

POLICY PAPER ON CREDIT INSTITUTIONS' ADMINISTRATIVE ORGANIZATION

Credit Institutions' Administrative Organization¹

Policy paper issued on the basis of Section 15 of the SOSCS

1. Introduction

Credit institutions engage in activities which differ in nature from those undertaken by other businesses. In contrast with many other enterprises, money flows at credit institutions are not counterposed by flows of goods. There is no direct link between performance and remuneration. In addition, monetary transactions are often initiated by the customers of credit institutions. For these and other reasons, reliance must be placed to a major extent on the adequate functioning of the existing administrative organization, including internal control. Within the present context, these can be described as follows:

- administrative organization: the totality of measures relating to the systematic collection, recording and processing of data for the management and the proper functioning of the credit institution, and the reports that have to be rendered thereon.
- internal control: control on the judgement and activities of staff insofar as that control is exercised for the benefit of the management of the credit institution by or on behalf of that management.

2. General

It must be stressed that the policy responsibility for the setting up and proper functioning of an adequate administrative organization rests with the management of the credit institution. The management should monitor the operations of the credit institution. This means (financial and management-oriented) information on the developments taking place in various parts of the institution, and the risks confronting the institution should be available. This information should make timely and adequate reporting to the management (as well as the supervisory authorities) possible.

Within the context of its supervisory task, the Supervisory Board should ensure that the management implements and maintains an adequate administrative organization. The manner in which a credit institution sets up its administrative organization, including internal control, depends not only on the earnings and expenses resulting from the measures to be taken, but also on the nature and magnitude of the activities undertaken and the risks run in the process.

The Bank is aware that it is impossible to rule out completely any irregularities which might thwart the system of measures and procedures. This system shall meet reasonable conditions. It must be noted that a credit institution should also ensure that any subsidiaries (such as leasing and trust companies) and (foreign) branches operate an adequate administrative organization.

¹ This guideline is primarily based on the guideline 'Credit Institutions' Administrative Organization' issued on May 27, 1993 by De Nederlandsche Bank N.V. (Dutch Central Bank).

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In the case of a subsidiary which is not a credit institution, allowance should be made, with regard to the (set-up of the) administrative organization, for the nature of the business and for what may be considered adequate in the sector concerned.

An adequate administrative organization is one where administrative systems, management information and internal control meet qualitative criteria through a system of measures and procedures. The general guidelines to be observed, notably with regard to the administrative organization, management information and internal control, are set out below.

The recommendations concerning matters which should be given greater attention are set out in greater detail in the appendix.

3. Guidelines for credit institutions' administrative organization

To attain a well-functioning administrative organization, a number of preconditions should be met:

- an organizational structure in which the delegation of responsibility is adequately organized, and the necessary segregation of duties has been effected
- a positive attitude on the part of the management with regard to internal control, reflected in prompt reactions to signals coming from within the institution
- sufficient supervision by and on behalf of the management on the proper functioning of the administrative systems and internal control procedures the imposition of stringent requirements on the expertise and attitude of staff.

Generally speaking, the functions, tasks and responsibilities of the credit institution's staff shall be unequivocally described/ laid down in writing. Activities with a managing, safeguarding, registering and controlling nature must be segregated; in principle, efforts shall be made to prevent such duties from being performed within one single department or by a single staff member.

These measures are meant to help limit the risk of (deliberate or other) errors and fraud occurring within the institution's operations.

The (internal) control measures pertaining to the operations must be such that these errors and fraud may, reasonably, be expected to be detected at an early stage, and if possible corrected.

The activities to be performed to that end may be delegated to the lower management concerned or to a specialized internal control body. In view of the vulnerability of credit institutions to infringements of internal control procedures, the introduction of a specialized internal control body (an internal control department and/ or an internal auditing department) is an obvious option when the level of activities expands.

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4. Administrative systems

Every credit institution should have a framework (responsibilities, procedures, etc.) for day to day management. The policy principles to be implemented shall be communicated to the departments concerned.

The credit institution shall have at its disposal administrative systems which ensure that every transaction or commitment entered into is recorded correctly, systematically and on a timely basis. The provision of information must be possible from a variety of aspects so as to control specific banking risks. The management shall receive correct, complete and timely information about the risk positions taken by the credit institution in relation to the approved limits.

The administrative systems must offer proper insight, on a timely basis, into balance sheet and off-balance sheet positions and the development of the results.

5. Management information

With the aid of the (financial) information which becomes available periodically, the management should be able to ascertain whether and if so, to what extent, the targets set have been realized.

Managers at all levels of the credit institution shall be properly informed about the way tasks are being performed by their staff (plan/realization).

The frequency with which a manager receives management information, and the degree to which that information is detailed, are closely related to his position within the organization.

On the basis of the information reviewed, the manager involved can ascertain whether, and if so to what extent, redirection is required.

