

In case of discrepancies between the French and the English text, the French text shall prevail

Luxembourg, 1 April 1998

To all electronic money institutions,
payment institutions as well as PFS other
than investment firms¹

CIRCULAR IML 98/143
(as amended by CIRCULAR CSSF 04/155)

Re: Internal control

Ladies and Gentlemen,

The purpose of this circular is to specify the arrangements whereby Article 5(2) of the law of 5 April 1993 on the financial sector applies to banks and Article 17(2) of the same law to professionals of the financial sector (hereafter referred to as PFS).

This circular lays down the adequate internal control principles and provides, in particular, details on the internal audit function which banks and PFS shall implement. As specified under item 5.4. below, the work of an internal auditor is not limited to the inspection missions, but also consists in providing recommendations aiming to remedy identified shortcomings or anomalies.

1. Content of Articles 5(2) and 17(2)

Articles 5(2) and 17(2) provide that banks and PFS which are authorised to carry out their activities in Luxembourg shall justify that they have put in place appropriate internal

¹ Circular CSSF 98/143 no longer applies to credit institutions and investment firms. For these entities, the circular has been replaced by Circular CSSF 12/552, as amended.

control procedures. These procedures are part of an internal control system which is described in detail under item 5 below.

"Internal control" shall mean the measures established by the management, including the procedures and controls in place within a bank or a PFS which aim to ensure that:

- the objectives set by the undertaking are reached;
- the resources are used economically and efficiently;
- the risks are controlled appropriately and the assets are protected;
- the financial information and management information are complete and reliable;
- the laws and regulations as well as the internal policies, plans, rules and procedures are complied with.

This circular aims to specify and elaborate on these principles. It should be read in conjunction with Circular IML 95/120 on central administration and Circular IML 96/126 on administrative and accounting organisation which cover the aspects of administration and organisation referred to in the preceding definition.

Indeed, the internal control requirements within the meaning of this circular are fully met only when the standards on central administration and administrative and accounting organisation within the meaning of the two aforementioned circulars are complied with.

This circular cannot pretend to provide specific and comprehensive rules given the wide-ranging activities carried out by banks and PFS, but it is rather aimed to provide general guidelines which should prevail in the design and operation of the internal control. The organisational and internal control requirements relating to specific areas of the activity of a bank or a PSF are laid down in specific circulars such as Circulars IML 93/101, IML 93/102 and IML 95/119 relating to the organisation and internal control of the trading activity and activities in derivatives instruments.

The rules defined hereinafter may be adapted, where appropriate, to the size and nature of the activities of an institution. This is in particular the case for certain categories of PFS which carry out specialised activities.

2. Scope

Articles 5(2) and 17(2) of the aforementioned law are applicable to banks and PFS, respectively, which are legal persons governed by Luxembourg law, including their branches abroad.

In respect of branches in Luxembourg having their registered office outside the EC as well as branches of Community or non-Community PFS, Article 35(4) of the aforementioned law provides that they shall produce evidence of an adequate infrastructure in Luxembourg. To meet the legal requirements, the rules defined hereinafter are applicable to these branches.

This circular does not apply to Luxembourg branches of Community credit institutions for which the home country authority shall define how the EC branches will be included in the internal control mechanisms of the registered office. However, for the areas where the IML retains an oversight responsibility as host authority - for the liquidity and the measures taken to prevent money laundering - the relevant branches establish an internal control system which complies with the standards similar to those provided for in this circular.

The internal control rules must also be applied by branches that banks and PFS have abroad, without prejudice to the local rules which may exist in this area. Reference is made, in particular, to item 5.4.6. of this circular which deals with the scope of internal audits.

Moreover, credit institutions governed by Luxembourg law ensure that the rules defined hereafter are applied by their subsidiaries (within the meaning of Article 48, 8th indent of the aforementioned law) established in Luxembourg and abroad - without prejudice to the local rules which may exist in this area - insofar as these subsidiaries fall within the scope of the consolidated supervision carried out by the IML pursuant to Circular IML 96/125. As regards companies in which a stake between 20% and 50% is held, the Luxembourg institution, which is not a parent undertaking, is under a responsibility to strive together with the other shareholders or partners to establish an internal control system similar to that in place in the Luxembourg institution. Reference is also made to Chapter III item 1.4. of Circular IML 96/125 which covers the matter in question.

