



MODULE	HC:	High-Level Controls
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HC-6.5 Internal Audit

Introduction

HC-6.5.1 Bank licensees must establish and implement an effective internal audit function which provides an independent assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, to protect the bank and its reputation.

HC-6.5.2 The internal audit function must develop an independent and informed view of the risks faced by the bank based on its access to all bank records and data, its enquiries, and its professional competence. The internal audit function must discuss its views, findings and conclusions directly with the audit committee and, if necessary with the board of directors at their routine quarterly meetings, thereby helping the board to oversee senior management.

HC-6.5.3 In this Section, all references to the board of directors may also be taken as referring to the bank's audit committee where the audit committee is mandated to carry out such functions on the board's behalf.

HC-6.5.4 The extent of application of this Section must be commensurate with the significance, complexity and international presence of the bank (principle of proportionality).

HC-6.5.5 The key features for the effective operation of an internal audit function are:
(a) Independence and objectivity;
(b) Professional competence and due professional care; and
(c) Professional ethics

Independence and Objectivity

HC-6.5.6 The bank's internal audit function must be independent of the audited activities. This means that the internal audit is independent of all functions including compliance, risk management and financial control functions. The internal audit function must also have sufficient standing and authority within the bank and must operate according to sound principles.

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HC-6.5.7

The internal audit function must report directly to the audit committee and administratively to the CEO, thereby providing a framework for internal auditors to carry out their assignments with objectivity.

HC-6.5.8

The internal audit function must be able to perform its assignments on its own initiative in all areas and functions of the bank based on the audit plan established by the head of the internal audit function and approved by the board of directors. It must be free to report its findings and assessments internally through clear reporting lines. The head of internal audit must demonstrate appropriate leadership and have the necessary personal characteristics and professional skills to fulfill his or her responsibility for maintaining the function's independence and objectivity.

HC-6.5.9

The internal audit function must not be involved in designing, selecting, implementing or operating specific internal control measures. However, the independence of the internal audit function must not prevent senior management from requesting input from internal audit on matters related to risk and internal controls. Nevertheless, the development and implementation of internal controls must remain the responsibility of management.

HC-6.5.10

Bank licensees should, whenever practicable and without jeopardising competence and expertise, periodically rotate internal audit staff within the internal audit function.

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Professional Competence and Due Professional Care

HC-6.5.11

The head of internal audit must have the responsibility for acquiring human resources with sufficient qualifications and skills to effectively deliver on the mandate for professional competence and to audit to the required level (i.e. no other function must have the authority to dictate the qualifications and skills level required). He/she must continually assess and monitor the skills necessary to do so. The skills required for senior internal auditors must include the abilities to judge outcomes and make an impact at the highest level of the organisation.

HC-6.5.12

For purposes of Paragraph HC-6.5.11, professional competence depends on the auditor's capacity to collect and understand information, to examine and evaluate audit evidence and to communicate with the stakeholders of the internal audit function.

HC-6.5.13

The head of internal audit must ensure that internal audit staff acquire appropriate ongoing training in order to meet the growing technical complexity of the Bank licensee's activities and the increasing diversity of tasks that need to be undertaken as a result of the introduction of new products and processes within the Bank licensee and other developments in the financial sector.

HC-6.5.14

The internal audit function collectively must be competent to examine all areas in which the bank operates. Alternatively, when outsourcing arrangements are in place, it is the responsibility of the head of internal audit/coordinator to maintain adequate oversight and to ensure adequate transfer of knowledge from external experts to the bank's internal audit staff. The head of internal audit/coordinator must ensure that the use of those experts does not compromise the independence and objectivity of the internal audit function.

HC-6.5.15

For purposes of Paragraph HC-6.5.14, the coordinator must be an approved person within the Bank licensee.

HC-6.5.16

Internal auditors must apply the care and skills expected of a reasonably prudent and competent professional. Due professional care does not imply infallibility; however, internal auditors having limited competence and experience in a particular area must be appropriately supervised by more experienced internal auditors.

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Professional Ethics

HC-6.5.17 Internal auditors must act with integrity. Integrity includes, being straightforward, honest and truthful.

HC-6.5.18 Internal auditors must respect the confidentiality of information acquired in the course of their duties. They must not use that information (particularly ‘confidential information’ as defined in Article 116 of the CBB Law) for personal gain or malicious action and must be diligent in the protection of information acquired.

