



**Recommendation 11 of 2006  
of the Board of the Hungarian Financial Supervisory Authority  
on setting up and using internal safeguards**

I

Aim and effect of the recommendation

The purpose of the recommendations is to increase the predictability of legal practice and support the uniform application of legal regulations.

Compliance with the requirements presented in the Recommendation serves the fundamental interests of the institutions supervised by the Hungarian Financial Supervisory Authority (hereinafter ‘the Authority’).

The Authority’s recommendation on financial institutions’ internal audit systems issued in 2000 may be regarded as precedence to this Recommendation. The changes in the financial sector and the experiences accumulated by the Authority since the recommendation was issued already justify updating the recommendation. At the same time the intention not to separate the internal audit system from other elements of financial organizations’ internal safeguards became increasingly noticeable in both international and domestic regulatory and supervisory trends. These demands and supervisory efforts were the reasons why the Authority decided to amplify its recommendation pertaining to the internal audit systems of financial organizations in addition to the recommendation’s revision, outlining its expectations with respect to all elements of the financial organizations’ internal safeguards by issuing this Recommendation.

This is in accord with the requirements stemming from the new capital regulation of credit institutions and investment firms as well as the principles contained in related recommendations. In case of insurers Solvency II is expected to stipulate similar requirements with respect to the institutions’ internal governance and control functions.

The Authority employed the international standards on internal safeguards for the preparation of the recommendation including the standards published by the Committee of European Banking Supervisors (CEBS). This Recommendation is in accord with Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and Directive repealing Council Directive 93/22/EEC (MIFID).

In the interpretation of this Recommendation the expression ‘sector specific laws and statutes’ shall refer to Act CXII of 1996 on credit institutions and financial enterprises (hereinafter “Credit Institutions Act”); Act CXX of 2001 on capital market (hereinafter “Capital Market Act”); Act LX of 2003 on insurers and insurance activity (hereinafter “Insurance Act”); Act

LXXXII of 1997 on private pensions and private pension funds (hereinafter “Private Pension Fund Act”); and to Act XCVI of 1993 on voluntary mutual insurance funds.

The primary addressee of this Recommendation are financial organizations operating on the basis of the provisions of sector specific laws. However, in addition to the financial organizations the Authority also expects issuers to follow the supervisory requirements put forth in this Recommendation. <sup>1</sup>The norm document related to the subject of this Recommendation can particularly but not exclusively be found in the sector specific statutes. No references are made to statutory provisions in this Recommendation when the principles and expectations are set forth, however, the Authority continues to expect compliance with the statutes wherever they stipulate requirements that go beyond them.

## II Preamble

1. Financial organizations shall set up and operate internal safeguards that promote:
  - a) the prudent, reliable and efficient operation of the organization in compliance with statutes and internal regulations;
  - b) the protection of the organization’s assets and social goals, the economic interests of the clients and owners ;
  - c) and, thereby, the undisturbed and successful operation of the organization, preserving trust in the institution.

The most important function of the internal safeguards of financial organizations is to contribute to meeting these goals in a preventive and proactive manner by identifying and managing potential problems arising in the course of operation in the earliest possible phase, already at the time of occurrence or even before that, if possible, thereby guaranteeing the solution’s adequate speed and efficiency. The internal safeguards act as a primary filter in the protective network guaranteeing the safe operation of the system of financial intermediaries.
2. The internal safeguards of financial organizations consist of internal governance<sup>2</sup> and internal control functions.
3. Internal governance is guaranteed by the financial organization by way of setting up and operating an adequate organizational structure, organization and system of corporate bodies and by exercising management and supervisory functions. Internal governance shall be interpreted as part of corporate governance the former is narrower to the extent that it does not extend to relationships with owners and other stakeholders of an institution.
4. Internal control functions include the risk control function, the compliance function and the internal audit function.

---

<sup>1</sup> Az angol nyelvű változat nem teszi szükségessé a magyar mondat lefordítását.

<sup>2</sup> These expressions are given in English even in the Hungarian original reflecting the Authority’s intention to communicate established international terminology as accurately as possible in terms of content to financial organizations in Hungary in the Recommendation. That is because in this field Hungarian literature and legislation is characterized by lack of conceptual clarity and accuracy.

5. The elements of the internal audit function (hereinafter ‘internal audit system’) include the checks embedded in the processes, the control by management, the management information system and the independent internal audit unit.
6. The internal safeguards of the financial organization and the individual elements that form part thereof shall be set up and operated in light of the relevant statutory requirements, furthermore proportional to the particular features, complexities and risks of the service activities carried out by the institution.
7. In case of financial groups the Authority calls for the use of internal safeguards on the group level as well. Doing so attention shall be paid to the particular features of the provision of service and operation by groups in all subareas that constitute the internal safeguards (internal governance and internal control functions)<sup>3</sup>.
8. Upon outsourcing an activity the financial organization shall take into account the governance and control considerations that make up the internal safeguards and treat the outsourced activity accordingly. When an element of the subareas making up the internal safeguards of the financial organization is outsourced (for example the risk control function or a special area thereof) it shall be ensured that the responsibility for the given area remain with the management of the financial organization.
9. The management of the financial organization shall regularly review the functioning of the internal safeguards and its individual subsystems and make certain that, when necessary, corrective action is taken.
10. In case of cooperative credit institutions the Authority finds desirable tight cooperation with and professional control of the central organizations created by these institutions, primarily with the institution protection funds in setting up and operating internal safeguards, typically to offset the drawbacks arising from small size.
11. An audit committee shall be obligatory set up in public limited companies pursuant to Article 311 of Act IV of 2006 on business associations. The Authority recommends setting up an audit committee for all large financial organization engaged in complex and substantial international activities even when they are not public companies. The audit committee’s competencies include:
  - a) commenting on the financial report prepared in accord with the accounting act;
  - b) recommending someone for auditor and making a proposal for it’s compensation;
  - c) preparing the contract to be concluded with the auditor and signing the contract on behalf of the limited company on the basis of the powers conferred by the articles of association;
  - d) monitoring whether the auditor meets the relevant professional requirements and complies with the conflict of interests regulations, meeting the responsibilities related to cooperation with the auditor and, if necessary, recommending measures to be taken to the board of directors or the supervisory board;
  - e) assessing the operation of the financial reporting system and recommending the necessary measures; furthermore,

---

<sup>3</sup> Corresponding supervisory directive: 3/2002. Methodological Guidelines 3 of 2002 on the consolidated governance and risk management of financial groups

f) helping the work of the board of directors and the supervisory board in order to ensure adequate control of the financial reporting system.

