BANK OF ENGLAND

Speech

Increasing the relevance of Internal Audit

Speech given by

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The Central bank Governance Forum, Dubai

Hosted by the International Monetary Fund and Hawkamah

14 December 2016

Good morning everyone.

Firstly, may I say how grateful I am to the IMF and Hawkamah for inviting me to this conference. Before I joined the central bank community in 2005 I was lucky enough to have travelled a little as an internal auditor for American investment banks. Yet somehow I never before made it to the Middle East. So it really is a special honour for me to be here with you today in Dubai.

I'd like to talk about the relevance of Internal Audit under five headings:

1. the state of Internal Audit in commercial banks during the financial crisis;
2. subsequent changes to the relevant supervisory and professional landscape;
3. whether those changes have made any difference to the standards of internal auditing;
4. whether central banks and supervisors - and their own internal auditors - might be able to drive further improvement; and
5. as part of answering the last question, the independence of Internal Audit.

To the extent that this talk is biased towards banking in the UK it is because quite a lot has been going on in that space which I think may be of interest to you. I fully appreciate and applaud the fact that much has been done in other industries and jurisdictions.

1. The state of Internal Audit in commercial banks as the financial crisis developed

Many people agree that the financial crisis started on 9th August 2007 when asset backed markets suddenly seized up.[1] I can remember the day quite well. I was on holiday and spent two hours in the middle of a field trying to get a phone signal as I attempted to find out what on earth was going on.

Opinion as to when the financial crisis ended is more mixed. The Bank of England's Financial Policy Committee judged on 1st December 2015 that "the financial system has moved out of the post crisis period".[2] Others have cited the US Federal Reserve's decision to raise interest rates later in the same month as clear evidence that the crisis was over.

Using these dates I've managed to work out that the exact middle of the financial crisis was 9th October 2011. You may suspect that I am trying to contrive something – you are absolutely right!

[1] See for example, BBC News, Timeline: Credit Crunch to Downturn; http://news.bbc.co.uk/1/hi/business/7521250.stm
[2] Bank of England Financial Stability Report December 2015, page 7; http://www.bankofengland.co.uk/publications/Documents/fsr/2015/dec.pdf

Well, it so happens, that October 2011 was also when I had the opportunity to look at a draft paper called "The internal audit function in banks." It had been prepared by the Audit Sub-Group, of the Accounting Task Force, of the Basel Committee on Banking Supervision (BCBS). It was designed to help banking supervisors assess the effectiveness of the internal audit functions in banks.

During a conference call with the Chair and Secretary of the sub-group, I pointed out that the draft paper made no reference to the financial crisis. I thought that was strange given that a number of banks around the world had gone bust and that many others had been (or remained) on some form of life support.[3]

The response from the secretary of the group, Xavier-Yves Zanota,[4] was:

> "...that's true Stephen but what has the failure of these banks got to do with their internal auditors?"

So here, in the middle of the financial crisis, was a representative of the world's most senior supervisory group telling me that, in his opinion, the failure of many of the world's commercial banks had nothing to do with their internal auditors. In other words the internal auditors were irrelevant!

Now you might expect that the internal auditors within commercial banks would have been angered at this suggestion. But on the contrary, whenever I discussed the matter with them, they took it quite well!

I must confess that, at the time, I found this rather irritating. But as I've reflected on it over the years I've realised that the reaction of the internal auditors was entirely logical. They said to themselves:

> "My bank is bust; or would be bust without state support. In this litigious society, shall I:
>
> a) put my head above the parapet and declare that perhaps I could have done better; or
> b) go along with what seems to be the predominant view that it's nothing to do with me?"

The internal auditors thought long and hard about that question for at least a couple of seconds before going for option b).

The truth is that the internal auditors in commercial banks were (quite understandably) hiding. And I suspect that all of us in this room would have done exactly the same thing if we had been in their shoes.

"Where were they hiding?" you may ask. I think it was at least partly behind the Institute of Internal Auditor's (IIA's) definition of internal auditing.

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[3] For example, in the UK, the Bank of England operated the Special Liquidity Scheme (SLS) which ran from 2008 to 2012. Peak usage was £185bn supporting 32 banks. See Bank of England, Quarterly Bulletin 2012 Q1, page 59; http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb1201.pdf

[4] To whom I am very grateful for permission to use this quotation.

Let me remind you of what it was and *__still is__*:

> *"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."* [5]

Over the many years that I've been an internal auditor, I've attempted to use this definition to explain to my children what it is that I do all day[6]. And since this is the definition of internal auditing still used all over the world perhaps we should spend a little time on it.