Chapter 5.4.6. of this circular covers in particular the internal audits to be carried out in respect of the subsidiaries and participating interests between 20% and 50%.

3. Responsibility of the board of directors

The board of directors shall foster a positive attitude as regards the control within the bank or the PFS and promote the development of structures in order to achieve this goal. Within the scope of its supervisory mission, it shall ensure, on a regular basis, that the credit institution or the PFS has an adequate internal control system. It can delegate this mission to an audit committee pursuant to item 6 of this circular. In case of non-delegation to an audit committee, the control mission as described under item 6, shall be carried out by the board of directors itself.

The supervision which the board is called upon to undertake may be based, amongst others, on the report made to it by the management at least once a year (see item 4 hereafter).

The principles laid down above apply *mutatis mutandis* to those professionals that are physical persons or having adopted a legal form which does not provide for the existence of a board of directors.

4. Responsibility of the institution's management

The persons in charge of the daily management and authorised pursuant to Articles 7(2) and 19(2) of the law on the financial sector (hereinafter referred to as "the management") have joint responsibility for the establishment of an internal control system as described hereinafter and its proper operation.

The management sets down in writing the internal control system. This system relates to all areas of functioning of the bank or the PFS, operational, administrative and accounting. The internal control is an integral part of the functioning of the bank or the PFS.

The management determines the human and technical means to be implemented. It assesses the internal control at least once a year. This assessment is, in particular, based on the reports issued by the internal audit department, the reports or notes drawn up within the context of the permanent hierarchical controls and critical controls referred to in item 5 below. The purpose of this assessment is to gauge the effectiveness of the internal control.

The management informs at least once a year, in the form it deems most appropriate, the board of directors or the audit committee, if any (cf. item 6 below), on the state of the internal control. At the same time, it reports on the achievement of the objectives of the internal control, describes the means implemented and provides a summary of the main

observations made, deficiencies observed, in particular by the internal audit department, the corrective measures decided and the effective follow-up of these measures.

5. Internal control system

The internal control system to be put in place consists of three parts:

- it is based on the central administration and sound administrative and accounting organisation principles laid down in Circulars IML 95/120 and IML 96/126, respectively;
- it covers a financial and operational risk identification, measurement, limitation and information system of the bank or the PFS. Circulars IML 93/101, IML 93/102 and IML 95/119 include instructions on this aspect as regards the market activity and the activities on derivative instruments;
- finally, it includes an internal audit function the purpose of which is to assess, on a regular basis, the adequacy of the internal control.

The internal control system also provides for mechanisms aimed to prevent execution errors and frauds and to enable their early detection. Given the importance of the portfolio management activity and the service activities relating in particular to the administration of UCI's in banks and, where appropriate, Luxembourg PFS, the management of the relevant institutions defines an adequate internal control system for these activities, in particular in the fields of discretionary management, processing of held mail, safekeeping of securities of third parties, where appropriate, depositary bank, bookkeeping and net asset value calculation of investment funds.

The system shall provide the following control levels:

- the daily controls carried out by the executing staff;
- the ongoing critical controls carried out by the persons in charge of the administrative processing of the transactions;
- the controls carried out by the members of the management on the activities or functions which fall within their direct responsibility;
- the controls carried out by the internal audit department.

5.1. Daily controls carried out by the executing staff

The internal control system provides that the executing staff themselves control, on a daily basis, the transactions they carry out in order to detect as soon as possible the errors and omissions that occurred during the processing of the day-to-day operations. Examples of these controls are: the reconciliation of the cash position, the verification of his positions by the trader and the follow-up of outstanding issues by each employee.