12. In the event the parent company of the financial organization is not registered in Hungary, or is a member of an international financial group in some other way the Authority expects that the set up and operation of internal safeguards should be in line with the principles and solutions employed by the group meanwhile being in accord with the statutory provisions.

### III Internal Governance

#### 1. Basic Principles

13. The Authority lays big emphasis on the appropriate set up of the internal governance of financial organizations as it is fundamental with respect to the quality and safety of their operation.
14. Keeping the principle of proportionality in view the Authority expects versatile and large, internationally active organizations engaged in complex activities to meet higher level organizational and control requirements, than smaller institutions engaged in less complex activities and internationally inactive institutions.

#### 2. Organizational Structure and Organization

15. The Authority expects financial organizations and groups to operate in an organizational structure that duly transparent and guarantees an adequate basis for the efficient and safe control of the institution or the group. The Authority does not find an opaque organizational structure that cannot be supported with appropriate reasons acceptable and it does not support operational practices that deviate from the fixed organizational structure.
16. Reporting lines and the distribution of responsibilities and competencies within the institution shall be clear, accurate, unambiguously defined, transparent and coherent that guarantee the prevention and management internal conflicts of interests and competencies and can be enforced. Setting these up, communicating them to employees and operating them continuously are the primary responsibilities of financial organizations's management.
17. In the event where the business reporting lines do not match the organization of the institution or the group in a legal sense, it shall be made certain that the responsibilities and competencies of the individual areas are unambiguously clarified and transparent.
18. The Authority expects financial organizations to operate corporate systems in compliance with the statutory provisions that guarantee the efficient and prudent exercise of management, control and supervisory functions within institutions. Differences can be found between certain types of financial organizations and within individual sectors as

well in the practice of corporate governance in Hungary, partly because of the different statutory background. Thus many institutions are characterized by separate management board, board of directors and supervisory board as the highest bodies of governance and control. In case of others the composition of the management board is identical to that of the board of directors. Because of that the Authority is not satisfied with merely the formal existence of these bodies, but requires the implementation of management, control and supervisory functions, their efficient use, furthermore, the transparency of the practices employed.

19. The basic expectation of the Authority is that the organizational structure, the scopes of responsibilities and competencies and the lines of reporting shall be defined, furthermore, that the system of corporate bodies is set up in such a manner that they guarantee the exercise of management and supervisory functions over the outsourced activities where relevant and the entire group as well in case of financial organizations that qualify as parent undertakings.

### 3. Structure of the System of Corporate Bodies, Management and Supervisory Functions

20. Written documents, prepared in view of the statutory requirements, stipulate the supreme management and supervisory bodies of financial organizations, their responsibilities and the main procedural rules that govern their activities.

21. The role played by the various bodies (management board, board of directors, supervisory board, control committee and audit committee) based on the division of responsibilities and competencies at the institution shall be spelled out in the by-laws:

- a) in the development and implementation of the financial organization's business and operational objectives, the owners' economic and social objectives, risk strategy and risk profile, furthermore, of the policies helping to meet those objectives;
- b) in the communication of the objectives and policies within the organization;
- c) in the development and approval of the corresponding internal regulations and guidelines and in providing the conditions of application;
- d) in the supervision of operation matching the strategy and the policy;
- e) in the periodic review of strategies and policies and their modification when necessary;
- f) in the development, coordination and operation of internal control functions;
- g) in the development and operation of reporting related processes;
- h) in the regular assessment of operation of the financial organization's internal safeguards, together with the elements of their subareas.

22. The Authority expects the management and supervisory bodies of financial organizations to strive to make partnership with the Authority even beyond the compliance with statutory provisions, which is regarded by the Authority itself as a basic principal.

23. In the course of selecting, electing and appointing chairmen/members of management and supervisory bodies of financial organizations the Authority recommends taking the candidate's good reputation (based on considerations beyond a criminal records certificate) and the ability to fulfill the role in the organization (in addition to certificates of qualification, human qualities, experiences gathered at former places of employment, management skills, etc.) into consideration over and above the criteria set in sector

specific statutes as licensing prerequisites, together with an assessment of the [candidate's] expected integration into the organization.

24. The Authority requires members of the management and supervisory bodies of financial organizations to meet the highest level of professional competence and activities carried out with due care meeting ethical norms in addition to statutory requirements . The Authority urges the management and supervisory bodies to take an active role in meeting these goals within the entire organization.