HC-6.5.19 The head of the internal audit function and all internal auditors must avoid conflicts of interest (see Section HC-2.3). Internally recruited internal auditors must not engage in auditing activities for which they have had previous responsibility before a one year “cooling off” period has elapsed.

HC-6.5.20 Internal auditors must apply the bank’s code of ethics or must adhere to an established international code of ethics for internal auditors, such as that of The Institute of Internal Auditors (see Section HC-2.2).

Internal Audit Charter

HC-6.5.21 All Bahraini bank licensees must have an internal audit charter that articulates the purpose, standing and authority of the internal audit function within the bank in a manner that promotes an effective internal audit function as described in Paragraph HC-6.5.1.

HC-6.5.22 The charter must be drawn up and reviewed periodically by the head of internal audit and approved by the board of directors. It must be available to all internal stakeholders and, in certain circumstances, such as listed entities, to external stakeholders.

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HC-6.5.23

At a minimum, the internal audit charter must establish:

- (a) The internal audit function's standing within the bank, its authority, its responsibilities and its relations with other control functions in a manner that promotes the effectiveness of the function as described in Paragraphs HC-6.5.1 and HC-6.5.2;
- (b) The purpose and scope of the internal audit function;
- (c) The key features of the internal audit function described in Paragraphs HC-6.5.6 to HC-6.5.20;
- (d) The obligation of the internal auditors to communicate the results of their engagements and a description of how and to whom this must be done (reporting line);
- (e) The criteria for when and how the internal audit function may outsource some of its engagements to external experts;
- (f) The terms and conditions according to which the internal audit function can be called upon to provide consulting or advisory services or to carry out other special tasks;
- (g) The responsibility and accountability of the head of internal audit;
- (h) A requirement to comply with sound internal auditing standards; and
- (i) Procedures for the coordination of the internal audit function with the external auditor.

HC-6.5.24

The charter must empower the internal audit function, whenever relevant to the performance of its assignments, to initiate direct communication with any member of staff, to examine any activity or entity of the bank, and to have full and unconditional access to any records, files, data and physical properties of the bank. This includes access to management information systems and records and the minutes of all consultative and decision-making committees.

Scope of Activity

HC-6.5.25

The scope of internal audit activities must include the examination and evaluation of the effectiveness of the internal control, risk management and governance systems and processes of the entire bank, including the bank's outsourced activities and its subsidiaries (including SPVs) and branches.

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HC-6.5.26 The internal audit function must independently evaluate the:

- (a) Effectiveness and efficiency of internal control, risk management and governance systems in the context of both current and potential or actual emerging risks;
- (b) Reliability, effectiveness and integrity of management information systems and processes (including relevance, accuracy, completeness, availability, confidentiality and comprehensiveness of data);
- (c) Monitoring of compliance with laws and regulations, including any requirements from the CBB; and
- (d) Safeguarding of assets.

HC-6.5.27 The head of internal audit must establish an annual internal audit plan. It must be based on a robust risk assessment (including input from senior management and the board)

HC-6.5.28 The audit committee's approval of the audit plan also requires that an appropriate budget will be available to support the internal audit function's activities.

HC-6.5.29 The scope of the internal audit function's activities must ensure adequate coverage of matters of regulatory interest within the audit plan.

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Risk Management

HC-6.5.30

Internal audit must include in its scope the following aspects of risk management:

- (a) The organisation and mandates of the risk management function including market, credit, liquidity, interest rate and operational risks;
- (b) Evaluation of risk appetite, escalation and reporting of issues and decisions taken by the risk management function;
- (c) The adequacy of risk management systems and processes for identifying, measuring, assessing, controlling, responding to, and reporting on all the risks resulting from the bank's activities;
- (d) The integrity of the risk management information systems, including the accuracy, reliability and completeness of the data used; and
- (e) The approval and maintenance of risk models including verification of the consistency, timeliness, independence and reliability of data sources used in such models.

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HC-6.5.31 When the risk management function has not informed the board of directors about the existence of a significant divergence of views between senior management and the risk management function regarding the level of risk faced by the bank, the head of internal audit must inform the board about this divergence.

Capital Adequacy and Liquidity

HC-6.5.32 The internal audit must review the bank's system for identifying and measuring its regulatory capital and assessing the adequacy of its capital resources in relation to the bank's risk exposures and established minimum ratios.

HC-6.5.33 Internal audit must review management's process for stress testing its capital levels.