5.2. Ongoing critical controls

This category of controls includes inter alia:

- the hierarchical control;
- the validation (for example the joint signature, the access codes for given functionalities) combined to the control of compliance with the procedure for authorising and delegating powers set out by the management (in particular as regards loans);
- the reciprocal controls;
- the statement, on a regular basis, of the existence and value of the assets and liabilities, in particular by means of verification of the inventories;
- the reconciliation and confirmation of accounts;
- the control of the accuracy and completeness of the data transmitted by the persons in charge of the business and operational functions for an administrative follow-up of the operations;
- the control of compliance with the limits imposed by the management (in particular as regards trading activities and credit activities);
- the normal nature of the transactions concluded in particular in respect of their price, their size, the potential guarantees to receive or grant, the profits generated and losses incurred and the amount of potential brokerage fees.

These controls are often carried out outside the business and operational functions by the persons in charge of the administrative processing of the operations. The sound operation is only guaranteed if the principle of segregation of duties is complied with.

5.3. Controls carried out by the members of the management on the activities or functions which fall within their direct responsibility

The mission of a member of the management is not limited to the taking of business and operational decisions, but it also includes a control task. Thus, each member of the management controls personally and on a regular basis the activities or functions which fall within his direct responsibility. These controls are carried out based on data transmitted to him in this respect by the operational and administrative functions.

Areas requiring particular attention by these persons are inter alia:

- the risks associated with the activities and functions for which they are directly responsible;
- compliance with the business policy and management policy laid down by the management;
- compliance with the established budgets: review of the actual achievements and gaps;
- compliance with the limits and instructions (in particular based on "exception reports");
- the characteristics of the transactions, in particular their price, their individual profitability;
- the development of the overall profitability of an activity.

The members of the management shall inform, on a regular basis, their colleagues of the management on the exercise of their control mission.

5.4. Controls carried out by the internal audit department

The internal audit function is entrusted to the internal audit department, composed of one or several persons.

The internal audit verifies the proper operation of the internal control. It represents, within the bank or the PFS, an independent function of periodic assessment of the operations in order to assist the management and the persons in charge of the institution and to allow them to have a better control over their activities.

5.4.1. Permanent nature

The management of each bank or PFS shall take the necessary measures in order for the institution to have an internal audit function on a permanent basis.

5.4.2. Independence

The internal audit department shall be independent from the activities and functions it audits. It shall not depend on a department of the bank, but it shall be linked, from a hierarchical point of view, directly to the management and report directly to it. It should carry out its mission on its own initiative and express itself freely.

The person in charge of the internal audit department shall be able to inform directly and on its own initiative the chairman of the board of directors or, where appropriate, the members of the audit committee or the external auditor of the institution, in accordance with the procedures to be laid down by each institution.

5.4.3. Audit charter

The audit charter is a document in which the objectives, powers and responsibility of the internal audit department, as described in this circular, are defined.

The charter is drawn up on the basis of a proposal of the internal audit department, by the management and confirmed by the board of directors and, where appropriate, through the audit committee. It is recommended for the preparation of such an audit charter to draw on the models developed by the Institute of Internal Auditors (IIA Inc.).

The audit charter:

- sets out the objective of the internal audit function;
- defines the position of the internal audit department within the organisation;
- confers the right of initiative to the internal audit department and allows it to review all the activities and functions of the institution including those of their branches abroad and subsidiaries in Luxembourg and abroad, to access all documents, materials, minutes of the consultative and decision-making bodies of the institution, to meet all the persons working in the institution, to the extent required to fulfil its mission;
- defines the responsibilities of the internal audit department and the nature of its works;
- lays down the communication lines of the conclusions that can be drawn from the control missions.

The existence of the audit charter is brought to the attention of all employees of the institution, including those who work in the branches abroad and in the subsidiaries in Luxembourg and abroad.

5.4.4. Objectivity

The internal auditors shall carry out their tasks in an objective way.

The objectivity requires that the internal auditors avoid conflicts of interest. In this respect, to the extent possible, a rotation of the control tasks assigned to the various auditors should be ensured and it should be avoided that the auditors hired within the bank or the PFS control the activities or functions which they performed themselves in the recent past.