#### 4. Role of the Supervisory Board

25. The supervisory board has an outstanding role in the provision of financial organizations' internal safeguards, in respect of which the Authority expects them to follow the Recommendation.<sup>4</sup>
26. Based on the previous section, in the event there is no audit committee at the institution the supervisory board shall always:
- a) ensure that the institution has a comprehensive control system that is suited for efficient operation;
  - b) recommend an auditor and make a proposal for his remuneration;
  - c) check annual and interim financial reports;
  - d) manage internal control unit;
  - e) develop recommendations and proposals based on the conclusion of inspections carried out by the internal audit.
27. Within the frame of the internal audit unit's management the supervisory board:
- a) approves the annual audit plan of the internal audit unit;
  - b) discusses at least twice a year the reports prepared by internal audit and checks the implementation of the necessary measures;
  - c) helps the work of internal audit by commissioning an external expert, if necessary;
  - d) makes a proposal for changing the number of the internal audit unit's staff.
28. Irrespective of statutory requirement preliminary consent from the supervisory board is recommended for making decisions regarding to the employment or termination of employment of the head of the internal audit unit, of senior internal auditors and of the independent internal auditor, including their remuneration.
29. Within ten days from the meeting of the supervisory board the chairman of the board is recommended to send the minutes, proposals and reports concerning agenda items discussed by the supervisory board, the subject of which is serious violation of the internal regulations of the financial organization, or severe irregularity noticed in management or control.
30. Typically statutes stipulate detailed responsibilities for the supervisory board with respect to the independent internal audit unit and define regular reporting requirements for the board of directors and the management board to the supervisory board. According to the position taken by the Authority it is expedient to inform the supervisory board and/or the audit committee on the functioning of additional elements of the internal audit system

---

<sup>4</sup> Lásd 1. számú lábjegyzet megjegyzését.

(management control, checks embedded in the processes and management information system), furthermore, about other subsystems that belong to the internal safeguards, making it thereby possible that the supervisory board and/or the audit committee become familiar not only with the activities and conclusions of the internal audit unit and the reports received from the management, but get information on the financial organization's whole system of internal safeguards. In respect of these topics it is recommended to have a summary assessment prepared for the supervisory board and/or the audit committee at least annually.

31. Furthermore, in case of institutions where there is no management board or board of directors or the board of directors performs operative tasks that are practically identical to those of the management board, the Authority expects that over and above the responsibilities stipulated in the statutes the supervisory board get actively involved in practising control functions following the criteria proposed in this Recommendation.

## IV

### Internal Control Functions

#### 1. Independence of Internal Control Functions

32. The Authority recommends financial organizations to set up and operate (i) risk management function, (ii) compliance function and (iii) internal audit system in order to implement efficient and comprehensive internal control of all activities and organizational units of the institution.
33. These functions, detailed later in this Recommendation and together referred to as internal control functions, shall be independent of the activities and businesses they supervise and control.
34. A control function (risk management, compliance, internal audit) may be regarded independent, if the following conditions prevail:
- a) The staff involved in the control function does not engage in activities that fall within their range of control.
  - b) The control function is organizationally separated from the areas of activities and organization it is to control. The head of the given function may only be subordinated to someone who is not responsible for the management of the supervised and controlled areas.
  - c) The head of the control function reports directly to the management of the institution, the supervisory board or the audit committee; furthermore, appears at least once a year before the body he has to report to.
  - d) The remuneration of the staff of the control function shall be independent from the performance of the controlled area, or the area to be supervised and controlled.
35. Risk management, compliance function and independent internal audit areas shall also be organizationally independent from each other as they perform different tasks. The coordination of their activities should be guaranteed by the management of the institutions or the audit committee. Big organizations may set up risk committees or compliance

committees in order to increase efficiency. However, in case of small institutions even organizational separation may not be always necessary; however, in such cases the elimination or mitigation of real or potential conflicts of interests between the different functions shall be guaranteed by other means (which are to be duly documented).

36. The management of the financial organization is responsible for setting up and operating the risk management function, the compliance function and the internal audit system in accord with the relevant statutory requirements; furthermore, for the provision of the conditions and resources needed for the operation. Within that [the management is responsible] in particular for elaborating the policies pertaining to the various control functions, for their communication within the organization, for the approval of internal regulations affecting the different control functions and for exercising the corresponding control activities.
37. Management support is a factor that fundamentally determines the operation of the internal control functions. At the same time internal control functions are fundamentally expected to support the activities of the institution's management.

## 2. Risk Control Function

38. Risk is an integral part of the activities of financial organizations. Accordingly, the aim of the risk control function is not to minimize risks, but to make sure that the institution properly identifies, measures and manages the risks in order to ensure that the size of the emerging risks do not threaten the continuity of the operation.
39. Elements of risk management:
  - a) definition of the risk management policy (determining the types and volume of risks the institution or the group is willing to assume with respect to different categories of risks, in particular in the fields of credit risk, market risk, operational risk or liquidity risk etc.);
  - b) determining the processes, procedures, tasks, decision making and control competencies related to the risk management system;
  - c) developing procedures and methods to be used for the measurement of risks;
  - d) the measurement of risks;
  - e) setting up risk limits;
  - f) preparing reports pertaining to risk the management activities;
  - g) the procedures to be followed in case of exceeding the predefined risk limits;
  - h) internal audit procedures linked to the risk management system.
40. The Authority expects financial organizations and groups to set up and operate systems that ensure separate and continuous assessment of the various emerging and relevant risk types (before and after making the decisions) and the overall risk position of the institution or the group, furthermore, keeping the risks on the required level.
41. Several other recommendations and methodological guidelines of the Authority deal with the topic of risk management that define more detailed criteria for financial organizations and groups for the creation and exercise of efficient risk control:
  - a) Recommendation 2 of 2002 on the asset and liability management of credit institutions and on the management of market risks;
  - b) Recommendation 3 of 2000 on the risk management systems of investment firms;

- c) Recommendation 8 of 2001 on the management of credit risk;
- d) Recommendation 9 of 2001 on the risk management of voluntary pension, health and mutual funds and private pension funds;
- e) Methodological Guideline 1 of 2002 on the control of agents' activities employed for the intermediation of services provided by financial organizations and on the management of risks;
- f) Methodological Guideline 3 of 2002 on the consolidated governance and risk management of financial groups;
- g) Methodological Guideline 4 of 2003 on the asset and liability management of insurers;
- h) Methodological Guideline 5 of 2004 on the credit institutions' management of interest rate risks;
- i) Recommendation 2 of 2006 on the investment decision making process of those engaged in investment (asset) management, expectations related to their deals and the management of emerging risks.

