

**Methodological Instruction
of the Banking Supervision Division of the National Bank of Slovakia
No 3/2005**

**relating to the system and procedures of the internal control of a bank
and branch of a foreign bank pursuant to Article 23, paragraph 1
of Act No 483/ 2001 Coll. on Banks and on the amendment
of certain acts as later amended**

Purpose of the methodological instruction

Under Article 23, paragraph 1 of Act No 483/2001 Coll. on banks and on the amendment of certain acts as later amended (hereinafter referred to as "the Act") a bank is obliged in its articles of association to allocate and arrange powers and responsibility in the bank for a system of internal control, including an internal control and internal audit unit, corresponding to the complexity and risks of the banking activities, as well as to arrange relations and cooperation between the statutory body, the supervisory board, managerial staff of the bank, the internal control and internal audit unit. Under Article 26, paragraph 2 of the Act a branch of a foreign bank is obliged to proceed in establishing a system of internal control in a manner analogous to that of a bank. This means that every bank and branch of a foreign bank must have a functioning system of internal control. The aim of this methodological instruction is to set unified rules by which the structure of the system of internal control of a bank or branch of a foreign bank should be managed.

This methodological instruction is classified in the category "**Risk Management Process**".

Content of the methodological instruction

A: [definition of the system of internal control \(point 1\)](#)

B: [procedural control \(points 2 and 3\)](#)

C: [extra-procedural control \(point 4\)](#)

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A: definition of the system of internal control

1. A system of internal control represents procedural control pursuant to points 2 and 3 and extra-procedural control pursuant to point 4. A bank and branch of a foreign bank (hereinafter referred to as "branch") should use the requirements set by this methodological instruction appropriately in their internal regulations.

B: procedural control

2. A bank and branch should ensure the performance of **direct procedural control** and its definition in the system of internal regulations. Direct procedural control is deemed all forms of constant control measures, procedures and mechanisms at individual sections of a bank or branch that are a direct (immediate) component of working processes on a daily basis and the working process is not completed without them. Direct procedural control should be performed by employees or organisational units involved in individual working processes.

3. A bank and branch should ensure the performance of **direct procedural control** and its definition in the system of internal regulations. Indirect procedural control is deemed all forms of constant control measures, procedures and mechanisms at individual sections of a bank or branch that are an indirect (mediate) component of working processes. Indirect procedural control should be performed by the managing employees of individual sections of the bank or branch who are responsible for the control procedures and for the results of the control or by employees entrusted by such staff.

C: extra-procedural control

4. A bank and branch should ensure the performance of **extra-procedural control** and its definition in the system of internal regulations. Extra-procedural control is deemed control independent of operating and trading processes. Extra-procedural control is performed by a separate and independent unit for internal control and internal audit. Extra-procedural control may in exceptional and pre-defined cases be performed as a component of the working process of a bank or branch; in this case the bank or branch must ensure that independence is maintained and that any conflict of interests is excluded.

D: tasks of the internal control and internal audit unit

5. The control activity of the internal control and internal audit unit should include all operating and trading processes of the bank or branch and correspond to the extent, complexity and risks of the banking activities.

6. The internal control and internal audit unit should, in accordance with Article 23, paragraph 2 of the Act, be responsible in particular for the control (examination) and evaluation of:

- a. the functionality, effectiveness, efficiency and appropriateness of the internal control system,
- b. the functionality, effectiveness, efficiency and appropriateness of the individual managing and control systems of the bank or branch, in particular the system of accounting, reporting and controlling and the information system,
- c. the functionality, effectiveness and appropriateness of the risk management system¹⁾,
- d. compliance with prudent banking principles,
- e. compliance with laws and other generally binding legal regulations,
- f. observance of internal regulations and procedures within the bank or branch,
- g. the preparedness of the bank or branch to perform new types of trades from the aspect of risk management,
- h. information that the bank is obliged to publish under Article 37, paragraph 4 of the Act.

The internal control and internal audit unit should be responsible also for monitoring the removal of shortcomings found and the realisation of proposals (recommendations) for remedying shortcomings. The internal control and internal audit unit should through its activity perform special functions supporting the managerial levels of the bank; for this purpose it

can in the framework of its tasks perform an advisory activity to the management of the bank (supervisory board, board of directors) or branch (branch manager) or to organisational units of the bank or branch under the condition of guaranteeing its independence. The internal control and internal audit unit performs also special control checks, for example, controls at the request of the supervisory board in a scope delimited by it according to Article 25, paragraph 4 of the Act.

