Turks & Caicos Island Financial Services Commission
Guidelines Pursuant to Section 43 of the Financial Services Commission Ordinance 2007
Internal Control and Audit in Licensed Banks

Introduction

1. These guidelines, apply to all banks licensed under the Banking Ordinance. They are issued under section 43 of the Financial Services Commission Ordinance to provide guidance as to the conduct expected by the Commission of licensees in the operation of their licensed business. Failure to follow these guidelines is considered by the Commission, and may also be taken into account by the Court, in determining whether there has been a contravention of any financial services Ordinances or other provisions.

Internal Controls

2. In reviewing whether licensed banks continue to meet the standards required of licensed persons, the Commission needs to be satisfied that banks conduct their business at all times in a prudent manner. Banks are in the business of risk-taking and it is vital that, as part of an internal control system, all risks are recognized and continuously assessed. It is the overall responsibility of a bank's Board of directors and Senior Management to ensure that there is effective control over the entire business and that it is conducted prudently, consistent with the risk profile that has been approved. The Board and Senior Management must understand the business of the bank and be committed to maintaining a robust control environment for its operations. Control activities must be an integral part of a bank's daily operations

3. Accordingly, the Commission keeps under close review the internal control and compliance environment within each bank, including the framework by means of which the bank identifies, monitors, manages and mitigates the risks to which it is exposed. Internal controls include the arrangements in place for delegating authority and responsibility within the bank; separation of the functions that involve committing the bank, paying away funds, and accounting for assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit/compliance functions to test adherence to the internal controls as well as to applicable laws and regulations.

Control Environment

4. The control environment is critical within a bank as a weak environment has the potential to undermine a control system that might otherwise be adequate. By 'control environment' is meant the overall attitude, awareness and actions of directors and management to internal controls and recognition of their critical importance. The control environment encompasses management style, corporate culture and the values shared by all employees, and includes staff training on control

matters, and the methods for reviewing controls (internal audit/compliance etc.).

5. The scope and nature of controls within a bank needs to reflect its risk profile, the extent of direct control by senior management over day to day operations, the degree of centralization in its operations and the degree of reliance on information technology. Controls must be designed and operated to provide reasonable assurance that:

- all the bank's revenues accrue to its benefit;
- all assets are adequately safeguarded;
- all liabilities are duly recorded;
- all statutory rand prudential requirements are met.

High level controls

6. High level controls are those primarily exercised at director/senior manager level. These would typically include: the setting of strategies and plans; the approval of risk policies; the establishment and review of the organizational structure; the system for delegation; review of high level management information; a framework for monitoring and periodic review of risk management and detailed control systems and for ensuring that follow-up actions are pursued. Particularly in the case of smaller banks with limited Senior Management personnel, it is important to ensure that at least two individuals are involved in all key decisions, in order to minimize the risk that misjudgement by a single individual may have a material negative impact on the bank.

Control system

7. It is not possible to establish a comprehensive list of internal control procedures applicable to any bank since they must reflect the particular business and risks. However, their overall objective must be to provide reasonable assurance that:

- the business is planned and conducted in a prudent manner and in compliance with established policies;
- transactions and commitments are made in accordance with management's general or specific authority; and
- management can safeguard the assets and control the liabilities of the business.

8. Appropriate activity controls must be developed and implemented, including:

- physical controls restricting access to tangible assets, notably cash and securities. These will include physical limitations, dual custody arrangements/double signatures and periodic inventories. Similarly, computer access must be suitably controlled.
- application of exposure limits eg clear loan exposure limits to reduce concentration of credit risk and diversity the risk profile. Reviewing compliance with limits and following up on instances of non-compliance is a critical aspect of the control system.
- approvals and authorisations for transactions above stipulated limits, with proper decision-taking processes and documentation. This ensures that an appropriate level of management is aware, and helps to establish accountability.
- appropriate accounting policies and processes are in place, providing proper clarity and facilitating effective management information.
- verifications and reconciliations to identify records that need correction. Results need to be reported to appropriate levels of management.

9. As part of its own reviews of the effectiveness of internal controls, the Commission pays particular attention to the availability of experienced personnel within a bank's back office and control functions in order to ensure that there is an effective check on its front office/business

origination units. Back office and control functions need to have sufficient expertise and authority within the bank, including access to the Board and Senior Management.

Internal audit/compliance

10. A bank's compliance function is a critical component of its internal controls. This typically involves a separate organizational unit or staff located within operating units, reporting to a senior person who is independent of the bank's business lines. In reviewing banks' arrangements, the Commission looks to ensure that banks have an adequately staffed, permanent and independent compliance functions that are effective in assisting Senior Management to deal with the compliance risks faced by the bank. Staff experience, training and authority are all most important; so too is the quality of the oversight exercised by the bank's Board over its compliance function. In smaller banks with limited personnel, compliance responsibilities may be handled as part of the internal audit function.

11. A bank's internal audit function needs to have responsibility for assessing: whether policies, processes and internal controls are effective and that they remain adequate and appropriate for the bank's business; and that the bank operates in compliance with its established policies and processes. In assessing its effectiveness, the Commission reviews to ensure that the function is appropriately resourced, with suitable independence and reporting lines to the Board and Audit Committee and that in practice its reports are acted upon by Senior Management. It also needs to be provided with access to proper access to the bank's staff and records, including with regard to any outsourced functions, thereby permitting it to fulfil its responsibilities. Among specific aspects reviewed by the Commission are the preparation by internal audit of suitable audit plans, reflecting its assessment of relative risks for the bank, the methodology employed in identifying these material risks, and the arrangements in place for ensuring that internal audit is alerted in a timely manner to material changes in a bank's risk management strategy, policies or processes.

Financial Services Commission
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