As the Authority assigns special importance to the development of the financial organizations' risk management systems, it strives to continuously update recommendations and methodological guidelines dealing with risk management and to issue new methodological guidelines when necessary. The current versions of recommendations and methodological guidelines are available on the Authority's home page.

### 3. Compliance Function

42. The aim of having the compliance function is to identify and manage compliance risks. Compliance risk is the risk of legal or supervisory sanction, substantial financial loss, or damaged reputation arising from not abiding by the statutes pertaining to the financial organizations or other requirements that do not qualify as statutes, including recommendations, directives and methodological guidelines issued by the Authority, the regulations of so-called self-regulatory bodies (KELER, stock exchange, MABISZ), market conventions and ethical norms as well (hereinafter referred to as 'compliance rules'). Special areas of managing compliance risks include the management of conflicts of interests, separation of financial and investment service activities, fight against abuses (insider trade or unfair exchange rate manipulation), fraud, money laundering and terrorist financing, but also extend to the tax risk of financial organizations and their clients, the fair treatment of clients, furthermore, to ensuring the correctness of consulting services provided to clients.
43. In case of financial organizations active in Hungary the following may be regarded as the most important compliance areas (with different weights at different institutions):
- a) Related to business areas in general*
- Secret and data protection (business, bank, securities and insurance secrets and the protection of personal data)
  - Prevention of money laundering and terrorist financing
  - Setting up and operating KYC (Know Your Customer) procedures
  - Prevention of external and internal fraud
  - Ensuring the observance of the generally accepted norms of market behaviour
  - Correct information providing and consulting for clients, handling customer complaints
  - Managing conflicts of interests between the institution and its clients

- Managing conflicts of interests between the different areas of the institution and in connection with that compliance with the provisions of sector specific regulation pertaining to conflicts of interests and meeting the obligation to report to the Authority
- Limiting the flow of information (Chinese Wall) among areas where the use of confidential information could give rise to abuses
- Definition and implementation of employee and staff training program in connection with the above

*b) In connection with investment service activities*

- Separation of financial and investment service activities
- Setting up internal regulations for the prevention and preclusion of insider trade and continuous monitoring of compliance with these rules
- Ban on the manipulation of market exchange rates
- Separation of organizational units performing financial or business analysis from the organizational units making investment decisions. Defining separate rules pertaining to the personal investment activities of the employees of these organizational units and continuous monitoring of compliance with these rules.
- Defining rules pertaining to the employees' own business activities and continuous monitoring of compliance with these rules.
- Defining internal compliance rules for the financial organization's own account investment activities and continuous monitoring of compliance with these rules.
- Developing and implementing a training program related to investment service activities.

*c) In connection with real estate transactions*

- Preclusion of abuse of confidential information related to real estate transactions
- Employees' own account real estate transactions

*d) Related to the non-business areas of the institution*

- Compliance with prudential requirements (capital adequacy and reserve creation)
- Reporting to HFSA and the National Bank of Hungary
- Compliance with tax and accounting statutes and standards

44. In the course of setting up and operating the compliance function it is necessary to take into consideration not only the particular features, extension and complexity of the services provided by the institution, but harmony with other internal governance and other control functions (risk control and internal audit) shall also be ensured. In particular the following should be determined:

- a) the supervisory functions the management of the financial organization exercises with respect to compliance activities in the framework of internal governance;
- b) whether a compliance officer has been appointed within the organization, or possibly [there is] an independent [compliance] organizational unit;
- c) what type of compliance risks are managed first in the framework of the compliance function, or added to other control functions (such as checks embedded in the processes, risk control and internal audits);
- d) whether the financial organization operates a compliance function as part or the management of operational risks, or independently;
- e) the way the compliance function is controlled in the framework of management control or by the independent internal auditor;
- f) the special compliance features of providing services outside of Hungary;
- g) the way the compliance function is exercised on the level of financial groups and in respect of outsourced activities;

45. In case of credit institutions, insurers and investment firms operating as a stock company (excluding home savings and loan associations) the Authority expects the employment of at least one compliance officer. However, in case of smaller financial organizations with less complex activities the Authority finds the management of compliance risks within the risk control or internal audit function also acceptable, provided this arrangement does not affect the independence of the internal audit unit.

In case of credit institutions, investment firms and insurers under consolidated supervision pursuant to the Authority's resolution the Authority regards appointing a group level compliance officer as well, who is responsible for ensuring the unity of the group level compliance function, as good practice. In that framework the group compliance officer expediently performs the following tasks with a view to the relevant statutory (in particular secret protection) requirements:

- identification and analysis of group level risks from a compliance perspective;
- development of uniform compliance procedures and rules;
- coordination of the activities of compliance officers belonging to the group.

46. The management of the financial organization determines the institution's compliance policy. Concerning the form of it the Authority finds several solutions acceptable depending on the way the function is organized at the institution. Thus it may take the form of an independent document, or may be part of the risk management policy, or other internal regulations.

47. With respect to the operation of the compliance function the Authority expects extending that to all activities and business areas of the financial organization.

48. The tasks of the compliance function are in particular:

*a) Regulatory tasks*

- Definition of the range of compliance rules to be employed by the financial organization, in particular the range of compliance relevant information .
- Analysis of the possible effects of regulatory changes (monitoring changes in the institution's internal and external environment).
- Initiating modifications necessitated by regulatory changes.
- Preparing and continuously updating compliance policy and related internal regulations and procedures. Within that elaborating the methods and procedures for the identification, assessment and analysis of compliance risks.