E: management responsibilities of a bank or branch of a foreign bank in the framework of the system of internal control

7. A bank and branch are obliged under Article 41, paragraph 3 of the Act to inform the National Bank of Slovakia immediately of any shortcomings found in performing activities under Article 23, paragraph 2 of the Act. A bank and branch are obliged under Article 41, paragraph 4 of the Act to submit by 31 March of the calendar year a report on the result of the activity of the internal control and internal audit unit for the preceding calendar year, on measures adopted for remedying shortcomings in the activity of the bank or branch found by the internal control and internal audit unit and the approved plan of control activity for the calendar year.

8. Under Article 23, paragraph 1, point (c) of the Act the management of the bank (supervisory board or the board of directors) or branch (branch manager) is responsible for the establishment and functionality of the internal control and internal audit unit; this responsibility cannot be transferred to a different subject. The internal control and internal audit unit should be directly subordinate to the bank's management (supervisory board or board of directors) or one of the members of the bank's management (of the supervisory board or the board of directors) or the branch's management, which in the optimal case should be the chairman of the supervisory board or the chairman of the board of directors of the bank or the branch manager. The supervisory board may establish an audit committee for supplementing the internal control system. The role of the audit committee should be to assist the bank's management (supervisory board or board of directors) in fulfilling its responsibility for the functionality of the internal control and internal audit unit. The audit committee should be composed mostly of members of the board of directors and the supervisory board.

9. The management of a bank (supervisory board or board of directors) or of a branch (branch manager) should be responsible for the preparation, approval and enforcement of the organisational code of the bank or branch, where this is a principal pre-requisite for the functionality of the system of internal control.

10. The management of a bank (board of directors) or of a branch (branch manager) should be responsible for the preparation, approval and enforcement of the written form of the statute of the internal control and internal audit unit. The statute of the internal control and internal audit unit should

- a. take account of the principles of internal control and internal audit unit set out in this methodological instruction,
- b. contain a definition of the principles, aims, tasks, standing and organisational links, powers, responsibilities and system of reports of the internal control and internal audit unit,
- c. contain the procedures of the internal control and internal audit unit in monitoring the removal of shortcomings found and the realisation of proposals (recommendations) for remedying shortcomings,
- d. be regularly re-evaluated and changed if necessary

F: principles of the internal control and internal audit unit

11. A bank or branch should, in the written statute of internal control and internal audit unit, set out the principles of internal control and internal audit unit as defined in points 12 to 19 of this methodological instruction.

Separation of activities and responsibilities

12. The internal control and internal audit unit should be an independent internal organisational unit of the bank which, charged by the management of the bank (board of directors) or branch (branch manager), performs extra-procedural internal control (the tasks set out in points 5 and 6 of this methodological instruction).

13. The internal control and internal audit unit should be independent of the controlled operating and trading processes. Staff of the internal control and internal audit unit should therefore principally

- a. not be charged with tasks and activities not relating to internal control and internal audit and not in accordance with their control activity.
- b. not be involved in the operating and trading processes of the bank or branch,
- c. not have responsibility for the result of the controlled processes.

14. Staff of other units of the bank or branch should principally not be charged with tasks of the internal control and internal audit unit; this does not exclude the fact that in justified cases staff of other units of the bank or branch may for reason of their specific knowledge be charged with activities for the internal control and internal audit unit.

Independence of the internal control and internal audit unit

15. The internal control and internal audit unit should have the right to separately and independently,

- a. set its tasks; the power of the supervisory board to require the manager of the internal control and internal audit unit of the bank to perform a control of the bank in a scope delimited by it according to Article 25, paragraph 4 of the Act is not affected by this,
- b. to draw up reports and evaluations of the results of controls.

Access to information

16. A bank or branch should ensure for the internal control and internal audit unit

- a. the possibility to participate at meetings of all decision-making and advisory bodies and committees of the bank,
- b. the possibility of complete and unlimited access to documents, information, data, source material, operating and trading procedures of the bank or branch, instructions and decision of the bank or branch and to persons and physical values which have or could have direct or indirect importance for internal control.

17. All organisational units of the bank or branch should be obliged to provide information to the internal control and internal audit unit in the case of serious shortcomings.

Qualification of staff

18. The management of a bank (board of directors) or of a branch (branch manager) should ensure sufficient resources necessary for realising the statute of the internal control and internal audit unit, in particular financial resources and a sufficient number of qualified staff and their substitutability so as to correspond to the extent and complexity of the bank's activities and supervision requirements.

19. The qualification (knowledge and abilities) of staff of the internal control and internal audit unit should systematically correspond to

- a. the latest state of the controlled operating and trading procedures,
- b. the risks of the controlled operating and trading processes.