Presumably the first sentence is the most important so let's focus on that. Boiling it down, we get:

> Internal audit is an *"__assurance__"* and *"__consulting__"* function *"__designed to add value__"* and *"__improve an organization's operations__".*

And analysing that we have:

- Firstly "*__assurance__*". The Oxford English Dictionary defines assurance as:

  "*A positive declaration intended to give confidence*"

  Well, I suppose that's OK if everything in the company is going just fine. But if that's the case, then I'm not sure we need internal auditors. And the truth is that my children never really liked the word "assurance" at all.

- Now "*__consulting__*". The dictionary defines[7] this as:

  "*Experts making recommendations*"

  Well the good news is that the children can understand that. But then they would ask me tough questions like – "well Daddy if you are such an expert at investment banking, why aren't you doing

[5] From the IIA's 'Global' website: https://global.theiia.org/standards-guidance/mandatory-guidance/Pages/Definition-of-Internal-Auditing.aspx

[6] I find that one's children are brilliant for testing out explanations. Nine-year olds are the best. They still love you enough to bother to listen to what you are saying but they are smart enough (and honest enough) to tell you if you are talking nonsense.

[7] Admittedly I am paraphrasing here given a rather circular set of definitions. In the interests only of complete transparency: *Consulting* is: "The business of giving expert advice"; *Advice* is: "Guidance or recommendations offered with regard to prudent action"; *Guidance* is: "Advice or information aimed at resolving a problem or difficulty"; *Recommendation* is: "A suggestion or proposal as to the best course of action, especially one put forward by an authoritative body"; *Suggestion* is: "an idea or plan put forward for consideration". *Proposal* is: "A plan or suggestion, especially a formal or written one, put forward for consideration by others." https://en.oxforddictionaries.com/

investment banking and making lots of money!" To be honest, I'm not at all sure that internal auditors *are* experts in the areas they are auditing.[8]

And then my children would ask "what happens if people disagree with your recommendations". The problem with the word "recommendation" is that it implies that whoever is in receipt of the auditor's idea for improving things can ignore it. I'm not sure that's right either (a point that I will return to later).

- That Internal Audit is "*designed to add value*" didn't really help me to distinguish the internal auditors from anyone else – "Daddy, is there anyone in your company whose job is not to add value?" my children would ask sarcastically.

- And finally, internal auditors are meant to "*improve an organization's operations*". OK, now we're getting somewhere. That's got to be worth having and it's certainly something the children can understand.

  But the trouble with this as a purpose for Internal Audit is that it is entirely possible to go around making marginal improvements whilst an organisation teeters on (and in the case of some banks during the crisis, fall over) the edge of a cliff!

The truth is that the definition of internal auditing is rather ambiguous to say the very least. Quite good for hiding behind.

Having carefully analysed the definition of internal auditing, I found myself reluctantly agreeing with Xavier. Incredible though it may seem, the dire situation that banks found themselves in during the financial crisis really was nothing to do with their internal auditors!

Whether this was a satisfactory state of affairs is another question entirely.

2. Changes to the supervisory, legislative and professional regimes since then

In October 2011, it was difficult to see how Internal Audit's lack of relevance was going to change for the better. The internal auditors were hiding, bank chief executives weren't exactly clamouring for greater internal challenge and audit committee chairs were defending the internal audit functions which they had been overseeing. The Institute of Internal Auditors seemed quite attached to its definition of internal auditing and the authorities had bigger things to worry about than the internal auditors. Other stakeholders - shareholders, depositors and taxpayers seemed generally unaware that internal auditors even existed!

[8] Of course that doesn't stop them being expert internal auditors. Indeed I would say that one of the defining qualities of an expert internal auditor is the ability to protect value and drive improvements in areas where they are most definitely *not* experts.

Well, I'm pleased to say that as the financial system stabilised and the crisis ground into its second half, supervisors and legislators started to find the time to call out that the irrelevance of Internal Audit was not acceptable.

For me, the turning point was 11th October 2011 when Andrew Bailey – at the time the Director of UK Banking Supervision – said in a speech:

> *"…internal audit functions of firms must be active and able to push their case strongly. To be frank, I think one of the relatively untold stories of the financial crisis concerns how little attention these functions have attracted. Boards and senior management […] must be supported by robust […] audit functions (internal and external). Unfortunately, when I look across the landscape, I don't believe that we are in the right place today in terms of the role and influence of these […] functions."* [9]

Subsequently, the Basel Committee's Audit Sub-Group decided that it was important that their guidance "incorporates lessons drawn from the recent financial crisis" [10] and they added a crucial word to their first principle for effective internal audit published in June 2012:

> *"Principle 1: An effective internal audit function […] help[s] the board and senior management* ***protect*** *[my emphasis] their organisation and its reputation."* [11]

And the Institute of Internal Auditors – to their credit – responded to the prodding from supervisors.

