

# Review of Credit Institutions' Internal Controls

by Billy Clarke<sup>1</sup>

## ABSTRACT

During 2002, the Bank requested credit institutions to undergo an independent review of their internal control and risk management systems. The request was prompted by a report into trading losses at the US subsidiary of Allied Irish Banks p.l.c. This article outlines the review requested by the Bank and the development of the review procedure after consultation with credit institutions and auditors. The article presents a summary of the general results and some conclusions.

## 1. Introduction

On 14 March 2002 the Bank wrote to the credit institutions subject to its authorisation and regulation, requesting an independent review of each institution's internal controls and risk management systems. The request was prompted by a report<sup>2</sup> into trading losses at Allfirst, the US subsidiary of Allied Irish Banks p.l.c. (AIB). One of the principal conclusions of that report was that the currency trader primarily responsible for the losses circumvented the internal controls that were intended to prevent any such fraud by manipulating the weak control environment in Allfirst's treasury.

The primary objective of the review requested by the Bank was to establish the quality of controls in Irish credit institutions when compared to international standards, as well as to gain a degree of independent assurance in this regard. At the outset, the Bank was aware that some credit institutions had already commenced projects of this nature and considered it worthwhile for all credit institutions to obtain an independent view of the strength of their internal control and risk management systems.

This article outlines the review requested by the Bank and the development of the review procedure after consultation with credit institutions and auditors. The article presents a summary of the general results and some conclusions.

1 The author is Deputy Head of Banking Supervision in the Irish Financial Services Regulatory Authority. The views expressed in this Article are not necessarily those held by the Bank and are the personal responsibility of the author. He would like to thank Fiona McMahon, Geraldine McWeeney and the staff of Banking Supervision Department for their work on this project and Patrick Neary and Andrew Mawdsley for helpful comments.

2 On 6 February 2002, Allied Irish Banks p.l.c. announced that it had uncovered suspected fraudulent activities by a trader in its US subsidiary, "Allfirst" (Allfirst Financial Inc. and Allfirst Bank), resulting in losses estimated at US\$750 million. AIB appointed Promontory Financial Group LLC (headed by Eugene A. Ludwig) and the law firm of Wachtell, Lipton, Rosen and Katz to report to the Boards of AIB and Allfirst on the Allfirst treasury losses (the "Ludwig Report").

## 2. The Review Task

### 2.1 Scope of Review

The review requested by the Bank placed particular emphasis on controls in the area of treasury and trading functions in credit institutions and on the management of the relationship between Irish parent institutions and foreign subsidiaries.

This was the first time the Bank had requested a review requiring external expertise on the internal control systems in credit institutions. In order to clarify the scope and nature of the review, the Bank engaged in consultations with the Irish Bankers Federation (IBF), the Federation of International Banks in Ireland (FIBI) and the principal auditing firms for Irish credit institutions. It soon became apparent that the scope of such a review, depending on its extent, could be very far-reaching with prohibitive costs. Following the extensive discussions with the IBF, FIBI and the auditors, it was decided that the most feasible approach, particularly in terms of potential timing and cost, was to focus initially on the high-level controls in each credit institution, mainly in the areas of corporate governance, internal audit and treasury. The outcome of this review could then determine whether a more detailed examination would be required in individual cases outside of the normal supervisory process.

### 2.2 Reference Standards

The Bank highlighted several sources for guidance on best international standards under the headings of corporate governance, internal audit and treasury. These standards are set out in detail in documents issued by the Basel Committee on Banking Supervision, the Report of the Review Group on Auditing and the Combined Code. The Bank added some areas extracted from the Ludwig Report.

The standards were then used to develop a template containing over 200 control objectives. The template was used as a self-assessment questionnaire for credit institutions, which formed the basis of the review conducted by the independent reporting parties.

### 2.3 Review Procedure

The main stages in the review procedure were as follows:

- Each credit institution was required to appoint an independent reporting party for the purpose of the review. Although this role was not restricted to auditing firms, in many cases the party appointed was the credit institution's external auditors;
- Each credit institution completed the self-assessment questionnaire setting out the controls that were in place that would address numerous control objectives

extracted from the reference documents. The questionnaire had to be signed off by each director of the relevant credit institution to the effect that the document described the controls in operation in the institution to the best of their knowledge and belief;

- A programme of tests of the controls described by the institution was agreed between the independent reporting party, the credit institution and the Bank; and
- After testing, the independent reporting party prepared a report setting out any exceptions noted during testing and giving other observations on the credit institution's controls.

### 3. Summary of Results

#### 3.1 Parent — Subsidiary Relationships

As stated earlier, one element of the review was the relationship between parent entities and their subsidiaries with particular regard to the scope of internal audit and risk management in a group context. This was mainly considered from the perspective of Irish credit institutions and their subsidiaries in Ireland and elsewhere. There were no significant exceptions or comments in this area.

#### 3.2 Controls to be Strengthened

While not representing significant concerns, the analysis of reports received by the Bank suggested that some controls could be strengthened by:

- the establishment of appropriate sub-committees of the Board with adequate terms of reference;
- updating the terms of reference of existing sub-committees to reflect business development, particularly the Audit Committee;
- developing internal audit planning to improve the coverage of all business areas;
- greater segregation of duties, particularly in the smaller institutions; and
- continuously developing controls in relation to treasury and trading activities.

As a result of the review, some individual credit institutions identified specific areas that they wished to strengthen even in instances where the independent reporting party did not raise exceptions. No pressing issues were identified requiring regulatory intervention above the norm.

### 4. Conclusions

The review demonstrated the significant effort required to gain independent assurance on the quality of internal controls in credit institutions. The exercise has encouraged institutions to

assess their controls from a fresh perspective. In addition, each director had to take the opportunity to form their own view on the adequacy of the systems in place.

The high-level controls in credit institutions in the areas of corporate governance, internal audit and treasury have now been reviewed against objective international criteria. The individual reports will be verified and assessed as part of the regulatory programme for credit institutions.

## References

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