HC-6.5.34 Internal audit must review the bank's systems and processes for measuring and monitoring its liquidity positions in relation to its risk profile, external environment, and minimum regulatory requirements.

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Regulatory and Internal Reporting

HC-6.5.35 The internal audit function must regularly evaluate the effectiveness of the process by which the risk and reporting functions interact to produce timely, accurate, reliable and relevant reports for both internal management and the CBB. Such reports include, but not limited to, the PIR and public disclosure requirements included in the CBB Rulebook, Module PD.

Compliance

HC-6.5.36 The internal audit function must at least periodically review the scope of the activities of the compliance function. The audit of the compliance function must include an assessment of how effectively it fulfils its responsibilities.

Finance

HC-6.5.37 The internal audit function must periodically review the controls over the bank's finance function.

HC-6.5.38 The internal audit function must devote sufficient resources to evaluate the valuation control environment, availability and reliability of information or evidence used in the valuation process and the reliability of estimated fair values. This is achieved through reviewing the independent price verification processes and testing valuations of significant transactions.

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HC-6.5.39

The internal audit function must, as a minimum, also include the following aspects in its scope:

- (a) The organisation and mandate of the finance function;
- (b) The adequacy and integrity of underlying financial data and finance systems and processes for completely identifying, capturing, measuring and reporting key data such as profit or loss, valuations of financial instruments and impairment allowances;
- (c) The approval and maintenance of pricing models including verification of the consistency, timeliness, independence and reliability of data sources used in such models;
- (d) Independently testing the valuations accorded to significant transactions;
- (e) Controls in place to prevent and detect trading irregularities; and
- (f) Balance sheet controls including key reconciliations performed and actions taken (e.g. adjustments).

Permanency of the Internal Audit Function

HC-6.5.40

The internal audit function must be permanent (see HC-3.2.3) and must be structured consistent with Paragraphs HC-6.5.59 to HC-6.5.63. Senior management and the board must ensure that the internal audit function is permanent and commensurate with the size, the nature and complexity of the bank's operations.

HC-6.5.41

Where the head of internal audit function ceases to act in this capacity, the CBB will meet with him/her to discuss the reasons.

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Responsibilities of the Board of Directors and Senior Management

- HC-6.5.42** The bank's board of directors must ensure that senior management establishes and maintains an adequate, effective and efficient internal control system (see HC-1.2.3(c)) and accordingly, the board must support the internal audit function in discharging its duties effectively.
- HC-6.5.43** The board of directors must review at least annually, the effectiveness and efficiency of the internal control system based, in part, on information provided by the internal audit function (see HC-1.2.10).
- HC-6.5.44** The board of directors, its audit committee and senior management must promote a strong internal control environment supported and assessed by a sound internal audit function.
- HC-6.5.45** As part of their oversight responsibilities, the audit committee must review the performance of the internal audit function.
- HC-6.5.46** Every three years, the audit committee must commission an independent external quality assurance review of the internal audit function.
- HC-6.5.47** Senior management must inform the internal audit function of new developments, initiatives, projects, products and operational changes.

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HC-6.5.48 Senior management must ensure that all internal audit findings and recommendations are resolved within six months from the issue date of the subject internal audit report.

HC-6.5.49 Senior management must ensure that the head of internal audit has the necessary resources, financial and otherwise, available to carry out his or her duties commensurate with the annual internal audit plan, scope and budget approved by the audit committee.

Responsibilities of the Audit Committee in relation to the Internal Audit Function

HC-6.5.50 The audit committee must oversee the bank's internal audit function (see also Paragraph HC-3.2.3).

HC-6.5.51 The bank's audit committee and the internal audit function must develop and maintain their own tools to assess the quality of the internal audit function.

HC-6.5.52 The audit committee must ensure that the internal audit function is able to discharge its responsibilities in an independent manner, consistent with Paragraph HC-6.5.6. It must review and approve the audit plan, its scope, and the budget of the internal audit function. It must also review audit reports and ensure that senior management is taking necessary and timely corrective actions to address control weaknesses, compliance issues with policies, laws and regulations, and other concerns identified and reported by the internal audit function.

Management of the Internal Audit Department

HC-6.5.53 The head of the internal audit department must ensure that the department complies with internationally recognised internal auditing standards established by a professional body responsible for the internal audit profession, such as The Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing.