*b) Operative tasks*

- Investigation and continuous monitoring of compliance with compliance rules in all areas affected by compliance risks. Reporting the violation of compliance rules to the top management.
- Consulting the management of the institution on matters of compliance and regular reporting.
- Compliance training of the institution's staff.
- Keeping records of compliance relevant information, classifying and listing the data in the available database according to given criteria and monitoring the records.
- Meeting the reporting obligation toward authorities (for example conflict of interests, or money laundering, etc.).
- Commenting on new products and procedures with respect to compliance before their introduction.

#### 4. Internal audit system

#### 4.1. Basic principles

49. Tasks of the operation internal audit system:
- a) protecting the assets of the organization and of its clients and the interests of the owners;
  - b) promoting and controlling the operation of the organization in compliance with the statutes;
  - c) verifying compliance with the provisions included in the external and internal regulations pertaining to the organization and checking their sufficiency;
  - d) identification and reporting of deviation from the statutes or the provisions of internal regulations, risks involved in the practices used and in the built-in (checks) control; furthermore, when necessary making proposals for remedying the discovered deficiencies.
50. It is a fundamental requirement with respect to setting up and operating the internal audit system that it should be extended to all activities and organizational units of the financial organization, it should be incorporated into the day-to-day activities, made an organic part of that; furthermore, the control activity should be properly defined and traceable.
51. The Authority expects setting up and operating a group level internal audit system in case of financial groups.
52. In case of an outsourced activity the activity of the internal audit unit and management control are extended to the full scope of the activities performed for the financial organization by the external organization commissioned.
53. The organization stipulates the goal of operating the internal audit system, its scope of authority, responsibilities, elements, organization and the professional requirements pertaining to the leadership of internal control and the procedural rules for conducting investigations, furthermore the availability of the necessary computer and technical resources in the internal regulations approved by the institution's management (charta or internal audit by-laws).

#### 4.2. Checks embedded in the processes

54. Financial organizations shall set up individual business administration procedures and internal regulations so as to enable control checks embedded in the processes. Check points are inserted in the various processes in order to ensure that various tasks can only be performed after the control (and compliance) of the preceding task, thereby guaranteeing the compliance of the inputs of subsequent tasks. Carrying-out, processing and controlling a given task cannot be assigned to one and the same person. Job descriptions shall be extended to obligations pertaining to compliance with control tasks built into the workflow defined in the internal business administration regulations. Financial organizations set up their procedures ensuring that transactions can only be executed after documented control.
55. The Authority recommends financial organizations to expediently develop double lines of reporting in business areas. Reports that may be associated with positions and risks should

be expediently channelled to the risk management function in addition to business line superiors.

#### 4.3. Management Control

56. The aim of setting up different management levels and the organizational structure is directed at the complete and efficient implementation of the financial organization's objectives. Management control functions and responsibilities shall be realized on all levels of management. Among others management control has the responsibility of inspecting the proper operation of checks embedded in the processes. The means of management control include reporting; requesting reports; exercising the right to sign; inspecting the fulfillment of duties in terms of content, form and other aspects; on-site inspection and operating the management information system. Managers of the financial organization regularly control their staff and have them prepare reports. The detailed rules of management control (including reports and lines of duty) are included in their entirety in the internal regulations.
57. The Authority recommends financial organizations to set-up and operate an audit path for its activities. The audit path will include in particular the responsibility and information levels and connections of the different activities, furthermore, the management and control processes making possible the on-going monitor and the follow-up control of them . The audit path reveals the shortcomings of the system of checks embedded in the processes and helps to identify risks.

#### 4.4. Management Information System

58. Setting-up and operating a management information system covering the complete range of activities is an important part of the financial organization's activities. The aim of the management information system is to ensure that uniform and comprehensive information is available to the management in the course of management and control.
59. The management information system of the financial organization includes all the information collected for the management and the system that collects and channels the information adequately processed to the addressee. All that happens in a way to ensure that sufficient time remains for the manager to react to changes.
60. The Authority recommends financial organizations to employ electronic devices and channels for operating management information systems.
61. The management information system shall be set-up and operated so as to help the activities of the management with reliable and relevant information that is available in due time.
62. Additional requirements in respect of information systems are security, being regularly and independently reviewed and also being prepared for unexpected events.

#### 4.5. Internal Audit Unit

63. Over and above observing the relevant statutes with respect to operating the internal audit system the Authority requires compliance with one of the international internal audit

standard systems. In that respect the Authority recommends compliance with the practical standards and guidelines issued by IIA (Institute of Internal Auditors), the international organization of internal auditors and published by Belső Ellenőrök Magyarországi Szervezete (Hungarian Organization of Internal Auditors, BEMSZ) and by the Ministry of Finance and compliance with the Code of Ethics of IIA.

64. Employment of an internal auditor by all financial organizations is a basic expectation of the Authority irrespective of statutory obligations. [This applies to] insurance associations below three hundred million forints of premium income and voluntary funds as well (in case of small institutions part-time employment is acceptable). The Authority is convinced the employment of an internal auditor serves the interest of the Authority and the financial organization as well, since the internal auditor functions as a fundamental safeguard that supervises the activities of the financial organization and calls attention to erroneous practices potentially conflicting with the regulations.
65. In the event the size of the financial organization or the statutory requirements do not make the employment of several internal auditors necessary and the organization employs only one internal auditor, the guidelines pertaining to the internal audit organization or to the head of that organization shall be understood as applying to the internal auditor. In the event several financial organizations employ the same person as internal auditor within the bounds of the relevant statutes, a written agreement shall be obtained to the effect that they do not object to the joint employment of the internal auditor. It is expedient to note in the written agreement that the job description of internal auditors may not include any element that could give rise to conflicts of interest or hinder the partition of the separate jobs.
66. The activity of the internal auditor extends to the entire scope of the financial organization's activities and procedures and to all organizational units.
67. The Authority's expectation is to ensure the independence of the internal auditor's activities from the areas and activities he has to control. In order to ensure independence internal auditors may not be given responsibilities that may lead to conflicts of interests other than control. Only the supervisory board, its chairman, the head of the internal audit unit independently and the top manager of the financial organization (managing director or the chairman of the board of directors in case of pension funds) with consent or subsequent notification of the chairman of the supervisory board may assign additional audit tasks compared to the annual plan for the internal audit unit. The head of the internal audit unit has to report to a management level that makes the performance of duties possible for those in charge of internal audit. Internal audit proceeds independently in the course of planning its activities, implementing the program, selecting the methods and procedures and compiling the audit report which contains statements, conclusions and recommendations free of external influences, for the content of which internal audit is responsible.
68. The management of the financial organization is responsible for guaranteeing the independence of internal audit (in terms of competence and organization) together with the resources available for internal audit. The management of the financial organization shall determine and provide the resources for internal audit in accord with the particular features, extension, complexity and risks of the service activities carried out by the institution. Furthermore, it is also important to ensure that internal audit has access to all