G: performance of control by the internal control and audit unit

20. A bank and branch should ensure the conditions for the performance of control in accordance with points 21 to 33 of this methodological instruction.

Planning a control

21. The internal control and internal audit unit should draw up a periodic and strategic plan of control activity. Plans of control activity should

- a. be risk-oriented,
- b. take account of existing risks ensuing from an evaluation of suggestions from the management of the bank (supervisory board, board of directors) or of the branch (branch manager),
- c. correspond to the scope and complexity of the activities of the bank or branch.

The management of the bank (board of directors) or of the branch (branch manager) should approve the periodic and strategic plan of control activity and any changes to it.

22. The periodic plan of control activity is prepared by the internal control and internal audit unit in accordance with Article 41, paragraph 4 of the Act for the period of one calendar year, potentially also for a shorter time period.

23. The internal control and internal audit unit should draw up a strategic plan for a period of 3 to 5 years. A strategic plan of control activity should determine the periodicity (frequency) of performing the activities, taking account of the scope and complexity of the activities of the bank or branch. All operating and trading processes of the bank should be subject to a periodicity (frequency) of control that should not be longer than three years; a bank's operating and trading activities having especial risks should be subject to control at least once per year.

24. A bank and branch should ensure the possibility for the immediate performance of any particular control outside the plan of control activity.

Focus of control activity

25. The focus of control activity results from the task of the internal control and internal audit unit. Control activity should be risk-oriented and relate to all operating and trading processes of the bank, in particular to the system of internal control itself, the accounting system, reporting, controlling, the information system and the risk management system.

26. The type, scope, periodicity (frequency), ways and methods of control activities should be aimed so that the internal control and audit unit ascertains and describes the degree of correctness and appropriateness of the controlled operating and trading processes of the bank and reveals the causes of undesirable phenomena arisen.

Reports of the internal control and internal audit unit

27. Under Article 25, paragraph 5 of the Act the manager of the internal control and internal audit unit shall immediately inform the supervisory board of the bank and the National Bank of Slovakia of any shortcomings found in performing activities pursuant to Article 23, paragraph 2 of the Act; the manager of the internal control and internal audit unit should immediately inform also the bank's board of directors or branch's management (branch manager) of any shortcomings.

28. The internal control and internal audit unit should draw up a written report on each control performed and submit it without delay to the bank's management (board of directors) or the branch's management (branch manager). A report of the internal control and internal audit unit should contain

- a. the subject of control (the organisational unit, the operating and trading process, etc.),
- b. the findings of the control, in particular substantial shortcomings found (reservations),
- c. risks for the bank or branch; these should be immediately notified to the management of the bank (supervisory board, board of directors) or of the branch (branch manager),
- d. an assessment of the results of the control, in particular proposals (recommendations) for remedying shortcomings (achieving an improvement),
- e. the opinion of the respective (competent) staff of the controlled organisational unit of the bank or branch as to the shortcomings found (reservations) and to the proposals (recommendations).

29. The internal control and internal audit unit should immediately following the end of a calendar year draw up a report on the results of the internal control and internal audit unit's activity and submit it without the bank's management (board of directors) or the branch's management (branch manager) and the National Bank of Slovakia. This report is to be submitted by the bank or branch to the National Bank of Slovakia under Article 41, paragraph 4 of the Act by 31 March of the calendar year. The report on the result of the internal control and internal audit unit's activity should contain

- a. a report on adherence to the plan of control activity for the calendar year,
- b. a report on all controls performed over the course of the calendar year,
- c. a report on serious shortcomings (reservations) and measures adopted and performed for remedying shortcomings in the activity of the bank or branch found by the internal control and internal audit unit.

Monitoring measures for remedying shortcomings found

30. The internal control and internal audit unit should monitor the removal of shortcomings found and the realisation of proposals (recommendations) for remedying shortcomings.

31. The internal control and internal audit unit should, if within an appropriate time shortcomings found are not removed and proposals (recommendations) for remedying shortcomings are not realised, immediately inform the bank's management (supervisory board, board of directors) or the branch's management (branch manager) and the National Bank of Slovakia.

Documentation

32. The internal control and internal audit unit should be obliged to ensure the documenting of every control performed by it so that the control activities performed, the control findings (shortcomings found) and the assessment of the control's results are also retrospectively verifiable.

33. A bank or branch should ensure that reports and documentation of the internal control and internal audit unit are archived for at least 10 years; the procedure and conditions should set out in the statute of the internal control and internal audit unit.

Done in Bratislava on 21 June 2005

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Note:

1) Decree of the National Bank of Slovakia No. 12/2004 on risks and a system of risk management.