

BASEL COMMITTEE ON BANKING SUPERVISION

Chairman of the Task Force on Accounting Issues

Mr Jim Sylph
Technical Director
International Federation of Accountants
535 Fifth Avenue, 26th Floor
New York, New York 10017
USA

8 February 2001

Dear Mr Sylph,

Re: **The Audit of International Commercial Banks - Proposed International Auditing Practice Statement**

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Draft of "*The Audit of International Commercial Banks*", published for comment in September 2000. The Committee has a strong interest in promoting high quality audits of banks and has carefully reviewed the Exposure Draft of this proposed International Auditing Practice Statement in this light.

In our judgement, the proposed Statement provides helpful guidance to auditors of banks. Having said this, we do have comments on the following larger issues:

The scope and title of the proposed Statement

In our view, the current title of the proposed Statement implies that the focus of the Statement is solely on issues unique to international commercial banks. Inasmuch as the focus of the statement is, in fact, much broader than the auditing issues arising from the complexities of international commercial banks, we believe that other types of banks should not be excluded from the scope of the Statement. As a result, we are of the view that the title should be shortened to *The Audit of Banks*.

Emphasis on modern systems of internal control

We believe that the guidance in the proposed Statement could be significantly improved by adopting a modern internal control framework.

The Basel Committee issued policy guidance in 1998 entitled *Framework for Internal Control Systems of Banking Organisations*.¹ This policy was the first significant international supervisory guidance on the evaluation of bank internal controls based on an advanced, modern internal control framework. It is broadly

¹ In this regard, we note the significant contribution of the IAPC to the final paper in the form of comments received from the then Chairman, Bob Roussey.

consistent with the Committee of Sponsoring Organizations' of the Treadway Commission framework widely used in the US as well as with other modern internal control approaches published in several countries. Adoption of such an approach in the Statement would facilitate auditors in evaluating and characterising internal controls in accordance with concepts that are widely accepted by global financial institutions and consistent with enhancements to risk management policies and practices.

In contrast, the internal control framework used in the proposed Statement has not been significantly revised since ISA 400 Risk Assessments and Internal Control was issued in 1991, and therefore may be difficult to apply in the context of current and evolving risk management approaches at banking organisations. We recommend that the International Auditing Practices Committee undertake a project to update its guidance on internal control framework in a manner consistent with our policy guidance, and that the Statement then be amended accordingly.

Guidance on the audit of banks' regulatory capital

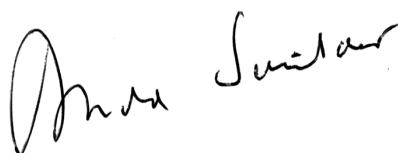
The proposed Statement does not provide guidance on the audit of banks' regulatory capital positions. We observe that financial statement disclosure of regulatory capital and/or regulatory capital ratios is becoming mandatory in a growing number of countries. Moreover, regulatory capital compliance is also a major issue for banks around the world. These factors underline the necessity of including guidance in this area in the Statement.

The Basel Committee is currently consulting on a major revision to the Basel Capital Accord. The second consultative package proposes a significant increase in disclosure of qualitative and quantitative information by banks, much of which is likely to be included in annual financial statements and thus subject to audit. IAPC may need to consider amending the Statement once the Committee's proposals have been finalised, and in the shorter term, we would welcome any comments you might have on the audit implications of the Committee's proposals.

Other comments of a technical nature

Also, enclosed with this letter is a report encompassing the specific technical comments that we have on the Exposure Draft. If you should have any questions regarding our comments, please feel free to contact Jerry Edwards at the Federal Reserve Board (+1 202 452 2741), Marc Pickeur at the Commission Bancaire et Financière (+32 2 535 2253) or Bengt A. Mettinger at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Arnold Schilder', written in a cursive style.

Arnold Schilder

Proposed International Auditing Practice Statement

The Audit of International Commercial Banks

Issued for Comment September 2000

Boxed Paragraphs after the Table of Contents

These paragraphs provide background information concerning the statement. They note that the purpose of the Statement is to provide practical assistance to auditors in the audit of banks, and that it is not intended to have the authority of an International Standard on Auditing. We recommend that a comment be added to this background information, explaining that the Statement does not reduce the need for the auditor to use high quality and up-to-date audit manuals and/or audit programs. In particular, the complexities of audits of international banks necessitate the use of comprehensive audit manuals and/or programs.