information and documents necessary to perform its duties, to be notified about all steering and management decision and resolution concerning the business activity, to be able to request information from anyone, to access any one of the premises, furthermore, to be able to request declarations and certificates and to take minutes.

69. The Authority expects the financial organization's management to support the activities of internal audit with all the means available. Within that the management creates a culture, sets up and operates processes, which ensure that the audit conclusions are given due priority by the organization.
70. Internal auditor shall proceed in an objective manner in the course of their work. Internal auditors shall be impartial and unbiased, they shall avoid conflicts of interests and they themselves shall be controllable. The internal audit unit may only be involved in setting up and operating other areas that constitute the institution's internal safeguards for the purpose of commenting only.
71. The concerned parties shall be notified about any real or alleged damage to independence or objectivity.
72. Those performing internal audit activities shall either collectively possess or obtain all the professional skill, experience and other knowledge that are necessary for performing the duties. This way it is guaranteed that the internal audit unit as a whole is suited for the control of all activities and organizational units of the organization. The internal auditor shall perform his activities with due skill, care and diligence. Due professional care does not mean infallibility.
73. Having regards to the fast development of financial markets internal auditors of financial organizations are increasingly expected to continuously update their skills, experience and other knowledge. In this regard the Authority urges employees working in the area of internal audit to obtain Certified Internal Auditor qualification.
74. The head of the internal audit unit, or in absence of an internal audit unit the internal auditor shall beyond the above comply with statutory requirements.
75. Responsibilities of the head of the internal audit unit, or in absence of an internal audit unit the internal auditor are:
  - a) preparation of the internal audit manual;
  - b) compilation of internal audit strategic and annual inspection plans supported by risk analysis, implementation of the plans following approval of the supervisory board, furthermore, monitoring the implementation;
  - c) organization and effective management of the internal audit, efficient allocation of the resources available for internal audit so as to enable the realization of the approved plans;
  - d) coordination of the inspections and control of their execution;
  - e) [reporting immediately if a conflict of interests in respect of his assignment or his person becomes known to him together with the measures taken to preclude the conflict of interests to the head of the financial organization and disciplinary action may be taken against him for failing to do so, or for late reporting;
  - e) in the event an act, default or negligence justifying criminal, offence, damage compensation or disciplinary procedure is suspected in the course of the inspection

notifying immediately and recommending appropriate procedures, the head of the financial organization, or in case the head of the financial organization is involved, the chairman of the supervisory board;

- f) sending the audit report to the heads of the inspected organizational unit, the financial organization (managing director) and the supervisory board following the completion of the inspection;
- g) monitoring the implementation of the action plans;
- h) ensuring that inspections are logged, the inspection documents are kept and the documents and data are stored in a safe manner;
- j) ensuring the development and employment of quality assurance and development procedures in the course of internal audit covering all aspects of internal audit, which include regular and periodic internal and external quality assessments and continuous internal monitoring activity;
- k) ensuring the professional training of internal auditors;
- l) compilation of a summary report on the activities of internal audit semi annually in case of financial organizations where the law so requires, while in case of other organizations at least once a year (however semi annual reporting is recommended for them as well).

76. The summary report on internal audit should include the following:

- a) presentation of the activities carried out by internal audit:
  - aa)* evaluation of the fulfillment of tasks stipulated in the internal audit plan, reasons for any deviation from the plan and justification of unplanned inspections;
  - ab)* the human and material resources of inspections, the factors helping and hindering the activity;
  - ac)* the most important conclusions of the audits;
  - ad)* the number of reports made in connection with a suspicion in the course of the inspection of an act, default or negligence justifying criminal, offence, damage compensation or disciplinary procedure and a brief summary thereof;
  - ae)* major proposals made for the improvement of the regularity, financial efficiency, effectivity and successfulness of checks embedded in the procedures, preliminary and follow-up management control;
- b) the determination of the priority and utilization of the most important conclusions and recommendations made by internal audit:
  - ba)* the report on the implementation of the action plans and the experience related to the utilization of audit conclusions and recommendations;
  - bb)* proposals for the development of inspection activities.

77. In case of a financial group the internal audit unit of the credit institution, investment firm, or insurer under consolidated supervision manages, coordinates and controls the internal audit of the group members.

#### 4.6. The Activity of Internal Audit

78. Internal audit performs its duties in accord with the internal audit manual approved by the management of the institution with regards to the preliminary opinion of the supervisory board. The internal audit manual provides for:

- a) the internal audit by-laws determining the scope of competencies, responsibilities and goals of internal audit;
- b) the professional code of ethics of internal auditors;
- c) the organizational chart demonstrating the functional independence of internal audit;

- d) the internal rules, procedures and methodological guidelines pertaining to internal audit, or references to their availability, the key steps and phases of different inspection methods;
- e) the risk analysis methodology;
- f) the rules guaranteeing the quality of internal audit;
- g) the formal requirements related to inspection documents, the document filing order, the standard document templates and the provisions concerning the structure and content of inspection reports;
- h) the rules pertaining to the utilization of the conclusions of audits and ordering follow-up measures;
- i) the criminal, offence or damage compensation and disciplinary procedures applicable during the inspection;
- j) the basic principles pertaining to the continuous education of internal auditors;
- k) the provisions pertaining to the involvement of external experts.