Objectivity requires moreover an independent mind and independence of judgement: the internal auditors should not make their own judgement dependent on that of other persons including in particular those audited. Similarly, the auditors shall not be in charge of the preparation or the implementation of administrative and accounting organisation and internal control measures in order to safeguard their independence of judgement.

However, the objectivity requirement does not exclude the possibility for the management to consult the internal audit department and to invite it to submit an opinion on the organisation and internal control where deemed necessary, in particular in the event of the reorganisation or the launch of new activities or new products.

5.4.5. Professional competence

The competence and in particular the knowledge and experience of each auditor are essential for the sound operation of the internal audit department. It is important that the internal audit department includes persons having received advanced training and possessing adequate technical competencies. When selecting these persons, the nature and diversity of the activities carried out by the institution shall also be taken into account.

The professional competence shall also be assessed in respect of the internal audit department as a whole, which shall have a full range of technical competencies necessary to examine all the areas in which the institution operates.

The internal audit department shall maintain the acquired knowledge up-to-date and provide continuously updated training to each of the auditors.

In specific areas where the internal audit department does not possess sufficient competence to conduct an audit, it may use the services of an external expert, provided however that the expert is placed under the dependence of the head of the internal audit department who still supervises the intervention. Moreover, such a use shall comply with the conditions listed under item 5.4.9. g) of this circular and, in particular, the condition of independence of the expert vis-à-vis the *réviseur d'entreprises* (statutory auditor) of the institution.

5.4.6. Scope of audits

a) At the Luxembourg institution level

The scope of intervention of the internal audit covers all activities and functions of the credit institution or the PFS. It cannot be limited in scope.

In general, the internal audit department reviews and assesses whether the administrative and accounting organisation of the institution as well as the internal controls defined under items 5.1. to 5.3. above are adequate and operate efficiently. It takes into account the rules and recommendations established by the IML in this circular as well as aforementioned Circulars IML 93/101, IML 93/102, IML 95/119 and IML 96/126 and, where appropriate, those which the IML addresses individually to the establishment to which it belongs.

In particular, the internal audit department verifies, inter alia, that:

- the risk identification, measurement, limitation and information system functions properly;
- the administration of securities and assets is sound;
- the segregation of duties functions properly;
- the execution of the transactions is adequate;
- the registration of the transactions is accurate and complete and that the provision of reliable and quickly available information is ensured;
- the decisions taken by the management and by the persons acting by delegation and under its responsibility are executed and the rules imposed on the exercise of the activities of a bank or PFS are complied with;

- the data on which the managers shall rely to be able to exercise their control function pursuant to item 5.3. above, are actually submitted to them,
- [...]*

Where there is within an institution a separate department in charge of the control or the supervision of a specific activity or function, the existence of such a department will not relieve the internal audit department of its responsibility to control this specific area. However, the internal audit department will be able to take into account, within its work, the assessments issued by the department on the area in question.

b) At the branches and subsidiaries level

The scope of intervention of the internal audit department of the Luxembourg bank also includes the branches abroad as well as the subsidiaries (within the meaning of Article 48, 8th indent of the law relating to the financial sector) in Luxembourg or abroad.

Thus, in respect of branches, the internal audit department of the registered office carries out on-site inspections on their premises on a regular basis. Where the institution has a branch of a certain size, it will establish a dedicated internal audit department at the branch. From a hierarchical and functional point of view, this department depends on the internal audit department of the registered office to which it belongs and to which it reports. It is thus subject to the provisions of this circular, without prejudice to the local rules in this field.

The provisions relating to branches also apply to the Luxembourg PFS.

In respect of the subsidiaries within the meaning specified above, the Luxembourg credit institutions provide that their internal audit department carries out on-site inspections on their premises on a regular basis. As regards subsidiaries of a certain size, the Luxembourg parent undertaking shall ensure that they have their own internal audit department which shall moreover comply with the provisions of this circular, without prejudice to the local rules in this field. The reports established by the internal audit departments of these subsidiaries will be submitted to the local management and a summary thereof to the internal audit department of the Luxembourg parent undertaking which will analyse and report the main deficiencies observed, the corrective measures decided and the effective follow-up of these measures to its management.

