SEMINAR ON INTERNAL AUDIT IN BFSI

February 9, 2013

AGENDA

- Background
- Regulator and Regulatory framework
- Guidelines for Internal Audit
- Functions of a Bank
- What we do different
- Future trends

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BANKING AND BANKING SYSTEM

- What is Banking ?
  - Business of accepting deposit and lending **money** by financial intermediaries
  - Safeguarding deposits and providing loans to the public

- What is Banking System?
  - Principal mechanism which creates and control the money supply of country

EVOLUTION OF BANKING

- First phase: Pre Nationalisation Era (1947-1969)
  - In 1949 – The nationalisation of RBI and enactment of the Banking Regulation Act gave extensive regulatory power to RBI over the commercial Banks
  - In 1955 – State Bank of India is established and in 1960 its Associates
- Second phase: Nationalisation to Liberalisation (1969-1991)
  - In 1969 – 14 major commercial banks were nationalised (In 1980 – 6 more banks)
  - In 1976 – Regional Rural Banks were set up
- Third Phase: Post Librelisation (After 1991)
  - Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks
  - New generation tech-savvy banks, like UTI Bank (since renamed Axis Bank), ICICI Bank and HDFC Bank came into existence

BANKING - ROLE IN THE ECONOMY

- Mopping up small savings at reasonable rates with several options
- Financing development projects
- Development of industrial and agricultural sectors
- Overcome the problem of unemployment

TYPES OF BANKS

- Types of Banks
  - Central Bank of India
    - -Reserve Bank of India
  - Commercial Banks
    - -Public Sector Banks
    - -Private Sector Banks
    - -Foreign Banks
  - Co-operative Banks
    - -Primary Credit Societies
    - -Central Co-operative Banks
    - -State Co-operative Banks
  - Specialised Banks
    - -EXIM Bank
    - -SIDBI
    - -NABARD

BANKS: HOW ARE THEY DIFFERENT?

- Banks bear various kinds of Risk:
- Operational Risk: Risk arising from the people, systems and processes
  - Transaction Volume
  - Decentralisation due to branch network
  - Technological dependence

- Credit Risk: Credit risk refers to the risk that a borrower will default on any type of debt by failing to make payments which it is obligated to do
  - Involved in lending activity to retail, commercial, agricultural lending
  - Secured and Unsecured lending
  - Long term and short term lending

BANKS: HOW ARE THEY DIFFERENT?

- Market risk: Risk of losses in positions arising from movements in market prices
  - Equity risk,
  - Currency risk,
  - Commodity risk,

- Information technology risk: Any risk related to information technology
  - Multiple systems are used
  - Huge branch network need to be always connected
  - Highly customer confidential data is maintained

BANKS: HOW ARE THEY DIFFERENT?

- Legal and Compliance risk: Risk of breaching the laws and regulatory guidelines
  - Regulator as RBI
  - Banking regulation act
  - Litigation risk

- Reputational risk: Risk related to the trustworthiness of business
  - High customer facing transactions
  - Trust is everything
  - Operating in public domain

BANKS: HOW ARE THEY DIFFERENT?

- Liquidity risk: Risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss
  - High investment book
  - Asset Liability Management
  - Matching the short term liabilities to long term assets

- Interest rate risk: The risk that an investment's value will change due to a change in the absolute level of interest rates.
  - Most of the assets and liabilities are linked to interest rate
  - Rate sensitive assets and rate sensitive liabilities mismatch

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REGULATOR

- Reserve Bank of India (RBI) is India's central banking institution
- Established on April 1, 1935 in accordance with the provisions of the RBI Act, 1934
- Share capital of Rs. 5 crore, divided into shares of Rs. 100 each fully paid up
- Nationalized in the year 1949

REGULATOR

- Main functions of RBI:
  - Monetary authority and acts as the bank of the national and state governments.
  - Formulates, implements and monitors the monetary policy.
  - Facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.
  - Sole right to issue bank notes of all denomination
  - Act as a Banker's Bank

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RBI GUIDANCE ON RISK BASED INTERNAL AUDIT

- RBI released guidelines on Risk Based Internal Auditing in the Banks in year 2002.
- The key features were:
  - Focus to shift from the present system of full-scale transaction testing to risk identification, prioritization of audit areas and
  - Allocation of audit resources in accordance with the risk assessment
  - Need to develop a well defined policy, duly approved by the Board,
  - The policy to lay down the maximum time period beyond which even the low risk business activities/locations should not remain unaudited.

RBI GUIDANCE ON RISK BASED INTERNAL AUDIT

- Requirements
- Functional independence of Internal Audit (IA)
  - Independent from the internal control process to avoid any conflict of interest
  - Should have an appropriate standing
  - The internal audit head should report to the Board of Directors/Audit Committee of the Board
  - IA should not be assigned any responsibility of performing accounting or operational functions.