79. Based on the work plan of internal audit or the request of the supervisory board the task of the internal audit is:

- a) to inspect and assess the compliance, effectivity and efficiency of the institution's operation with respect to statutes and regulations;
- b) to inspect the management of resources, the protection and enlargement of assets;
- c) to thoroughly analyze and evaluate the functioning of the internal safeguards of the financial organization with a systemic approach (including internal governance, risk management and compliance functions, furthermore, other elements of the internal audit system), their reliability, effectivity and efficiency, covering the information technology employed by the institution and the related control processes as well;
- d) to make conclusions and recommendations in connection with the inspected processes and to prepare analyses and assessments to improve and develop the systems;
- e) to prepare recommendations and proposals for the elimination of risk factors and shortcomings;
- f) to monitor the measures taken on the basis of the audit reports;
- g) to help the operation of the financial organization with consultancy.

The Authority also expects the internal audit of the financial organization to regularly control the substantiation and reliability of reporting to the Authority (in particular in aspects of internal regulations, its accounting basis, comprehensiveness, integrity, closeness, IT reliability and operational considerations of processes and control systems); furthermore, the verification of the performance of tasks stipulated in resolutions, or management letters closing the inspections for the elimination of systemic deficiencies and legal violations discovered by the Authority by the set deadline and their monitoring to see whether the financial organization has done everything in order to correct the mistakes and diminish the identified risks.

80. Internal audit conducts its activities on the basis of the strategic and annual audit plans prepared on the basis of risk analysis. The Authority expects financial groups to determine the plans for the whole group as well and that those contain considerations of group level management .

81. The annual audit plan shall be based on the priorities arising from risk analysis and the resources available for internal audit taking potential extraordinary inspection tasks also into account. The annual audit plan contains the following:

- a) analyses that substantiate the annual audit plan, in particular the risk analysis;
- b) subjects of the planned inspections, the name of the inspected areas or organizational units and the types of inspections (special, comprehensive, thematic or follow-up inspections);
- c) determination of the required inspection resources;
- d) the schedule of audits.

82. Internal audit conducts the inspections on the basis of authorization (which may take the form a warrant or a document approved by the relevant body of the institution) according to the inspection program approved by the head of internal audit and registered appropriately according to the documentary norms of the organization so as to be traceable later, under the supervision of the head of internal audit. The audit program includes the following for each inspection:

- a) name of organizational unit conducting the inspection;
- b) name of the inspected area or organizational unit;
- c) subject of the inspection;
- d) the preliminary assessment of the risks pertaining to the inspected activity and the aim of the inspection;
- e) the detailed tasks of the inspection;
- f) the period to be audited;
- g) references to statutory or other authorizations pertaining to the inspection;
- h) the procedures and methods of the inspection determined in line with the audit goals and tasks;
- i) the inspection questionnaires (if necessary);
- j) the names of the auditors, experts and the head of the inspection, the serial number of their warrants and the distribution of tasks;
- k) the planned duration of the inspection and the deadline for making the reports;
- l) the date of issue;
- m) approval of the authorized person.

83. An audit report is prepared about the inspections carried out by internal audit, including statements and conclusions and the recommendations pertaining to taking and implementing the necessary measures. Before the finalization of the inspection report the inspected party is entitled to learn the conclusions of the inspection and comment on them. In the event the responsibility is established the inspected party shall furnish written explanation by a set deadline. The final report closing the inspection is prepared after taking the written comments of the head of the inspected organization into account and sent to the supervisory board, the top manager of the financial organization (managing director) and the head of the organizational unit concerned. In the event the head of the concerned organizational unit disagrees with any one of the conclusions, his position and arguments shall be included in the inspection report. The Authority regards the presentation of disagreement not in the inspection report, but in a separate document as an acceptable practice. However, in that case it should be forwarded to the top manager of the organization and the supervisory board together with the inspection report.

In the event infringement of the law is suspected the internal auditor shall take priority action and notify the head of the organization without delay. If in the course of the inspection the internal auditor discovers criminal acts or acts that may justify substantial damage claims, in addition to the above he shall also prepare minutes. In the event the original report is not made in Hungarian language, then it shall also be translated and the report should be made available to the Authority.

84. The head of the inspected organizational unit takes action to eliminate the mistakes and deficiencies discovered by the audit. He notifies the internal auditor, the board of directors and the supervisory board about the planned measures in writing within the time allowed by the internal by-laws following receipt of the report. In case matters that call for action from the management of the organization the necessary measures are initiated by the top manager (managing director) of the financial organization and the supervisory board. This is also the way to proceed in case the elimination of the mistakes and deficiencies cannot be expected from the measures planned by the inspected organizational unit. The Authority also finds summarizing the measures to be taken to eliminate mistakes and deficiencies identified by different inspections in an action plan with the consent and cooperation of the inspected organizational unit as part of the final report a good practice. This way the board of directors and the supervisory board are informed about the planned measures by sending the final report.
85. The internal auditor shall monitor the implementation of the decision for the execution of measures and of the action plan, including the implementation of measures required as a consequence of an inspection carried out by an external party, such as the Authority or the auditor, and notifies the head of the organization in the event of failed implementation.