* Repealed by Circular CSSF 04/155 concerning the Compliance function

As regards companies of a certain size in which a stake between 20% and 50% is held, the Luxembourg institution, which is not a parent undertaking, is under a responsibility to strive together with the other shareholders or partners concerned, to establish within these companies an internal audit department which complies with the standards similar to those provided for in this circular, without prejudice to the local rules in this field. The Luxembourg institution will do its utmost to have a summary of the internal audit reports of these companies which it will submit to its internal audit department for review. This department shall report the deficiencies observed, the corrective measures taken and the follow-up on these measures to the management.

The management of the Luxembourg parent undertaking will lay down the general rules as regards the internal audit both for its branches and subsidiaries.

5.4.7. Execution of audits

a) Audit plan

- All audit missions are carried out according to a plan. The plan is established by the internal audit department for a period of several years (in general three years). Its purpose is to cover all activities and functions within a reasonable timeframe, by taking into account both the risks posed by an activity or a function of the institution and the efficiency of the organisation and internal control in place for this activity or function. The plan takes also account of the developments and innovations planned as well as the risks which may arise therefrom. The plan is discussed with the management which shall approve it formally. It should be reviewed on an annual basis and adapted, where appropriate, to developments and emergencies. Any adaptation is to be approved formally by the management. The approval implies that the management provides the internal audit department with the necessary means for the execution of the audit plan.

- The plan, which is adequately documented, sets out the objectives of each mission and the scope of the tasks to be executed, gives an estimate of the time and human and material resources necessary and assigns a frequency to each mission.

The audit plan focuses on the risk of execution errors and the risk of fraud. In addition, given the importance of the wealth management activity and the service activities in particular relating to the UCI industry in banks and, as the case may be, Luxembourg PFS, the audit plan is also expected to cover, properly and with sufficient frequency, these

activities, in particular in the fields of discretionary management, processing of held mail, safekeeping of securities of third parties, where appropriate, the depositary bank, bookkeeping and net asset value calculation of investment funds.

- Where the internal audit department of the parent undertaking of the Luxembourg institution carries out on-site inspections on its subsidiary, on a regular basis, it is recommended for efficiency reasons, that the Luxembourg institution coordinates, insofar as possible, its audit plan with that of the parent undertaking (cf. item 5.4.9. on this subject).

The internal audit department regularly informs the management of the execution of the audit plan.

b) Mission programmes

Each audit mission shall be prepared on the basis of a work programme which includes, in particular, the objectives as well as the tasks to be executed to achieve them, the scope of the tests and the time budget. The programme is to be adapted, where appropriate, according to the findings made.

c) Work documents

Each mission shall be executed on the basis of work documents drawn up according to a fixed pattern that clearly reflect the work carried out, the techniques and work methods used as well as the steps followed. These documents will allow tracking the controls carried out, the deficiencies identified and the conclusions. They are to be reviewed by the person in charge of the mission or the internal audit department.

These documents shall be kept during five years and made available to the *réviseur d'entreprises* as well as the IML who will be able to assess the scope and the quality of the controls carried out.

d) Written reports

A written report shall be produced on each mission by the internal audit department. This written report is generally intended for the supervised persons as well as - possibly in summarised form - to the management. The reports shall also be made available to the *réviseur d'entreprises* and the IML. These reports shall be drafted in French, German or English.

The report includes not only a description of the shortcomings and anomalies identified, but also the recommendations and proposals on the corrective measures to be taken, as well as in general a position statement from the supervised persons. The internal audit department gives an indication of the relative importance of the anomalies and shortcomings as well as the recommendations and corrective measures.

The internal audit department prepares a table of the internal audit department's missions and the related written reports. It will draft at least once a year a **summary report** on all the controls carried out during the financial year. This report, which will be submitted to the management and, on request, to the board of directors and, if any, to the audit committee, will list the controls carried out, outline the main shortcomings identified, the corrective measures decided and the follow-up on these measures. A copy of the report is submitted to the IML, as provided for in item 8 hereafter and it is made available to the *réviseur d'entreprises*.

e) Follow-up

The recommendations of the internal audit department which are intended to improve the organisation and the internal control shall be followed up. To this end, the management approves, on the proposal of the internal audit department, a procedure whereby these recommendations are to be implemented and within which timeframes.