In the UK, the Chartered Institute of Internal Auditors[12] set up an independent committee[13] which, in July 2013, issued a comprehensive "Code" for internal auditors in financial services. The Code raised expectations significantly. Its first paragraph says:

> *"1. The primary role of Internal Audit should be to help the Board and Executive Management to* ***protect*** *[my emphasis again] the assets, reputation and sustainability of the organisation."* [14]

The new Code, and particularly its emphasis on protecting the assets and reputation of the organisation, was warmly welcomed by the regulators.[15]

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9 From "Why Prudential Regulation Matters", speech by Andrew Bailey, Director of Banking Supervision at the Financial Services Authority, 11th October 2011. http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/1011_ab.shtml. Andrew subsequently became the Chief Executive of the Prudential Regulation Authority and Deputy Governor of the Bank of England. Since July 2016 he has been the Chief Executive of the Financial Conduct Authority.

10 Basel Committee on Banking Supervision, June 2012; 'The internal audit function in banks'; http://www.bis.org/publ/bcbs223.pdf, page 1, para 1.

11 Ibid. page 2.

12 The CIIA is the UK member of the IIA's global network.

13 I was an "observer" to the Committee. I confess that I did speak.

14 Chartered Institute of Internal Auditors; Effective Internal Audit in the Financial Services Sector, July 2013; https://www.iia.org.uk/media/1558662/Effective-internal-audit-in-Financial-Services-sector.pdf

15 Bank of England, News Release 8th July 2013, "PRA and FCA welcome Internal Audit guidance": http://www.bankofengland.co.uk/publications/Pages/news/2013/087.aspx

And then, in July of 2015, the Global IIA adopted a brand new mission statement articulating what internal audit hopes to accomplish. The new mission is:

> *"To enhance and **protect** [my emphasis yet again] organizational value by providing risk-based and objective assurance, advice, and insight."* [16]

This new mission applies globally and therefore, I assume, to all of the internal auditors present here today.

In the quotations above, I have been emphasising the word "***protect***". I think it is a very important word for two reasons.

Firstly, if we get to the point where internal audit functions start getting good at protecting their banks then that sounds like a useful thing for supervisors and other financial authorities like central banks.

And secondly, I think it helps to resolve the "irrelevance" point. If the mission of an internal auditor is to "protect" the bank they work in then it seems to me that if the bank goes bust, at least someone will ask the question "where on earth was the internal auditor". That is absolutely *not* to assume that the internal auditor is responsible for the bank's failure. But the fact that the internal auditor now knows that the question will be asked, surely incentivises them to invest heavily in helping to prevent their bank from going bust in the first place.

Meanwhile, the UK's lawmakers were very busy. In June 2013, the Parliamentary Commission on Banking Standards published a 571 page report with the aim of restoring trust in UK banking.[17, 18] As you can imagine the scope of the report was very wide ranging and it covered internal audit in some depth. The Commission noted that:

> *"internal audit have lacked the status to challenge front-line staff effectively"* [19]

Key among the many changes proposed by the Commission's report, and then adopted into legislation, was a new "Senior Managers Regime" designed to:

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16 From the Global IIA's website:https://global.theiia.org/standards-guidance/Pages/Mission-of-Internal-Audit.aspx

17 Changing banking for good. Report of the Parliamentary Commission on Banking Standards, June 2013, page 8: http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf

18 I should also mention that in the UK, in November 2009, the 'Walker Review' (commissioned by the Prime Minister) into the Governance of UK Banks, did acknowledge the existence of the Internal Audit function and made some helpful recommendations. But the review also played down the relevance of Internal Audit suggesting that "failures that proved to be critical for many banks related much less to what might be characterised as conventional compliance and audit processes, including internal audit [….]". 'A review of corporate governance in UK banks and other financial industry entities'; http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf

19 Ibid. 17, page 18, para 20

"ensure that the key responsibilities within banks are assigned to specific individuals, who are made fully and unambiguously aware of those responsibilities and made to understand that they will be held to account for how they carry them out." [20]

The relevant legislation was enacted in 2013, and the new regime came into effect in March 2016. The Heads of Internal Audit at UK banks are now designated as one of a number of "Senior Managers" who must be approved by both financial regulators before taking up their position. The Head of Internal Audit has explicit responsibility for:

"management of the internal audit function of a firm and for reporting directly to the governing body of the firm on the internal audit function." [21]

Perhaps you are thinking that that sounds a bit too easy?

