



GUIDELINES TO BANKS

GUIDELINES NO. BU/G-7/2018/15

GUIDELINES ON INTERNAL CONTROL SYSTEMS

1. INTRODUCTION

- 1.1. These Guidelines on Internal Control Systems (“these Guidelines”) describe the essential elements of a sound internal control system. A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank’s reputation.
- 1.2. These Guidelines in **ANNEX 1** are issued pursuant to section 126 of the Banking Order, 2006 and apply to all banks in Brunei Darussalam (“Banks”).
- 1.3. It is up to individual Banks to determine how best these Guidelines should be implemented. The way in which the principles are implemented will depend on factors such as the Bank’s size and the nature, complexity and geographical extent of its business, and the legal and regulatory framework within which it operates.
- 1.4. The broad principles and standards under these Guidelines are aligned with the September 1998 Basel Committee paper ‘*Framework for internal control systems in banking organisations*’.
- 1.5. These Guidelines shall take immediate effect.
- 1.6. Autoriti Monetari Brunei Darussalam (“the Authority”) expects Banks to embrace the spirit of these Guidelines to the fullest extent possible and adhere to the Guidelines on a “comply or explain” basis.



2. BACKGROUND

2.1. According to the Basel Committee, the types of control breakdowns typically seen in problem bank cases can be grouped into five categories:

2.1.1. **Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank.**

Without exception, cases of major loss reflect management inattention to, and laxity in, the control culture of the bank, insufficient guidance and oversight by boards of directors and senior management, and a lack of clear management accountability through the assignment of roles and responsibilities. These cases also reflect a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control consciousness within business areas.

2.1.2. **Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet.**

Many banks that suffered major losses neglected to recognise and assess the risks of new products and activities, or update their risk assessments when significant changes occurred in the environment or business conditions. Many cases highlight the fact that control systems which function well for traditional or simple products are unable to handle more sophisticated or complex products.

2.1.3. **The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance.**

2.1.4. **Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems.**

To be effective, policies and procedures need to be effectively communicated to all personnel involved in an activity. Some losses in banks occurred because relevant personnel were not aware of or did not understand the bank's policies. In several instances, information about inappropriate activities that should have been reported upward through organizational levels was not communicated to the board of directors or senior management until the problems became severe. In other instances, information in management reports was not complete or accurate, creating a falsely favourable impression of a business situation.



2.1.5. **Inadequate or ineffective audit programs and monitoring activities.**

In many cases, audits were not sufficiently rigorous to identify and report the control weaknesses associated with problem banks. In other cases, even though auditors reported problems, no mechanism was in place to ensure that management corrected the deficiencies.

2.2. The internal control framework underlying this guidance is based on international best practice in place at major banks. Moreover, this evaluation framework is consistent with the increased emphasis of banking supervisors on the review of a bank's risk management and internal control processes rather than on simply following a set of rules. It is important to emphasise that it is the responsibility of a bank's board of directors and senior management to ensure that adequate internal controls are in place at the bank and to foster an environment where individuals understand and meet their responsibilities in this area. In turn, it is the responsibility of banking supervisors to assess the commitment of a bank's board of directors and management to the internal control process.

2.3. Internal control is a *process* effected by the board of directors, senior management and all levels of personnel. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within the bank. The board of directors and senior management are responsible for establishing the appropriate culture to facilitate an effective internal control process and for monitoring its effectiveness on an ongoing basis; however, each individual within an organisation must participate in the process.

2.4. The main objectives of the internal control process can be categorised as follows:

2.4.1. efficiency and effectiveness of activities (*performance objectives*);

Performance objectives for internal controls pertain to the effectiveness and efficiency of the bank in using its assets and other resources and protecting the bank from loss. The internal control process seeks to ensure that personnel throughout the organization are working to achieve its goals with efficiency and integrity, without unintended or excessive cost or placing other interests (such as an employee's, vendor's or customer's interest) before those of the bank.



- 2.4.2. reliability, completeness and timeliness of financial and management information (*information objectives*); and

Information objectives address the preparation of timely, reliable, relevant reports needed for decision-making within the banking organisation. They also address the need for reliable annual accounts, other financial statements and other financial-related disclosures and reports to shareholders, supervisors, and other external parties. The information received by management, the board of directors, shareholders and supervisors should be of sufficient quality and integrity that recipients can rely on the information in making decisions. The term reliable, as it relates to financial statements, refers to the preparation of statements that are presented fairly and based on comprehensive and well-defined accounting principles and rules.

- 2.4.3. compliance with applicable laws and regulations (*compliance objectives*).

Compliance objectives ensure that all banking business complies with applicable laws and regulations, supervisory requirements, and the organisation's policies and procedures. This objective must be met in order to protect the bank's franchise and reputation.

- 2.5. The internal control process, which historically has been a mechanism for reducing instances of fraud, misappropriation and errors, has become more extensive, addressing all the various risks faced by banking organisations. It is now recognised that a sound internal control process is critical to a bank's ability to meet its established goals, and to maintain its financial viability.

- 2.6. Internal control consists of five interrelated elements:
- 2.6.1. management oversight and the control culture;
 - 2.6.2. risk recognition and assessment;
 - 2.6.3. control activities and segregation of duties;
 - 2.6.4. information and communication; and
 - 2.6.5. monitoring activities and correcting deficiencies.

Problems observed in large losses at banks can be aligned with these five elements. The effective functioning of these elements is essential to achieving a bank's performance, information, and compliance objectives.

MANAGING DIRECTOR
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