Chapter 1. Introduction

The scope of the Exposure Draft presumably includes audits of the parent bank or bank holding company, any banking subsidiaries of the bank, and any foreign branches of the bank and its banking subsidiaries. We recommend, for better understanding by the reader, that the Introduction to the Exposure Draft explicitly list the entities that it encompasses.

Chapter 2. Audit Objectives and the Audit Process

Paragraph 2.3

Paragraph 2.3 states that an auditor should highlight in the audit report when the financial statements of a bank are prepared according to the accounting principles and regulations of a particular country and may contain material differences from accounts prepared according to different frameworks. We recommend that the Statement be expanded to include similar disclosure for auditing standards, which also may differ from country to country. (See also our comment on paragraph 7.3).

Chapter 3. Agreeing the Terms of the Engagement

Paragraph 3.3

This paragraph discusses matters that the auditor should consider addressing in the engagement letter. In some countries, bank regulatory authorities review auditors' workpapers to obtain information that will aid in the identification and understanding of possible weaknesses, problems, and risks within a bank. The workpaper review can identify areas where the auditor performed audit work sufficient to enable regulatory examination procedures to be limited as well as higher risk areas in which examination procedures should be expanded. We recommend that the following bullet point be added at the end of this paragraph: "the access that the bank regulatory authorities, upon request, will be granted to the auditor's workpapers, if such access is required by law or regulation, and the bank's advance consent to this workpaper access."

Recommended New Paragraph

We recommend the addition of a paragraph to this chapter, indicating that the auditor should consider whether the firm and its staff members meet the independence requirements under IFAC's Code of Ethics and any other standards applicable to the engagement. This assessment should be considered both in the firm's decision of whether to accept the engagement and later as it plans for the staffing the engagement.

We recommend that the auditor also confirm his/her independence under IFAC's Code of Ethics and any other standards applicable to the engagement in the engagement letter and discuss any matters/potential issues relating to independence with those individuals at the bank charged with governance. If any subsequent developments occur that may relate to independence prior to the completion of the audit, this chapter should recommend that the auditor reassess his/her independence in a supplemental letter to those charged with governance.

Chapter 4. Planning the audit

Paragraph 4.1

The fourth bullet point of paragraph 4.1 refers to "the **entity's** ability to continue in operation for the foreseeable future". We recommend that two new sentences be added to this bullet point as follows: "If, in the case of a branch or subsidiary, the going concern capacity depends on the parent organisation, the parent organisation needs to be assessed as well. ISA 570 "Going Concern" provides guidance on going concern issues."

Paragraph 4.4

The last sentence of this paragraph refers to the **accounting** implications of the use of financial instruments. This wording does not appear to adequately reflect the necessary scope of the considerations. We recommend that this wording be supplemented as follows: "and accounting, *disclosure and auditing* implications thereof."

Paragraph 4.7

The paragraph introduces a number of important risk terms.

The definition of operational risk is in our view insufficiently detailed. For example: (1) the first sentence does not refer to internal procedures; (2) there is no reference to external events such as external system failures or external fraud; (3) system failures may also arise due to technical problems (both internal and external); and (4) procedures and controls could fail in addition to being inadequate (in design). In addition, the use of the term "**unexpected** losses" may be confusing given its meaning in the Basel Committee's proposed New Basel Capital Accord and current accounting developments in the field of "expected losses." The use of this term might also be restrictive as banks may even expect certain operational losses when for instance launching new products or processes.

We therefore recommend that the Basel definition of operational risk be used instead. This is a common industry definition, and it states that operational risk is "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events."

The list of risks in paragraph 4.7 excludes one we also consider important, namely strategic risk. The future outlook and plans of a bank should be an important consideration in planning an audit. Although the Exposure Draft does contain various references to considerations other than at a particular point in time, the principles, procedures and considerations discussed are primarily concerned with the auditor being in a position to do sufficient and appropriate audit work to express an audit opinion as of a particular point-in-time, i.e. year-end. We recommend that the paragraph be expanded to include also strategic risks.