Well, on top of a host of other regulatory requirements, being a Senior Manager in the UK carries with it a number of special conduct obligations.[22] These include making sure that the area you are responsible for is controlled effectively and complies with regulatory standards. You can only delegate your responsibilities to an 'appropriate person' and you must oversee that delegation effectively. And you must disclose appropriately any information of which the regulators would reasonably expect notice. To top it off, there is a new criminal offence of taking or agreeing to a decision (or failing to take reasonable steps to prevent a decision) that causes the failure of a UK bank.[23]

So, if the IIA's new mission – to protect organisational value – doesn't focus the mind of bank internal auditors then, in the UK at least, the prospect of seven years in prison (which is the maximum penalty for failing to take reasonable steps to prevent a decision that results in the failure of a Bank) surely will!

3. Have these changes made any difference to the standards of internal auditing in the UK?

Well, there have not been any bank failures in the UK since the above reforms. Despite being a strong advocate for the Internal Audit profession I'm not sure the internal auditors can claim the credit for that!

But there is no doubt that the new guidance and its emphasis on "protecting" the organisation has, along with supervisory pressure and the new Senior Managers Regime, prompted some real improvement within the internal audit functions of the UK's commercial banks. According to my supervisory colleagues: [24]

[20] Ibid, page 8
[21] PRA Rulebook - Senior Management Functions 3.5; http://www.prarulebook.co.uk/rulebook/Content/Part/212475/16-12-2016
[22] PRA Rulebook - Conduct Rules 3.1-3.4; http://www.prarulebook.co.uk/rulebook/Content/Part/302382/16-12-2016
[23] Financial Services (Banking Reform) Act, S 36; http://www.legislation.gov.uk/ukpga/2013/33/section/36
[24] Bank of England, Speech by Sasha Mills - Internal Audit and supervisory expectations – building on progress. February 2016. http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech879.pdf

- access to key information and attendance at key governance forums is much improved;

- Internal Audit's reporting lines have been adjusted to better preserve their independence – it is now much less likely that Internal Audit reports to Finance or Risk; and

- resourcing (in terms of overall headcount) appears to have increased generally across the industry.

This is good news.

But, it is equally clear that there is further to go. In particular: [25]

- Internal Audit needs to stand its ground more; it needs to invest in developing talented internal auditors who can go "toe-to-toe" with senior management on key issues;

- internal audit reports should be more concise and more readable and focus on the key risks to the business;

- internal auditors should be more forward looking and focus more on "emerging risks"; and

- internal audit departments need to invest more in quality assurance and in challenging themselves.

And it is these opportunities which bring me to the real point of this talk.

4. How can central banks and supervisors – and their own internal auditors – drive further improvement?

As a supervisory body we, at the Bank of England, think it is in our interests for banks to have effective internal audit functions that help to protect the assets and reputations of the organisations they work for. And we think that the internal audit profession in the UK is making real progress towards this.

But we also know that Internal Audit has further to go and that we are operating in an international marketplace with interconnected global companies. And, just as importantly, Internal Auditing itself is very much a global profession. With respect to improving professional standards, there are limits to what any of the 39 central banks represented here today can achieve by themselves.

[25] Ibid., and from remarks given by David Eacott to the Chartered Institute of Internal Auditors in November 2016.

So I am hoping that each of you, the central banks here today, will consider demanding more of the internal auditors within your own financial services industries. I have no doubt that central banks are influential enough to be able to do this irrespective of whether or not they are directly responsible for supervision.

I know that some of you are already doing this and that some of you may be further along this path than we are in the UK. But I think it is also likely that the internal audit functions in your financial services sector, just like ours, still have some distance to travel.

I trust, therefore, that it is not controversial to suggest that your central banks should push to raise Internal Audit standards within your financial services sector.

But may I also suggest that the internal auditors *within* your central banks and supervisory authorities could help with this. Over a third of us here today are central bank internal auditors, so perhaps I could expand on this a little and explain why it might be a more controversial suggestion.

I think that in the field of Internal Auditing, the subject matter experts in your central banks are likely to be your very own internal auditors. If that is the case then surely it should be possible to leverage that expertise for the greater good. And yet, in my experience, it is not common for the internal auditors in central banks to proactively and forcefully engage with the internal audit profession in their countries to demand higher standards.

