of different groups within the organisation. Previously known as the 'three lines of defence' model, in 2020 it was refined by the Global IIA to foster closer collaboration between business functions including internal audit. This was not a radical change but a subtle shift of language to enhance clarity and purpose.

Accountability – the governing body; typically, the board and its sub-committees i.e. the audit committee is accountable to stakeholders for oversight.

Actions – management; first and second line are responsible for managing risks.

Assurance – internal audit; independent function reporting directly to the highest point of authority in the organisation – the governing body (audit committee) – providing advice, insight, and continuous improvement, but at the same time supporting management in their role.

The purpose of the three lines is to create and protect value. Success requires effective alignment, communication, coordination, and collaboration, with all roles operating concurrently.

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[14] The Chartered IIA, ***the Three Lines Model,*** adapted from the Global IIA

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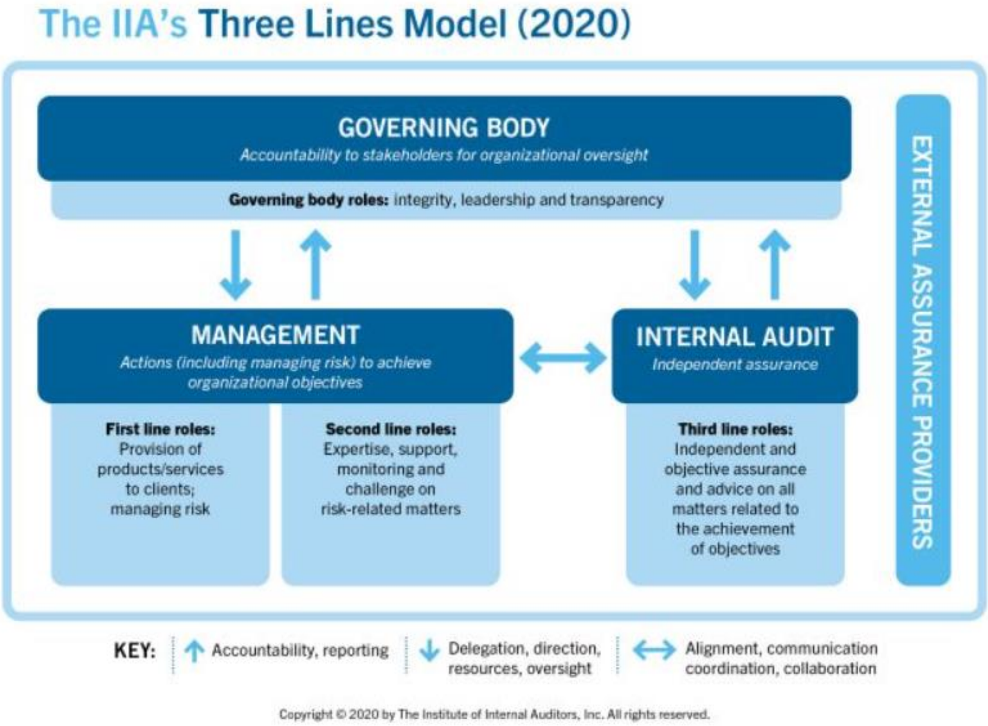
email **info@iia.org.uk** www.iia.org.uk



In 2015, the Financial Stability Institute published 'The Occasional Paper No 11 - The "four lines of defence model" for financial institutions: Taking the three-lines-of-defence model further to reflect specific governance features of regulated financial institutions'[15]. We would suggest that the revised three lines model provides increased rigour in the relationship between internal audit and its key stakeholders across the organisation.

In terms of suggestions regarding individual principles highlighted below are suggested additions in italics:

Principle 2 - The board and senior management should identify responsibilities for climate-related risk management throughout the organisational structure.

We would also suggest the following amendments (emphasis added):

> ***Internal audit has a role to play in these conversations as the primary role of internal audit should be to help the board and executive management to protect the assets, reputation, and sustainability of the organisation. It does this by assessing whether all significant risks are identified and appropriately reported by management and the risk function to the board and executive management; assessing whether they are adequately controlled; and by challenging executive management to improve the effectiveness of governance, risk management, and internal controls.***

[15] Bank for International Settlements (BIS), Financial Stability Institute, Occasional Paper No 11, ***The "four lines of defence model" for financial institutions - Taking the three-lines-of-defence model further to reflect specific governance features of regulated financial institutions***

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Principle 4 – Measuring the effectiveness of the principles might be challenging without further guidance and definitions. Principle 4 states that "banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of defence […]". This is an important principle, and one in which the role of internal audit is both valuable and clear. But this principle could go further by recognising that climate-related financial risks are closely related to, and associated with, other risks. For example, risks around reputational damage or incoming legislative and regulatory changes.