Other risk terms where we have comments on their usage are as follows:

Country and transfer risks are treated as synonyms in the draft statement. In the Basel Committee's *Core Principles for Effective Banking Supervision* (page 20), transfer risk is a part of country risk: "Risks associated with the economic, social and political environments of the borrower's home country. ...There is also a component of country risk called 'transfer risk', which arises when a borrower's obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the borrower regardless of its particular financial condition."

Interest rate risk is related to "sensitivity of earnings" in the draft statement. The measurement of sensitivity may, however, be different at individual banks, due to differences in the accounting principles used. The Basel Committee's revised paper *Principles for the Management of Interest Rate Risk* states (page 6) that "Interest rate risk is the exposure of a bank's financial condition to adverse movements in interest rates."

Legal risk is defined in the draft statement without inclusion of the risk arising from changes to the law and from (the wider implications of) legal proceedings. The Basel Committee's *Core Principles for Effective Banking Supervision* state (page 22): "This can include the risk that assets will turn out to be worth less or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and many or all other banks; and, laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering new types of transactions and when the legal right of a counterparty to enter into a transaction is not established."

Understanding the nature of banking risks

This section makes no explicit reference to the potential significance of risk correlation. However, this is an important issue, reflected by the growing interest in enterprise-wise risk management. We recommend that a new paragraph be added to the Statement covering this issue, and offer the following suggestion:

"The individual risks enumerated above can be correlated with one another. For example, a bank's credit exposure in a securities transaction can increase as a result of an increase in the market price of the securities concerned. Similarly, non-payment or settlement failure can have consequences for a bank's liquidity position. When analysing the risks to which a bank is exposed the auditor therefore must consider these and other risk correlations."

Paragraph 4.10

The last sentence of the first paragraph reads in pertinent part "Operational risk, **primarily** arises out of." Operational risk is a broadly defined risk and any illustration provided should

reflect this fact. We recommend that the sentence be reworded as follows: “Significant contributing factors to operational risk include:”

Paragraph 4.12

A key anti-money laundering control is “knowing-your-customer” and the purpose of the account before agreeing to open the account. We recommend that the fourth sentence of paragraph 4.12 be amended to mention this important preventive policy/procedure/control in addition to those currently listed.

Paragraph 4.13

In relation to the fifth bullet point, it is noted that the reliability and timeliness of information is also of significance to external parties who receive information from a bank. We recommend that the following sentence be added to conclude the paragraph: “External parties will also rely on information generated by a bank.”

Paragraph 4.14

Paragraph 4.14 lists several considerations in the development of the audit plan. One consideration that is not included is the auditor's reputational risk. Due to their special nature, the audit of banking activities might present an increased risk to the auditor's reputation. For example, reputational risk may be increased because of the risk of fraud or money laundering. We recommend that reputational risk to the auditor be added to the list in paragraph 4.14 and commented on in a new, related paragraph.

Materiality

Paragraph 4.15

Paragraph 4.15 provides a list of factors influencing the selection of materiality. We recommend that a fourth bullet point be added on non-monetary factors such as reputation risk that may have a significant impact on the continued soundness, and even viability, of a bank.

The work of internal auditing

Paragraph 4.23

Paragraph 4.23 comments on the use of the work of internal audit. Large banks typically have significant internal audit functions, which often are of crucial importance for the audit of the bank. We believe that the use of internal audit should be further elaborated on in this paragraph by adding a statement underlining the importance of having the auditor assess the quality of the internal audit work. A reference to the Basel Committee's paper *Internal audit in banking organisations and the relationship of the supervisory authorities with internal and external auditors* would likely be helpful.

Related party transactions

Paragraph 4.29

The regulatory aspect of related party transactions is not referred to in this section. We recommend that the following sentence be added to paragraph 4.29: “In this context, it is

noted that related party transactions may be subject to quantitative and/or qualitative regulatory restrictions, and an audit requirement, in certain jurisdictions.”

Chapter 5. Establishing the Degree of Reliance on Internal Control

We believe that the guidance in the proposed Statement could be significantly improved by adopting a modern internal control framework. As mentioned above, the Basel Committee issued policy guidance in 1998 entitled *Framework for Internal Control Systems of Banking Organisations*. This policy document represents the first significant international supervisory guidance on the evaluation of bank internal controls based on an advanced, modern internal control framework that draws from much of the latest thinking on control concepts.