Why is this? I hear two reasons from central bank internal auditors; both of which I understand but both of which I disagree with: The first reason goes along the lines of:

> *"I am an active member of my local IIA but I avoid speaking about internal audit standards in financial services in case I encroach on the territory of the supervisors and possibly even contradict them".*

I think that this potential problem can be easily solved. All that is needed is extensive communication and collaboration with the supervisors (and any other policy makers) to avoid such contradictions. If only it were as easy as that!

The truth is that this then often prompts the second reason:

> *"I cannot collaborate with the supervisors in the way that you suggest because I am meant to be auditing them - I am meant to be completely independent of them."*

Now this is much harder to deal with. And independence is such an important topic for internal auditors that I hope you can forgive me for saying a few words about it.

5. The Independence of Internal Audit

Let me be clear that I think that the need for internal auditors to maintain their objectivity – their impartiality – is of paramount importance. If the readers of internal audit reports, or the recipients of their "recommendations", start to question the internal auditor's motives, then all is lost. _Internal auditors must be independent of executive management._

But, they are certainly not independent of the organisations that they work for. They are very much a part of the organisation and, I hope, striving to protect it. Internal auditors, unlike consultants, external auditors or supervisors, are – as the name suggests - "internal" to the organisation. I think that it is from this unique combination of being part of the organisation and yet independent of executive management, that internal auditors derive their ability to help protect the organisation. This combination is, in fact, Internal Audit's unique selling point or USP.[26]

Being independent of executive management means that the internal auditors don't report to executive management. It means resisting being unduly influenced by them. It means asking them challenging but constructive questions. It _doesn't_ mean that the internal auditor cannot work with or collaborate with executive management.

Perhaps I can give you two examples which illustrate how the concept of Internal Audit independence can sometimes be misconstrued or even misused.

Example 1: Attendance at project boards:

> Wherever I have worked as an internal auditor, I've always attended[27] and spoken at the meetings of the boards overseeing the organisation's most risky projects. I've sometimes encountered executives who have suggested that it would be far better if I did not attend so that I can "maintain my independence" from the project. I advise them that it is far better that I am inside the room so that I can _leverage_ my independence.
>
> Sometimes they say "but who will conduct the investigation if the project goes disastrously wrong?"[28] The answer is "certainly not me – I've been too close to the project. But, since my job is to help protect the organisation, I will try to help you and the organisation avoid that disastrous outcome!"

[26] It is important that supervisors appreciate this and do not expect Internal Auditors to act as an arm of the regulator. Of course there must be a close, cooperative and open relationship, but if the organisation thinks that the internal auditors are, in fact, external then the internal auditors are in danger of losing their USP.

[27] I describe myself as an attendee, as opposed to a member, but certainly not an "observer" which would imply that I don't speak!

[28] Or alternatively, "Who will come along and bayonet the wounded?" This is a common charge against internal auditors who adopt the 'come along afterwards if everything goes badly' approach.

Example 2: Negotiating management actions in response to audit recommendations

Another area in which the independence of internal auditors is sometimes misunderstood is when negotiating management actions in response to internal audit "recommendations". I suggested earlier that the word "recommendation" feels rather too optional to me. I admit though that in the absence of a better word in the English language I still use "recommendation". However, rejecting an internal audit "recommendation" should be anything but a free option for executive management.

Internal auditors need to be able, as my supervisory colleague said, to stand toe to toe with management and negotiate cost effective action plans to address the issues that have been identified. If agreement cannot be reached the matter should be escalated, ultimately to the Audit Committee of the Board, and it should be clear that management and the internal auditor disagree about the correct course of action. If there has been a robust and respectful negotiation, then such an escalation should be very rare.

This may sound obvious. But there are some internal auditors who avoid these tough negotiations, citing independence. They say "it's my job to point out the weaknesses; it's management's job to come up with the solutions. I will compromise my independence if I start to discuss the solutions with management. But I'll come back in two years and check that the issues have been addressed." I'm afraid that such an approach makes it far too easy for the internal auditors to be ignored. And from there it is a short step to irrelevance.

So, to summarise, I think that whilst *independence from* management is of paramount importance to internal auditors, maintaining independence does not preclude *working with* management. Indeed, to be effective, internal auditors *must* work with management.

I do realise that there are shades of grey here and that internal auditors have to balance staying informed with the need to keep a healthy distance from running the company. Doing this, whilst ruthlessly maintaining independence, is part of the internal auditor's art.

All of which brings me back to the discussion about whether or not the internal auditors in your central banks are able to collaborate with supervisors and exert influence over the IIA and other internal audit practitioners in your country in the interests of raising standards in Internal Auditing.

I hope that I have convinced you that they can.

And that therefore they should.

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