We would suggest amendments as follows –

> ***Clarity should be provided around internal audit's third line responsibilities as a provider of independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management. The third line (the internal audit function)*** should carry out regular reviews 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, ***thereby enabling them to provide an assurance to the board/audit committee as to the rigour within the internal control environment such that it mitigates the risk of reputational damage by supporting accurate, timely, and complete reporting.***

Principle 6 – We are supportive of the proposed principles' attempts to create a common baseline for internationally active banks and supervisors. We support and argue for international and universally understood standards, frameworks and reporting mechanisms for banks and other organisations in an effort to avoid fragmented and inconsistent approaches to climate change risks and climate-related reporting.

We believe that financial markets need clear, comprehensive, high-quality information on the impacts of climate change and would support steps to reach this goal.

As referred to earlier, the UK government has introduced mandatory climate-related financial disclosures by publicly quoted companies, large private companies, and LLPs[16], coming into effect from April 2022. During the government's consultation period, we emphasised that without universally agreed and common metrics, standards, measurements, and principles it is difficult to make comparisons between different organisation's disclosures relating to climate-related financial risk. We would therefore urge the Committee to support clear, consistent, and comparable climate-related risk reporting from the banking sector, using a commonly agreed and universal approach.

Principle 7: looks at management, monitoring, and reporting of climate-related financial risk. The quality of the data that banks and other organisations rely on to effectively manage climate-related financial risks is a potential barrier to its effectiveness. In preparing this response to the Committee, we spoke with several CAEs within the financial services sector who expressed support for the principles outlined within the consultative document but highlighted that accessing comprehensive, and accurate data is not always straightforward.

We suggest amendments and additions to the wording in principle 7 as follows:

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[16] Department for Business, Energy & Industrial Strategy, ***Mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs***

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Risk data aggregation capabilities and internal risk reporting 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, ***accurate, and complete*** information to ensure effective board and senior management decision-making.

The reporting should be timely and updated regularly. Banks ***should also decide the level of internal assurance that is needed*** and may also consider an appropriate interval for updating internal risk reports, taking into account the evolving nature of climate-related financial risks
Internal audit should exercise informed judgement as to what extent it is appropriate to take account of relevant work undertaken by others, such as risk management, compliance or finance in either its risk assessment or determination of the level of audit testing of the activities under review. Any judgement which results in less intense internal audit scrutiny should only be made after an evaluation of the effectiveness of that function in relation to the area under review.

(The above suggestion is taken directly from the Chartered IIA (UK and Ireland) FS Code[17])

Q3. How could the transmission of environmental risks to banks' risk profiles be taken into account when considering the potential application of these principles to broader environmental risks in the future? Which key aspects should be considered?

In the UK we have two primary regulators in the financial services sector - the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

To inform our work on 'Harnessing internal audit against climate change risk', we held meetings with an advisory panel of CAEs and experts with knowledge of climate change risk. We considered the roles of the UK's regulatory bodies, the PRA and the FCA in supporting banks to understand and adhere to new expectations and approaches to managing the financial risks from climate change.

During our discussions, the PRA was described by members of our advisory panel as having a good understanding of the threat of climate-related financial risks. They were viewed as going 'above and beyond' because not only did they set out expectations for banks and insurers to adhere to – but outlined a roadmap to help organisations get there. In short, the PRA was credited with not just setting new rules and expectations but making it easy for the banks to understand and implement the necessary changes. Banks and regulatory bodies could benefit if the Committee takes a similar approach. That is, creating the principles and taking additional steps to ensure that those principles are straightforward to adopt and put into practice.

We would agree that "supervisors and banks could benefit from the Committee's guidance to foster alignment in terms of supervisory expectations for addressing these risks" (para. 3). We would agree that further guidance from the Committee would be an effective method to transform the high-level principles into more workable principles accompanied by real-world impact. This might also encourage banks to adopt the principles without delay.

[17] Chartered IIA, ***Internal Audit Financial Services Code of Practice: Guidance on effective internal audit in the financial services sector***

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In future it would be beneficial for the Committee to expand its work around climate change risk to align with and complement efforts to address related broader environmental risks.

Conclusions

The Chartered IIA supports the principles for the effective management and supervision of climate-related financial risks, although the principles could be strengthened and expanded upon in some areas (as outlined above).

We support and argue for international and universally understood standards, frameworks and reporting mechanisms for banks and other organisations in an effort to avoid fragmented and inconsistent approaches to climate change risks and climate-related reporting. Financial markets in particular need clear, comprehensive, high-quality information on the impacts of climate change and would support steps to reach this goal.

The Committee must therefore accompany the principles with further guidance and support for banks and supervisors to assist in implementing changes which reflect the spirit of the principles. This will increase the likelihood of timely adoption and effective real-world changes that are needed to tackle the very pressing issue of climate-related financial risk, especially for those banks and organisations who are less mature in this area.

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