The internal audit department verifies, by an appropriate method, the effective follow-up of the recommendations. It reports, on a regular basis, on this subject to the management.

5.4.8. Person in charge of the internal audit department

Prior to 1.1.1999, banks and PFS shall give the IML the name of the person in charge of the internal audit department. In case of replacement of the person in charge of the internal audit department, the institutions shall inform the IML as soon as possible by stating the reasons for this replacement. The long-form report to be set up by the *réviseur d'entreprises* shall include the name of the person in charge of the internal audit department. Similarly, it shall state any replacement and explain the reasons for such a change (cf. item 9 on this subject).

5.4.9. Use of professional third parties

a) Smaller-sized institutions carrying out low-risk activities are authorised to renounce entrusting the internal audit function to a department or full-time employee. These institutions may use external experts for internal audits.

Experts may be internal auditors of the group to which the institution belongs. Where experts act as *réviseurs d'entreprises*, they shall, in all respects, be **independent** from the external auditor of the institution or its audit firm as well as the group to which the auditor belongs.

b) The management of the institutions, which do not have their own internal auditor, shall designate a person, whether a member or not of the management, having sufficient knowledge regarding audits to monitor the works of the external expert. This person is in charge of the proper execution of the internal audit function of the institution and, from a hierarchical point of view, it shall have the necessary independence in order to properly take on the responsibility. The management also provides that this person carries out some routine controls at department level, which cannot be carried out by the external expert due to his periodic presence. The designated person establishes an internal audit plan pursuant to item 5.4.7. a) above which will be approved by the management. Moreover, this person establishes at least once a year a summary report on all the controls carried out during the financial year pursuant to item 5.4.7. d) above. The person in question may carry out within the institution other tasks which are not incompatible with the mission described above.

A copy of the summary report, which it prepares, is submitted to the IML, as provided for in item 8 hereafter, and it is made available to the *réviseur d'entreprises*.

c) The use of an external expert shall be based on a written mandate which shall take account of all the internal audit principles referred to above. In particular, the management will select the expert by taking into account his professional competence as well as the nature and diversity of the activities carried out by the institution.

The written mandate sets the responsibilities of the expert by referring to the principles of this circular. Pursuant to this mandate, the experts shall be subject to professional secrecy as defined in Article 41 of the law on the financial sector. They may have access to all the data on the activities of the institution as regards both the assets and liabilities, by taking into account, within the framework of the organisation of their work, that they may incur

the sanctions provided for in Article 458 of the Criminal Code if they disclose information subject to professional secrecy.

d) The expert carries out his work under the audit plan of the institution by following a work programme, by producing detailed documentation on his work and by drafting reports for each mission. These reports are to be drafted in French, German or English and are to be delivered to the person designated above and the management.

The files and work documents of the external expert shall be kept five years in the Luxembourg institution in order to allow the institution to trace the controls carried out, the anomalies identified and the conclusions. The IML as well as the *réviseur d'entreprises* shall have access to these files and documents as well as the control reports.

The management establishes a procedure whereby the recommendations of the expert are to be implemented and within which timeframes. The person designated above verifies whether the recommendations are followed effectively and informs the management about this on a regular basis.

e) Institutions which want to use an external expert for internal audits shall submit a **written request to the IML**. This request will include the required information, including in particular the name of the external expert, the natural person which represents the audit firm to assess whether the conditions laid down above are complied with.

f) Banks or PFS which have agencies, branches or subsidiaries are not allowed to systematically use an external expert as described above. Consequently, these institutions shall have their own internal audit department on a permanent basis. They may, at most, make use of the possibility described under item g) below.

The long-form report to be established by the external auditor (cf. item 9 on this subject) indicates whether the institution uses the services of an external expert as regards internal audits and the name of the expert in question.

g) The use of an external expert is also allowed where the internal audit department of the credit institution or the PFS does not have sufficient competence in one or several specific areas. In this case, it shall be executed in accordance with the same conditions as those defined in items a) to d) above. The expert shall be placed under the authority of the head of the internal audit department of the institution, who supervises his work.