The policy guidance is broadly consistent with the Committee of Sponsoring Organizations’ framework widely used in the United States as well as with other modern internal control approaches published in several countries. It defines the major elements of an internal control process to include:

- management oversight and the control culture;
- risk recognition and assessment;
- control activities and segregation of duties;
- information and communication; and
- monitoring activities and correcting deficiencies.

Adoption of such an approach in the Statement would facilitate auditors and banking supervisors in evaluating and characterising internal controls in accordance with concepts that are widely accepted by global financial institutions and that are consistent with enhancements to risk management policies and practices. In contrast, the internal control framework used in the proposed Statement has not been significantly revised since ISA 400 Risk Assessments and Internal Control was issued in 1991 and therefore may be difficult to apply in the context of these new risk management approaches.

We, therefore, recommend that the IAPC undertake a project to update its guidance on internal control frameworks in a manner consistent with our policy guidance, and that the Statement be revised to reflect this enhanced internal control framework once this project is completed.

Chapter 6. Performing Substantive Procedures

Paragraphs 6.14 - 6.16

In several places in paragraphs 6.14, 6.15, and 6.16 (and subsequent paragraphs in Chapter 6), the guidance is somewhat vague and tends to suggest that certain normally required procedures are, in some way, optional or at the discretion of the auditor.

For example:

In paragraph 6.14, Balances With Other Banks, under Existence, the first sentence states “The auditor considers third party confirmations of the balance;” the sentence would be clearer if written, “The auditor normally carries out third party confirmations of these balances.” The extent and timing of the confirmations will be a function of the adequacy of the system of internal control.

In paragraph 6.14, Balances With Other Banks, under Valuation, the first sentence would be clearer if written, “The auditor assesses the collectability of balances with other banks and whether it is necessary to carry out a detailed assessment with respect to any of these balances.” Since the auditor is required to assess the collectability of the balances, it is only the extent of the collectability assessment that is left to the auditor’s professional judgement.

In paragraph 6.15, Money Market Instruments, under Existence, the first sentence would be clearer if written “The auditor normally carries out a physical inspection, confirms the holdings of instruments with any external custodians and reconciles these holdings with the accounting records.” The extent and timing of the work will be a function of the adequacy of the system of internal control.

We recommend that all of the paragraphs in Chapter 6 be reviewed and conformed to the above suggestions.

Paragraphs 6.15 - 6.16

In both paragraph 6.15, Money Market Instruments, and 6.16, Trading Securities, there should in our view be an additional heading entitled “Ownership” and a paragraph addressing the additional procedures that need to be carried out by the auditor given that a significant number of these items may be bearer instruments.

In paragraph 6.16, Trading Securities, under Valuation, we recommend that the first sentence should more properly read “Since trading securities in most countries are ordinarily carried at market value, in such situations, the auditor determines” because it is primarily in such situations that artificial gains can be created by these transfers.

Paragraph 6.17

In paragraph 6.17, Other Financial Assets, under Completeness, we believe that the wording sets too low a level of expectations for the system of internal control over such transactions by suggesting that “there is often a lack of established procedures” and that “Many of these transactions are entered into orally, with written documentation being completed subsequently.” While this may occasionally be true for a small bank with only one or two such specialised transactions a year, more normally there should be a proper system of internal control for a regular flow of such transactions, including requirements for prior approvals and requirements for written documentation in the form of legal agreements which have been reviewed and approved beforehand by the bank’s legal department and/or legal advisors and which are signed on the date of the transaction. The wording should be amended accordingly to reflect this appropriately higher level of expectations.

Paragraph 6.18

Paragraph 6.18, Investments (Long-Term) should more appropriately be split into two separate paragraphs, under the following headings:

Portfolio Investments; and

Investments in Subsidiaries and Associated Companies.

With respect to Portfolio Investments, we recommend that the guidance should be expanded to address Existence (including the need for physical count and/or confirmation) and Valuation (including: (1) the need for a careful review for other than temporary impairment where the individual investments are held either at amortised cost or at fair value with unrealised gains (losses) recognised directly in equity; (2) the need for a careful review of investments transferred from the trading portfolio in case this has been done to avoid having to recognise reductions in their market value; and (3) the need for a careful review of the value of items which are not readily marketable).