6. Internal control

The way internal control is organized should offer reasonable certainty that:

- the activities are being performed in accordance with the policy principles set out
- transactions and obligations are being undertaken with due observance of the prevailing rules on responsibilities
- managers are capable of adequate management of the credit institution's assets and liabilities; measures have been taken to keep the risk of loss ensuing from irregularities, fraud and errors to a minimum, and to identify them in time
- the administrative systems ensure correct, complete and timely information
- the management is able to ascertain periodically and on a timely basis whether the solvency, liquidity and profitability, as well as the quality of the credit institution's assets are adequate

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- the management is able to identify, evaluate and quantify the risks attending banking activities in time. Risks should be recognized as such periodically and on a timely basis, and kept under control, so that appropriate provisions can be made if necessary
- the management is able to meet the reporting requirements, including those for the benefit of the Bank, and submit the relevant returns on time.

The management shall form an opinion of the scope and depth of the internal control measures (to be implemented), taking into account the earnings and expenses resulting from the measures to be taken.

It is the task of the management to assess (or have assessed) the internal control systems periodically in terms of their efficacy and lasting topicality and, where necessary, to make adjustments.

7. Recommendations regarding credit institutions' administrative organization

The following pages contain recommendations regarding a number of matters relating to the administrative organization which merit extra attention; they pertain to the administrative systems, management information and internal control. Individual credit institutions are explicitly given the scope to take alternative measures so as to tailor the administrative organization to their needs. It must be noted that the recommendations are not limitative in nature.

7.1 Administrative systems

The following aspects must be taken into account when organizing administrative systems.

- A. Management information.
In general, this includes:
- Formulated policy targets, a strategic plan, a short-term financial plan and a detailed budget.
 - Detailed procedure manuals.
 - An overview of staff members' (internal and external) responsibilities.
 - Correspondence files which provide insight.
 - A list of depositors' signatures.
 - Summarizing credit and revision proposals and more detailed files on loans per debtor or group of debtors.

More specifically:

- File information on marketable securities held in the name of the credit institution, held on account of customers or borrowed from third parties. Similar records are needed for securities which have been lent to third parties.
- Use of dealer tickets, confirmations of counterparties, nostro reconciliations and computer input reports.
- Taped registration of telephone calls made by dealers or other types of

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provisions for verification purposes in the event of a dispute with a counterparty.

- B. The correct, timely and systematic recording of every transaction or commitment undertaken with adequate information on:
- the nature and backgrounds of the transaction/commitment present and/or future rights and obligations ensuing from the transaction the distribution over time of the earnings and expenses resulting from the transaction.
- C. Recording the relevant technicalities of the transaction such as:
- the parties involved in the transaction
 - the amount, currency and exchange rate agreed
 - contract stipulations, dates of settlement and repayment
 - in the case of interest-rate related transactions, the agreed interest rates the commission agreed and other fees
 - the nature of and the value to be assigned to the collateral received in respect of moneys invested
 - the nature of and the value to be assigned to the collateral provided in respect of moneys raised.
- D. The administrative systems must be such that the management is always capable of:
- forming an opinion of the nature, size and quality of the assets identifying, quantifying and controlling risk positions
 - adequately assessing and safeguarding the financial performance of the credit institution's various departments
 - taking decisions on the basis of timely, correct and complete information.
- E. Registration of the position limits approved by the management which befit the nature and the size of the banking activities undertaken. These may include limits as to counterparty, sector of industry, country, interest rate risk, securities dealing portfolio, overnight and intraday foreign exchange positions, settlement risk, traded options, futures, interest and foreign exchange swaps. The information provided must be such that the actual positions can be reviewed in relation to the limits assigned.

7.2 Management information

Management information is an important tool in the adequate management of the risks involved in banking.

The frequency with which information becomes available and the degree of detail depend in part on the level of management to which it is supplied. The following information is considered important:

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- balance sheet and profit and loss account, to be provided regularly (in principle monthly)
- a survey of the assets held for trading purposes, including their purchase price and current value
- a survey of the development of the securities investment portfolio
- a survey of the commitments outstanding, broken down by sector of industry, country or other criteria which are of importance for the credit institution
- a survey of payment arrears in respect of loans and overdrawn credit lines; the size of the provisions made for bad debts, including the underlying calculations
- a survey of foreign exchange transactions outstanding, cash and forward, including their valuation
- a summary of positions in traded options, futures, off-balance-sheet transactions and their valuation
- a survey and an analysis of the interest rate position (by currency if that is of material importance) including the off-balance-sheet products
- a survey of foreign exchange positions by currency
- a sensitivity analysis measuring the influence on the results of changes in exchange rates, interest rates and prices of securities included in the trading portfolio
- an overview of the development of liquidity
- a survey of the large items in assets and liabilities
- a survey of the risk reporting in respect of activities subject to solvency requirements as prescribed by the Bank
- an analysis of the financial core figures and the development over time of the various result components
- a survey of solvency and liquidity results.