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HC-6.5.54 The audit committee must ensure that the head of the internal audit function is a person of integrity. This means that he or she will be able to perform his or her work with honesty, diligence and responsibility. It also implies that this person observes the law and has not been a party to any illegal activity. The head of internal audit must also ensure that the members of internal audit staff are persons of integrity.

Reporting Lines of the Internal Audit Function

HC-6.5.55 The internal audit function must be accountable to the audit committee, on all matters related to the performance of its mandate as described in the internal audit charter. It must also promptly inform senior management about its findings.

HC-6.5.56 The internal audit function must inform senior management of all significant findings so that timely corrective actions can be taken. Subsequently, the internal audit function must follow up with senior management on the outcome of these corrective measures. The head of the internal audit function must quarterly report to the audit committee, the status of pending findings.

The Relationship between the Internal Audit, Compliance and Risk Management Functions

HC-6.5.57 The internal audit function must independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes created by the business units and support functions and provide assurance on these systems and processes.

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HC-6.5.58 The relationship between a bank's business units, the support functions and the internal audit function can be explained using the three lines of defence model. The business units are the first line of defence. They undertake the management of risks within assigned limits of risk exposure and are responsible and accountable for identifying, assessing and controlling the risks of their business. The second line of defence includes the support functions, such as risk management, compliance, legal, human resources, finance, operations, and technology. Each of these functions, in close relationship with the business units, ensures that risks in the business units have been appropriately identified and managed. The business support functions work closely to help define strategy, implement bank policies and procedures, and collect information to create a bank-wide view of risks. The third line of defence is the internal audit function that independently assesses the effectiveness of the controls over the processes created in the first and second lines of defence and provides assurance on these processes. The responsibility for internal control does not transfer from one line of defence to the next line.

Internal Audit within a Group or Holding Company Structure

HC-6.5.59 The internal auditors who perform the internal audit work at the bank must report to the bank's audit committee, or its equivalent, and to the group or holding company's head of internal audit.

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HC-6.5.60 To facilitate a consistent approach to internal audit across all the banks within a banking organisation, the board of directors of each bank within a banking group or holding company structure should ensure that either:

- (a) The bank has its own internal audit function, which should be accountable to the bank's board and should report to the banking group or holding company's head of internal audit; or
- (b) The banking group or holding company's internal audit function performs internal audit activities of sufficient scope at the bank to enable the board to satisfy its fiduciary and legal responsibilities.

HC-6.5.61

The board of directors and senior management of the parent bank in a banking group must ensure that an adequate and effective internal audit function is established across the banking organisation and must ensure that internal audit policies and practices are appropriate to the structure, business activities and risks of all of the components of the group or holding company.

HC-6.5.62

The head of internal audit at the level of the parent bank must define the group or holding company's internal audit strategy, determine the organisation of the internal audit function both at the parent and subsidiary bank levels (in consultation with these entities' respective audit committees and in accordance with local laws) and formulate the internal audit principles, which include the audit methodology and quality assurance measures.

HC-6.5.63

The group or holding company's internal audit function must determine the audit scope for the banking organisation. In doing so, it must comply with local legal and regulatory provisions and incorporate local knowledge and experience.

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Outsourcing of Internal Audit Activities

HC-6.5.64 Regardless of whether internal audit activities are outsourced, the board of directors remains ultimately responsible for the internal audit function.

HC-6.5.65 The head of internal audit/coordinator must ensure that any outsourcing providers comply with the principles of the bank's internal audit charter. To preserve independence, the head of internal audit/coordinator must ensure that the outsourcing provider has not been previously engaged in a consulting engagement in the same area within the bank unless a one year "cooling-off" period has elapsed. Subsequently, those experts who participated in an internal audit engagement must not provide consulting services to a function of the bank they have audited within the previous 12 months. Additionally, banks must not outsource internal audit activities to their own external audit firm (see OM-3).

HC-6.5.66 The head of internal audit/coordinator must ensure that, whenever practical, the relevant knowledge input from an expert is assimilated into the organisation. This may be possible by having one or more members of the bank's internal audit staff participate in the external expert's work.

Communication between the CBB and the Internal Audit Function

HC-6.5.67 The bank's internal auditor must have formal regular communication with the CBB to (i) discuss the risk areas identified, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank's response to weaknesses identified.

HC-6.5.68 At least two weeks prior to the prudential meeting date, all internal audit reports issued since the last prudential meeting must be submitted to the CBB supervisory point of contact.

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