With respect to Investments in Subsidiaries and Associated Investments, we recommend that the guidance should address Valuation (including: (1) financial support arrangements; (2) the need to restate amounts in accordance with the relevant accounting policies of the reporting entity; and (3) the need to eliminate inter-company transactions and balances on consolidation).

Paragraph 6.19

In paragraph 6.19, Loans, we recommend that the guidance should be expanded to also address Existence, including explaining the need to carry out a confirmation process, the nature, timing and extent of which will be a function of the auditor's reliance on the system of internal control.

In addition, we recommend that the guidance should also be expanded to address Securitisation of Loans, including explaining the need to assess whether the transactions qualify for sales treatment, whether appropriate provisions have been made for continuing recourse obligations and whether appropriate financial statement disclosures have been made – all in accordance with the applicable financial reporting and regulatory framework.

Paragraph 6.22a

In our judgement, the level of expectations articulated in paragraph 6.22a, Off-Balance Financial Instruments, with respect to an appropriate system of internal control and an appropriate financial reporting and regulatory framework described in the Exposure Draft is far too low. For example, under Completeness, reference is made to "Similar considerations as applicable to Other Financial Assets, will arise," which, as noted in our comment under paragraph 6.17 above, includes wording such as "a lack of established procedures" and "Many of these transactions are entered into orally." Since international commercial banks often enter into significant volumes of these transactions, and the risks of doing so need to be carefully managed, such banks appropriately establish rigorous systems of internal control over these transactions, including ensuring the completeness (and accuracy) of the recording of all transactions. The Exposure Draft should be amended to reflect this appropriately higher level of expectations.

In revising paragraph 6.22a, it might be useful to make a reference to the International Auditing Practice Statement *Auditing Derivative Financial Instruments*, assuming that the derivatives statement is finalised by the time this statement on bank audits is issued. However, the Exposure Draft of *Auditing Derivative Financial Instruments* makes an important reference to the Statement *The Audit of International Commercial Banks* concerning the audit of banks involved in issuing of derivatives. We are concerned, however, that this latter Statement does not provide adequate guidance on this subject.

Under Valuation, it would be helpful if the third paragraph provided detailed guidance on the issues of establishing appropriate “liquidity risk provisions, modelling risk provisions and provisions for operational risk”.

Under Valuation, it would be helpful if the fourth paragraph provided detailed guidance regarding situations where “market values need to be considered, but are not available.”

Paragraph 6.23

In paragraph 6.23, Interest Income and Interest Expense, under Measurement, we recommend that the last paragraph/sentence should be amended to read “The auditor should also verify whether income recognition on troubled loans complies with the policy of the bank, as well as the requirements of the applicable financial reporting and regulatory framework. This is especially true where such income is not being received on a current basis.” This would highlight that the auditor needs to consider compliance with the applicable financial reporting and regulatory framework.

Paragraph 6.28a

In paragraph 6.28a, Related Party Transactions, we recommend that the wording of the paragraph should be amended to acknowledge that the applicable regulatory framework may: (1) prohibit certain related party transactions; (2) permit certain related party transactions subject to specific approvals; and (3) generally permit other related party transactions. In addition, the paragraph should acknowledge that the applicable financial reporting framework might require disclosure of related party transactions.

Recommended new paragraphs following paragraph 6.29

We recommend that additional paragraphs should be added after paragraph 6.29 to address the substantive audit procedures to be carried out by the auditor with respect to: (1) the liquidity position of the bank; (2) the foreign currency position of the bank; and (3) the interest rate position of the bank. The paragraphs should also cover the procedures for auditing the disclosures required by the applicable financial reporting and regulatory framework.

Chapter 7. Reporting on the Financial Statements

Paragraph 7.3

Paragraph 7.3 deals with the need to disclose the country of origin of the accounting principles used in preparing the financial statements. According to the paragraph, the country of origin should be stated in any situation where it is not evident which country's accounting principles have been used. The paragraph also recommends that the auditor refer to the standards of the country of origin when reporting on financial statements that are distributed extensively outside the country of origin.

The same reasoning, however, is also relevant concerning the auditing standards and practices followed in the conduct of the audit. We recommend that the Statement should also require disclosure of the country of origin for the auditing standards and practices.

