

INSTRUCTION CPO/B-2001/5
BANK'S INTERNAL CONTROL SYSTEMS

I. AUTHORITY

This instruction is issued by the Central Payments Office of East Timor (hereinafter, "CPO") pursuant to Sections 23.1, 27.1(e), and 31.1 of *Regulation No. 2000/8 on Bank Licensing and Supervision* (hereinafter, the "Regulation").

II. APPLICABILITY

This instruction applies to all banks and to all branches of foreign banks licensed to operate in East Timor.

III. REQUIREMENTS

- A. The CPO requires that banks establish a sound internal control process for the purposes of preventing losses, maintaining reliable financial and managerial reporting, enhancing the prudent operation of banks, and promoting stability in the financial system of East Timor.
- B. The main principles of this instruction are derived from: the A Framework for Internal Control Systems in Banking Organizations, Publication No. 40, dated September 1998, of the Bank for International Settlements, Basel Committee on Banking Supervision and are supplemented with specific requirements of the CPO for implementation by banks. Through this instruction, the CPO does not prescribe in detail the manner in which each individual bank should implement its own system of internal controls. The applicability of the main principles of this instruction to each individual bank depends on the nature, complexity and risks of each bank's activities. However, the CPO requires that each bank have an appropriate system of internal control, which adheres to these fundamental principles.
- C. Each bank's internal control system will be assessed during on-site examinations by the CPO and external audits by independent auditors.

IV. PRINCIPLES FOR INTERNAL CONTROL SYSTEMS

A. Management Oversight and the Culture of Control

- 1. The Governing Board is responsible for (1) approving and periodically reviewing the overall business strategies and policies of the bank; (2) understanding the major risks faced by the bank, setting acceptable levels for these risks, and ensuring that bank administrators take the steps necessary to identify, measure, monitor and control these risks; (3) approving the organizational structure; and (4) ensuring that bank administrators monitor the effectiveness of the internal control system. The

board of directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained.

- a) The Governing Board shall conduct: (1) periodic discussions with management concerning the effectiveness of the bank's internal control system; (2) a timely review of evaluations of internal controls made by administrators, internal auditors, and external auditors; (3) periodic efforts to ensure that bank administrators have promptly followed up on recommendation and concerns expressed by auditors and the CPO on internal control weaknesses; and (4) a periodic review of the appropriateness of the bank's strategy and risk limits.
 - b) Pursuant to Section 19.1 of the Regulation, the audit committee can assist the Governing Board in fulfilling these responsibilities; however, pursuant to Section 16.5, the Governing Board and its members cannot delegate their responsibilities to others.
2. Senior bank administrators are responsible for: (1) implementing strategies and policies approved by the Governing Boards; (2) developing processes that identify, measure, monitor and control risk incurred by the bank; (3) maintaining an organizational structure that clearly assigns responsibility, authority and reporting relationships; (4) ensuring that delegated responsibilities are effectively carried out; (5) setting appropriate internal control policies; and (6) monitoring the adequacy and effectiveness of the internal control system.
 3. The Governing Board and Senior bank administrators are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organization of the bank that emphasizes and demonstrates to all levels of personnel the importance of internal controls. Bank personnel must be informed of, and held responsible for, their role in the internal controls process.

B. Risk Recognition and Assessment

All material risks that could adversely affect the achievement of the bank's goals should be recognized and continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organization (credit risk, country and transfer risk market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputation risk). Internal controls should be revised to appropriately address new or previously uncontrolled risks.

C. Control Activities and Segregation of Duties

1. Control activities should be an integral part of the daily activities of a bank. An appropriate control structure should be established with control activities defined at every sector of the bank's operations. The control structure should include:
 - a) Top level reviews -An adequate management information system should exist for the Governing Board and senior bank administrators to review the bank's progress toward established goals.
 - b) Appropriate activity controls for each unit and sub-unit of the bank - Administrators in charge of units and sub-units of the bank should receive

standard performance and exception reports on a frequent basis for purposes of performing a functional review.

- c) Physical controls -Access to tangible assets, including cash and securities, should be controls through physical limitations, dual custody, and periodic inventories.
 - d) A system for checking compliance with exposure limits and following up on non-compliance -Prudent limits on risk exposures should be established which are in addition to, but in compliance with, instructions of the *CPO*, A process for reviewing compliance with such limits and requirements for following up in instances of non-compliance should be established.
 - e) A system of ,approvals and authorizations -A system of approval and authorization for bank transactions which exceed a certain limit should be established to ensure that an administrator at an appropriate level is aware of the transaction or situation, and to establish accountability.
 - f) A system of verification and reconciliation- Verifications of transaction details and activities as well as periodic reconciliation's should be performed on a regular basis.
2. An appropriate segregation of duties should exist throughout the operational functions of the bank and personnel should not be assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimized, and subject to careful, independent monitoring. The responsibilities and functions of key individuals should be subject to periodic reviews to ensure that they are not in a position to conceal inappropriate actions.

D. Information and Communication

- 1. The bank must develop adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely, accessible, and provided in a consistent format.
- 2. Reliable information systems, covering all significant activities of the bank, must be in place. These systems, including those that hold and use data in an electronic form, must be secure, monitored independently and supported by adequate contingency arrangements. Controls over information systems and technology should include both general and application controls.
 - a) General controls ensure the continued, proper operation of computer systems and include in-house back-up and recovery procedures, software development and acquisition policies, maintenance procedures, and physical/logical access security controls.

- b) Application controls involve the processing of transactions and business activities and include edit checks and specific logical access controls unique to a business system.
 - c) Contingency arrangements cover the risk of loss or extended disruption of bank services related to computer systems. Business resumption and contingency plans should include the use of an alternate off-site facility and the recovery of critical systems supported by an external service provider.
3. The bank should establish effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and to ensure that other relevant information is reaching the appropriate personnel.

E. Monitoring Activities and Correcting Deficiencies

- 1. The overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the bank as well as periodic evaluations by the business function itself and by internal audit.
- 2. There should be an effective and comprehensive internal audit of the internal control system carried out by operationally independent; appropriately trained and competent staff. The internal audit function, as part of the monitoring of the system of internal controls, should report directly to the Governing Board or its Audit Committee, and to senior management
 - a) The internal audit function must be independent from the day-to-day functioning of the bank and must have access to all activities conducted by the bank, including branch and subsidiary operations.
 - b) The frequency and extent of internal audit review and testing of the internal controls within the bank should be consistent with the nature, complexity, and risk of the bank's activities.
- 3. Internal control deficiencies, whether identified by business line, internal audit, or other control personnel, should be reported in a timely manner to the appropriate level of administrators and addressed promptly. Material internal control deficiencies should be reported to the Governing Board and senior administrators of the bank.

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