6. Audit committee

a) Definition

The audit committee is a committee which may be created within the board of directors. It is composed of directors which are neither members of the management nor members of the staff and the purpose of which is to assist the board in the effective exercise of its supervisory mission.

b) Recommendation

The IML recommends larger institutions to establish an audit committee in order to facilitate the effective supervision of the activities by the board of directors. Such a committee is able to carry out a more thorough analysis of the institution's situation and is able to provide all members of the board with information enabling them to meet their supervisory responsibility. Such a committee also contributes to the efficiency of the internal control and the internal audit of the institution.

c) Composition, operation and competences

The board of directors sets down in writing the composition, missions and terms of operation of the audit committee when it is created. It lays down the conditions under which the *réviseur d'entreprises* as well as any person belonging to the institution are involved in its work.

The IML is of the opinion that the audit committee shall include at least three directors which are not members of the management and shall involve in its work: one member of the management, the person in charge of the internal audit department as well as the *réviseur d'entreprises* of the institution. These three persons will attend the meetings of the committee without being members.

The audit committee may ask any document and any information it deems necessary to fulfil its mission as defined under item d) above. To this end, it may refer to the work done by the internal audit department of the institution and request clarification from it. The audit committee approves the audit plan set by management.

The audit committee reports to board of directors on a regular basis.

d) Mission

The audit committee approves the audit charter (cf. item 5.4.3.). It assesses whether the human and material means committed to the internal audit are sufficient. It makes sure that the internal auditors have the necessary skills and may decide on the measures to be taken in this respect.

It takes note of the information on the state of the internal control provided by the management at least once a year pursuant to item 4 of this circular.

The *réviseur d'entreprises* involved in the work of the committee explains his audit programme and submits his audit reports, management letters as well as his long form reports. The audit committee analyses these reports and documents and makes a critical assessment thereof. It ensures that the recommendations of the external auditor which are aimed to improve the organisation and internal control are followed up by the management.

The audit committee deliberates regularly on:

- the state of the internal control system;
- the quality of the work carried out by the internal audit department;
- the compliance with the legal and statutory provisions as well as the IML rules for the drafting of the annual and, where appropriate, consolidated accounts and on the relevance of the accounting policies adopted.

The audit committee pays particular attention to the way in which the management follows up the recommendations of the internal audit department.

7. Relationships between the internal audit and the *réviseur d'entreprises*

The internal audit department of an institution shall build relationships with the *réviseur d'entreprises* which are likely to enable it to acquaint itself with the work carried out by the latter in order to facilitate this work as well as its own work as far as possible.

8. Reports to be submitted to the IML

Every year, the institutions shall submit to the IML the two following reports:

- A written report of the management on the state of the internal control. This report addresses the realisation of the internal control objectives, describes the means implemented and summarises the main observations made, deficiencies observed, in particular by the internal audit department, the corrective measures decided and the effective follow-up of these measures.
- A copy of the summary report on the controls carried out by the internal audit during the past financial year pursuant to items 5.4.7 d) and 5.4.9.

The two reports are to be drafted in French, German or English. They are to be sent to the IML at the same time as the annual accounts drawn up for publication.

9. Assessment of the internal control procedures by the *réviseur d'entreprises*

9.1. As regards banks governed by Luxembourg law, the analytical report to be drawn up by the *réviseur d'entreprises* according to IML Circular 89/60 shall contain a description and a point-by-point assessment of the internal control rules as laid down by this circular.

9.2. The relevant description and assessment are based on the end-of-year closures after 1 January 1999.

9.3. As regards PFS, the management letter of the *réviseur d'entreprises* shall point out, where applicable, any non-compliance with the internal control rules as laid down by this circular.

10. Repealing provision

Circular BC 2/77 on the internal and external control of credit institutions is repealed.

Yours faithfully,

INSTITUT MONETAIRE LUXEMBOURGEOIS

Jean GUILL
Director

Jean-Nicolas SCHAUS
Director