Appendix 1. Examples of Internal Control Considerations and Substantive Procedures for Two Key Areas of a Bank's Operations

The opening paragraph of this Appendix states:

“The internal controls and substantive procedures listed below represent neither an exhaustive list of controls and procedures that should be undertaken, nor do they represent any minimum requirement that should be satisfied. Rather, they provide guidance on the controls and procedures that auditors may wish to consider.”

This paragraph does not suggest to the reader that what follows either (1) provides details of the key controls that an auditor would expect to encounter during the audit of A) Treasury Operations and B) Loans and Advances, or (2) provides details of the normal audit procedures to be employed. Our concern is that this appendix may not be consistently interpreted and applied.

Appendix 2. Examples of Financial Ratios Commonly Used in the Analysis of a Bank's Financial Condition and Performance

We recommend that, in line with the text of paragraph 6.5 of IAPS 1006 and paragraph 35 of IAPS 1004, the following categories be added to those already listed:

- market risk (including interest and foreign exchange risk);
- funding risk;
- relations with related parties; and
- country risk.

The following may be useful as examples of ratios and data to cover in the categories that were recommended above:

- market risk (shares): concentration of risk of particular industries or geographic areas; profitability;
- interest rate risk: gap and duration analysis (basically a maturity analysis and the impact of changes in interest rates on the bank's earnings/own funds);
- foreign exchange risk: relative size of engagements and liabilities, earnings and expenses in foreign currency, impact of changes in the rates on the bank's earnings/own funds;
- funding risk: clients' funding to total funding (clients' plus interbank), maturities, average rate to be paid, geographical origin, currencies, relations with third parties: size, terms and conditions compared to other parties; and
- country risk: size, credit risk concentration, provisioning.

It may often be more useful to identify the areas that ratios could cover rather than to give the ratios themselves, as the analysis may require other ratios than those suggested.

Under paragraph (d), “Capital adequacy ratios,” the second bullet point should be replaced with two bullet points that would read “Tier 1 capital as a percentage of risk-weighted assets” and “Total capital as a percentage of risk-weighted assets.”

Appendix 3. Risks and Issues In Securities Underwriting and Securities Brokerage

We note that there are also other risks such as insider trading, price manipulation, and general compliance with the applicable rules and regulations. We recommend that the guidance should be expanded to cover these and related issues.

In the second paragraph of the second section, the first sentence would be clearer if written “as well as the methods used to offer those services.”

In the last paragraph, a reference to insider trading may be appropriate (the compliance issue).

There is not much discussion in this appendix about the depository function of the bank, a so-called fiduciary duty (see paragraph 1.4, fourth bullet). We believe that it would be appropriate to give more information about the operating procedures and internal controls in this area.

Appendix 4. Risks and Issues in Private Banking and Asset Management

Our suggested changes to Appendix 4 are intended to clarify the concepts summarised in these sections and to more fully describe the risk attributes associated with the topics under discussion. In order to discuss the aspects of sound practices along with the audit risk factors, we believe that a discussion along the following lines should be added between the second and final sentence in the first paragraph:

“Before auditing private banking activities, auditors should understand the basic controls over these activities. In general, auditors should determine the extent of the institution's ability to recognise and manage the potential reputational and legal risks that may be associated with inadequate knowledge and understanding of its clients' personal and business backgrounds, sources of wealth, and uses of private banking accounts. The auditor should fully evaluate:

- Management oversight over private banking activities includes the creation of an appropriate corporate culture. Additionally, high levels of management should set goals and objectives and senior management must be proactive in overseeing compliance with corporate policies and procedures.
- Policies and procedures over private banking activities should be in writing and should include sufficient guidance to ensure there is adequate knowledge of the organisation's customers.² For example, the policies and procedures should require that the organisation obtain identification and basic background information on their clients, describe the clients' source of wealth and lines of business, request references, handle referrals, and identify red flags and suspicious transactions. They

² The Basel Committee issued on 31 January 2001 a consultative paper on customer due diligence for banks.

should also have adequate written credit policies and procedures that address, among other things, money laundering-related issues, such as lending secured by cash collateral.