7.3 Internal control

The manner in which a credit institution organizes its internal control depends in part on the nature and the scope of the activities undertaken, the risks these entail, the degree to which the control exercised by the lower management over daily activities is laid down and the measure in which processing (automated or otherwise) is performed centrally or otherwise.

In this context, the following matters should be given attention.

A. Organizational and administrative management

In principle, a credit institution should have at its disposal:

- a formal organization chart with descriptions of staff members' jobs, competences, tasks and responsibilities. In conjunction with this, the reporting lines and communication structure
- a written general code of conduct for staff aimed at integrity (based in part on the relevant circular letters of the Bank)

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- an approach to familiarize staff with the activities to be performed and to inform them on adjustments within the organization and the tasks assigned to them
- a manual laying down the principles for reporting and the valuation rules
- descriptions of the activities to be performed daily and the controls to be exercised
- archives containing documents which are of importance for the credit institution, internal memorandums, correspondence, summarizing and detailed files on outstanding loans
- procedures for setting up and beginning new operations, dealing with the risks to be recognized, the limits to be maintained, the administrative reporting systems and the internal control to be exercised.

B. Segregation of duties

Through a segregation of duties, the credit institution can restrict the risk of errors and/or fraud.

- The credit institution ensures that, where possible, different persons are responsible for registering assets, the safe custody of assets and undertaking and authorizing transactions and obligations.
- The segregation of duties ensures that, where amounts of financial importance are concerned, no single person is able to withdraw assets (deliberately or otherwise) from the credit institution, is able to register liabilities erroneously, or record transactions erroneously, without there being a reasonable chance of rapid discovery.

C. Administration

A credit institution employs procedures to guarantee that:

- all transactions and obligations are registered in the correct administrative system, to the right amount, so that they are recorded on or off the balance sheet in the period that they were undertaken, while the result is allocated to the periods to which it relates
- the assets and liabilities recorded actually exist
- the (arithmetic) correctness of the administrative records is verified; to that end use can be made of control totals and reconciliations with external data
- documents are added to the administrative registration system which form proof of the existence of a transaction or obligation

Where use is made of automated systems, validation checks and audit trails could contribute to the reliability and verifiability of the figures.

D. Security

A credit institution shall guarantee that:

- security procedures have been instituted for the physical protection of assets and that these are adhered to; the responsibility shall rest with persons who

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- are not involved in the administrative tasks
- security procedures also include physical precautionary measures with regard to valuable, marketable assets, securities to be issued, and documents with a legal title
- there are (written) procedures for taking customers' assets into safe custody
- there are (written) procedures for the security of the administrative registration system.

E. Reconciliations

At a credit institution:

- the data recorded in the administrative systems shall be checked periodically and on a timely basis for the (existence and correctness of) assets and liabilities, documents and control accounts
- the frequency with which reconciliations are made depends in part on the number and the financial importance of the transactions passed through the account to be reconciled and the balance outstanding on that account
- shall determine and assess the nature and size of the reconciliation differences
- transactions concluded with counterparties in the money, capital and foreign exchange markets shall be confirmed on a timely basis.

F. Valuation

A credit institution shall ensure that:

- the value of assets, liabilities, off-balance-sheet rights and obligations be checked for correctness regularly
- provisions or other adjustments as to the value be made on a timely basis, in accordance with the institution's reporting policy and legal and supervisory requirements.

G. Testing compliance with the procedures

The manner in which a credit institution monitors compliance with the prevailing procedures depends in part on the importance attached thereto. The credit institution shall ensure that:

- there is a periodic assessment of the data reported which shows whether and if so, to what extent, the actual risk positions remain within the approved limits mentioned under I.3.
- there are procedures for corrective measures to be taken in the event of non-compliance with rules or limits
- there are procedures to guarantee that the right management levels are supplied with relevant and adequate information regularly and on a timely basis
- there are reporting systems to check whether loans and credits have been granted in accordance with the policy principles and procedures set out; the quality of individual loans and credits (and of the collateral required) should

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- be checked regularly, so that problems may be identified at an early stage
- a periodic assessment of any results realized in respect of assets held for trading purposes
- a periodic assessment of the sources from which liabilities are financed, of the degree to which this financing is concentrated at a small number of depositors, and the chances of these moneys being withdrawn
- a (monthly) assessment of the development of the results
- a permanent assessment of the articles of association, legislation and the rules and regulations of the supervisory authorities to ascertain whether, and to what extent, they exercise an influence on the credit institution's activities and whether the credit institution meets the directives.

For reasons of efficiency, the effectuation of the above test may be delegated to an internal control official or an internal control department and/or internal auditor.