## V

### The Relationship of the Financial Organization and the Statutory Auditor

86. In the narrow sense the services provided by statutory auditors cannot be regarded as part of the financial organization's internal safeguards, but as a kind of transition between the elements constituting the internal and the external system of safeguards and are connected to management and control functions at many points. For that reason the Authority finds it necessary to outline its main expectations pertaining to the relationship of financial organizations and their elected auditors in this Recommendation as well.
87. The Authority expects the financial organization to exercise due care during the selection of the statutory auditor through or involving the relevant bodies and regularly evaluate the auditor's performance.
88. In the course of selecting and evaluating the auditor through or involving the relevant bodies the financial organization shall:
- verify that whether [the auditor] may be commissioned to perform auditing tasks according to the record of auditors empowered for auditing financial organizations;
  - based on the available information analyses the constraints and conflict of interests conditions set forth in sector specific legislation;
  - summarizes previous experience with the given auditor, the available market information, the auditor's good business reputation and whether the auditor's remuneration is in line with the amount and professional level of work to be done or done before;
  - based on the available information checks whether the auditor has taken the necessary organizational, structural and administrative measures in order to prevent conflicts of interests.
89. If the involved financial organization through or with the involvement of the relevant body commissions an auditor or audit firm to perform multiple activities (for example

consultancy or tax related tasks in addition to auditing the financial reports), it takes all organizational, structural and administrative measures in order to avoid conflicts of interests.

90. The Authority recommends the financial organization to publish the assignments given to various auditors in the annual report, broken down according the following titles: statutory audit, services offering additional certainty, tax consultancy and other services.
91. Through or involving the relevant body the financial organization shall strive to follow the corporate governance principles mentioned below in the course of liaising with the auditor:
  - a) recognizes the importance of audit activity and communicates that within the organization;
  - b) monitors compliance with the provisions set forth in Act LV of 1997 on the Chamber of Hungarian Auditors and auditing activities, furthermore, in sector specific legislation so as to assure the independence of audit activity;
  - c) effectively reviews and utilizes the auditor's comments, including those contained in the so-called management letter;
  - d) takes efficient measures needed to eliminate the deficiencies based on the auditor's comments in time;
  - e) urges control of registers, reporting and internal audit by the auditor;
  - f) strives to have publicly disclosed information authenticated by the auditor as much as possible.
92. For the sake of the efficient operation of external and internal controls (e.g. control by owners) the internal audit unit of the financial organization maintains good relationship with the auditor. For that reason in line with the National Audit Standards:
  - a) internal audit informs the auditor about internal audit reports and any significant fact that may influence the auditor's work;
  - b) the auditor informs the internal audit unit about any significant fact that may influence the activities of internal audit;
  - c) the auditor gets familiar with the activities of internal audit in order to determine the risks of erroneous statements (errors) in financial statements and plans his procedures accordingly;
  - d) internal audit utilized the audit experience in its work.
93. In the event an auditor performs several services to one and the same financial organization, the auditor ensures adequate separation of the individual activities and takes the necessary organizational, structural and administrative measures in order to avoid conflicts of interests.

## VI Transparency

94. In order to ensure transparency of the activities and operation of financial organizations the Authority recommends financial organizations to publicly disclose regularly updated information on the structure and operation of their internal safeguards beyond the statutory requirements as well that may assists concerned parties in the real and authentic

evaluation of the financial organization. In that respect the content and structure outlined in the Recommendation is regarded as good practice by the Authority.

95. In terms of the form of public disclosure in addition to the printed form the Authority urges the extensive employment of electronic devices and communication channels.
96. The Authority recommends financial organizations to have procedures in place that enable the management or the supervisory board to learn about important and well founded comments made by the staff concerning the operation of the institution's internal safeguards or one of its subsystems. These procedures shall guarantee confidentiality in the interests of staff members initiating them. Furthermore, it shall also be made possible to initiate such procedures outside of the lines of reporting (e.g. directly to the head of compliance function or internal audit).

## VII Closing Provisions

97. Recommendation is a legal tool issued pursuant to Article 9/C (1) c) of Act CXXIV of 1999 on the Hungarian Financial Supervisory Authority.
98. The content of the recommendation issued by the Board of HFSA reflects the requirements set forth in the statutes, the principles, methods, market standards and customs recommended based on the Authority's legal practice. The Board of HFSA stresses that financial organizations may incorporate the recommendation into their regulations. Should that be the case the financial organization shall be entitled to indicate that the concerned regulation corresponds to the relevant number of recommendation issued by the Board of the Hungarian Financial Supervisory Authority.
99. Putting this Recommendation into force Recommendation No. 1 of 2000 on financial organisations' internal audit systems shall be repealed.

Related material:

1. Guidelines on the Application of the Supervisory Review Process under Pillar 2., CP 03 revised (CEBS, 25 January 2006)
2. Implication of Auditors in the Context of Verification of Information in accordance with the Capital Requirement Directive Discussion Paper January 2006 (Finland)
3. Issues Paper on the Possible Involvement of External Auditors in the Verification and Review Processes Foreseen in the Recast Directive 2000/12/EC (EGAA Sub-working group on Auditing, 22 February 2006)
4. Institute of Internal Auditors: [International Standards for the Professional Practice of Internal Auditing](#), version effective as of 1 January 2004
5. Materials related to the practical standards of the internal audit profession developed for budgetary organizations by the Ministry of Finance (government decree and practical guidelines)
6. OECD Principles of Corporate Governance, revised April 2004.
7. Enhancing Corporate Governance for Banking Organisations (BIS, February 2006)
8. Compliance and the Compliance Function in Banks (BIS, April 2005)
9. Compliance Function at Market Intermediaries (A Report of the Technical Committee of the IOSCO, March 2006)
10. Internal Audit in Banks and the Supervisor's Relationship with Auditors (BIS, August 2001)
11. Fit and Proper Principles (Joint Forum)
12. Draft of the Authority's Validation Manual
13. Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (MIFID).
14. Framework for Internal Control System in Banking Operations (BIS, 1998. October)
15. International Standards for the Professional Practice of Internal Auditing (IIA)