- Risk management practices and monitoring systems should stress the importance of the acquisition and retention of documentation relating to clients, as well as due diligence regarding obtaining follow-up information where needed to verify or corroborate information provided by a customer or his or her representative. Inherent in sound private banking operations is the retention of beneficial owner information in the organisation's home country for accounts opened by financial advisors or through the use of off-shore facilities. Organisations should ensure that management information systems are capable of monitoring all aspects of an organisation's private banking activities. These include systems that provide management with timely information necessary to analyse and effectively manage the private banking business and systems that enable management to monitor accounts for suspicious transactions and to report any such instances to law enforcement authorities and banking supervisors as required by regulations or laws.
- Segregation of duties, compliance, and audit are all control activities that are essential in enabling organisations to create an effective system of oversight by senior officials and the organisation's board of directors."

We also recommend the following changes and amendments:

That the last sentence in the first paragraph should begin a new paragraph and be changed to:

"After understanding the basic controls over private banking activities, the auditor should plan the audit based upon his or her understanding of the internal controls over these activities. The following list identifies many of the common audit risk factors to consider when determining the level and extent of tests to be performed. Since private banking frequently involves asset management activities; the audit risk factors associated with asset management activities are also included below."

That the last sentence in the first bullet in the list of audit risk factors be amended to read as follows:

"Also, the nature of private banking activities may increase the bank's susceptibility to money laundering, and thus may have increased operational, regulatory, and reputational risks, which may necessitate an expanded audit scope and an increase in the number of tests of transactions and controls."

That the fourth bullet be amended to as follows:

- *Services designed to legally transfer some degree of ownership/control of assets to third parties, including trusts and other similar legal arrangements.* Such arrangements are not confined to private banking relationships, however, they are commonly present in private banking relationships. For the bank, the risk is that the terms of the trust or other legal arrangement are not complied with or do not comply with the applicable law. This exposes the bank to possible liability to the beneficiaries. Controls in this area are particularly important, given that errors are often identified only when the trust or other arrangement is ended, possibly decades after its creation. Private bankers often are also involved in preparing wills or other testamentary documents, and act as executors. Improper drafting or execution of a will may carry financial consequences to the bank. Controls should exist in these

areas. Finally, trust and similar arrangements provided by private banks are often outsourced to third parties. The auditors should consider the extent of tests and confirmations needed to understand the risks and relationships and gain confidence in the controls over and within the outsourced service provider.

The first sentence in the fifth bullet should be amended to read as follows:

- *Credit risk.* Credit risk is often more complex when private banking services are provided because of the nature of customers' borrowing requirements.

The second bullet in the Asset Management section in our view should be expanded to clarify the issues. It appears that the primary point of this bullet is that the organisation providing the Asset Management services may have added risks if they (or their auditors) report information to regulators that is inconsistent with disclosures or reports being made by the client to the regulators. We recommend that the bullet should be modified to read as follows:

- *Compliance with regulatory requirements.* The organisation providing the Asset Management services may have reputational, fiduciary, or operational risk if they (or their auditors) report information to regulators that is inconsistent with disclosures or reports being made by the client to the regulators.

And that the fourth bullet in the Asset Management section should be modified to read as follows:

- *Fund manager remuneration.* There is a heightened potential for fund managers to make imprudent or illegal business decisions based upon a desire for personal gain through a bonus or incentive arrangement

In addition, we note that the second bullet point in the Private Banking section, which comments on confidentiality, implies that it is possible for an auditor to work under restrictions that might severely hamper the auditor's ability to determine whether the financial statements are fairly presented. We are of the opinion that these kinds of limitations present an unacceptable scope limitation when private banking activities are material and recommend that the statement be rewritten accordingly.

Appendix 5: Risks and Issues in Respect of Fraud

We recommend that the title of appendix 5 be changed to "Risks and Issues Associated with Fraud."

In addition, Appendix 5 would benefit from an introductory discussion before the table and text that list issues and warning signs/red flags associated with fraud. Accordingly, we recommend that the following be inserted after the heading for Appendix 5:

"The risk of fraudulent activities arises at banks both from within the institution and from outsiders. Among the many fraudulent activities that banks may face are check-writing fraud, fraudulent lending and trading arrangements, money laundering, and misappropriation of banking assets. Fraudulent activities may involve collusion by management of banks and their clients. Those perpetrating fraudulent activities may prepare false and misleading records to justify inappropriate transactions and hide illegal activities. Fraudulent financial reporting is another serious concern.

In addition, banks face an ongoing threat of computer fraud. Computer hackers and others who may gain unauthorised access to institutions' computer systems and information databases can misapply funds to personal accounts and steal private information about the institution and its customers. Also, as is the case for all businesses, fraud and criminal activity perpetrated by authorised users inside banks is a particular concern.

Fraud is more likely to be perpetrated at banks that have serious deficiencies in corporate governance and internal control. Significant losses from fraud may arise from the following categories of breakdowns in corporate governance and internal control:

- ***Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank.*** Major losses due to fraud often arise as a consequence of management's lack of attention 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 situations also may involve a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control consciousness within business areas.
- ***Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet.*** When the risks of new products and activities are not adequately assessed and when control systems that function well for simpler traditional products are not updated to address newer complex products, a bank may be exposed to a greater risk of loss from fraud.
- ***The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance.*** In particular, the lack of a segregation of duties has played a major role in fraudulent activities that resulted in significant losses at banks.
- ***Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems.*** When policies and procedures are not appropriately communicated to all personnel involved in an activity, an environment is created that may foster fraudulent activities. In addition, fraud may go undetected when information about inappropriate activities that should be brought to the attention of higher level management is not communicated to the appropriate level until the problems become severe.
- ***Inadequate or ineffective internal audit programs and monitoring activities.*** When internal audits or other monitoring activities are not sufficiently rigorous to identify and report control weaknesses, fraud may go undetected at banks. When adequate mechanisms are not in place to ensure that management corrects deficiencies reported by auditors, fraud may continue unabated.

The following table and discussion in this appendix provide examples of additional issues and “red flags” or warning signs associated with fraud.”

We recommend that the table in Appendix 5 should be modified to include the following additions/changes (add bold text and delete strikeouts):

	Deposit Taking	Dealing	Lending
Management & Employee Fraud	• Depositors' camouflage • Unrecorded deposits • Theft of customer deposits/investments, particularly in dormant accounts	• Off-market rings • Related party deals • Broker kickbacks • False deals • Unrecorded deals • Delayed deal allocations • Misuse of discretionary accounts • Exploiting weaknesses in matching procedures • Mismatching of book • Valuation rings • Theft or misuse of collateral held in custody	• Loans to fictitious borrowers • Use of nominee companies • Deposit transformation • Transactions with connected companies • Kickbacks and inducements • Use of parallel organisations • Funds transformation • Selling recovered collateral at below market prices security or to reduce the amount • Bribes to obtain the release of collateral or to reduce the amount claimed • Theft or misuse of collateral held in custody
External Fraud	• Money laundering • Fraudulent instructions • Counterfeit currency or drafts • Check kiting	• Fraudulent custodial sales • False information or documents regarding counterparties provided initially or subsequent to transactions	• Impersonation and false information on loan applications and subsequently provided documents • Double-pledging of collateral • Land flips • Forged or valueless collateral • Misappropriation of loan funds by agents/customers • Selling collateral out of trust

We suggest that the following changes should be made to the section on Warning Signs of Fraud in the Lending Cycle:

In the second category on Use of Nominee Companies/Transactions with Connected Companies, add a third bullet:

- limited liability partnerships without full disclosure of ownership or with complex common ownership structures.

In the fourth category on Kickbacks and Inducements, add a third bullet:

- Indications of weak documentation controls (i.e. funding before documentation support is complete).

In the sixth category on Funds Transformation (methods used to conceal the use of bank funds to make apparent loan repayments), add a third bullet:

- lack of cash flow analysis that supports the income generation and repayment ability of the borrower.

In the seventh category on Impersonation and False Information on Loan Applications/Double-Pledging of Collateral/Land Flips/Forged or Valueless Collateral, change the first bullet to:

- no on-site appraisal or visitation of borrower;

AND, add three additional bullets:

- valuation is ordered by and received by the borrower rather than by the lender;
- lack of verification of liens to substantiate lien positions and priorities;
- lack of physical control of collateral that requires physical possession to secure a loan (e.g. jewellery, bearer bonds and art work).

The following changes should be made to the section on Warning Signs of Fraud in the Deposit Taking Cycle:

In the third section on Theft of Customer Deposits/Investments, add a third bullet:

- insufficient controls over dormant accounts.