RBI GUIDANCE ON RISK BASED INTERNAL AUDIT

- Risk Based Audit Planning (RBAP)
- Key steps to do RBAP are:
  - Identification of **Inherent Business Risks** in various activities undertaken by the bank.
  - Evaluation of the effectiveness of the control systems for monitoring the inherent risks of the business activities **‘Control risk’**.
  - Drawing up a risk-matrix to determine focus areas in terms of **Frequency of audit**

RBI GUIDANCE ON RISK BASED INTERNAL AUDIT

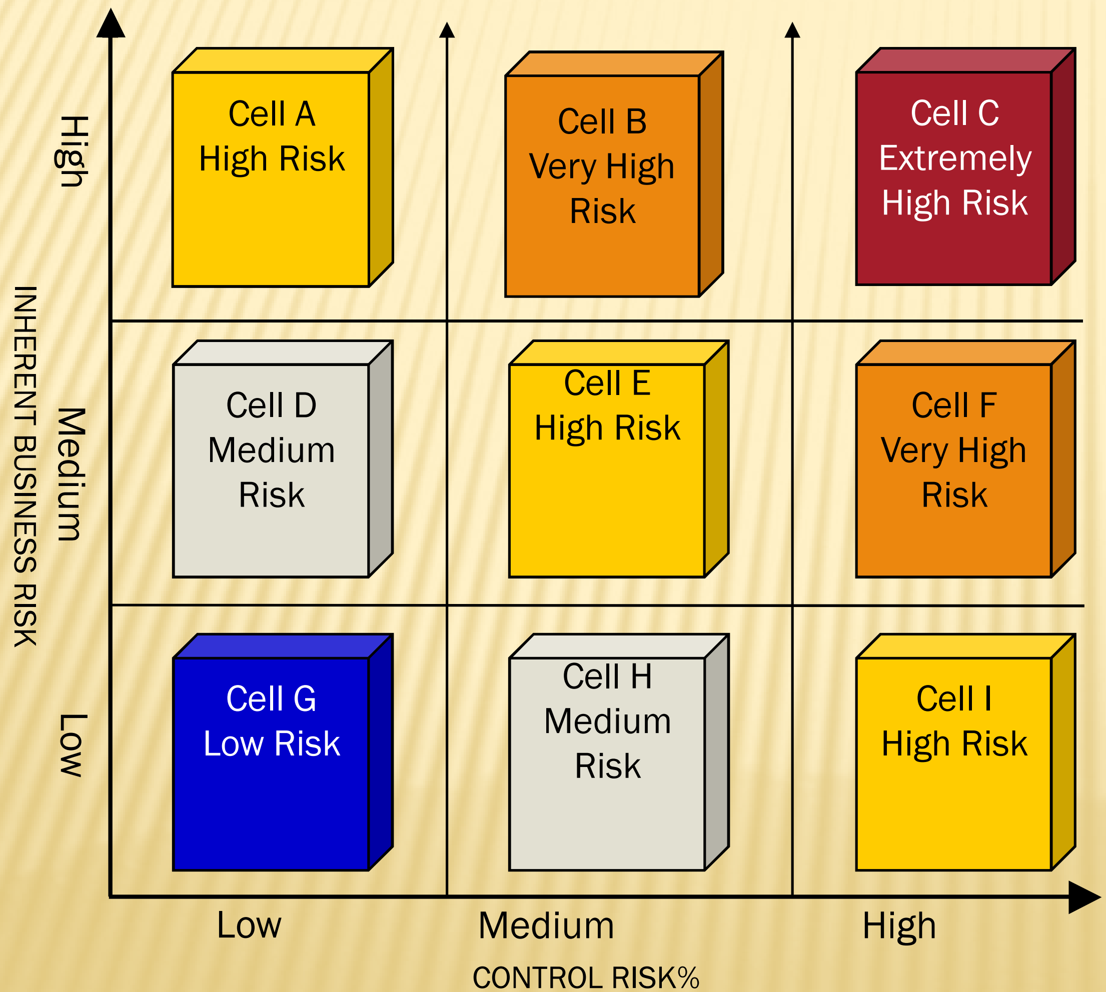
- **Inherent Business risk** for each audit entity can be identified on the basis of:
  - Operational risk
  - Credit risk
  - Market risk
  - Information Technology risk
  - Legal and Compliance risk
  - Reputational risk
- Objective scoring (1to10) or subjective scoring (High/Medium/Low) can be done

RBI GUIDANCE ON RISK BASED INTERNAL AUDIT

- **Control risk** for each audit entity can be assessed on the basis of:
  - Previous audit scores
  - Significant change in management / key personnel
  - Results of latest regulatory examination report
  - Reports of external auditors
  - Industry trends and other environmental factors
  - Time lapsed since last audit
  - Volume of business and complexity of activities
  - Substantial performance variations from the budget
- Again qualitative or quantitative scoring can be done.

RBI GUIDANCE ON RISK BASED INTERNAL AUDIT

Frequency of audits



Cell	Frequency of Audits
C	Twice in a year
B,F	Once in a year
A,E,I	Once in 18 months
D,H	Once in 2 years
G	Once in 3 years

BASEL COMMITTEE ON BANKING SUPERVISION

- The Bank for International Settlements (BIS) is an international organization of central banks.
- Basel Committee on Banking Supervision (BCBS) is a sub committee of BIS which formulates rules on Capital Adequacy
- Since 2009 central bankers of G-20 major economies and few other major banking locales like HK and Singapore are members of BCBS committee.
- The committee does not have the authority to enforce recommendations
- The recommendations are enforced through national laws and regulations
- Regulators of the respective countries are responsible for implementation like RBI in India, FSA in UK, OSFI in Canada

BASEL COMMITTEE ON BANKING SUPERVISION

- Released a consultative document on **“The internal audit function in banks”** in December 2011
- The document talks about 20 principles with respect to Bank IA function and its Supervisor. Can be categorized as:
  - Principles relating to the **supervisory expectations** relevant to the internal audit function
  - Principle relating to the **relationship of the supervisory authority** with the internal audit function
  - Principles relating to the **supervisory assessment** of the internal audit function

BASEL COMMITTEE ON BANKING SUPERVISION

- Principles relating to the **supervisory expectations** relevant to the internal audit function:
  - Independently and objectively evaluates the quality and effectiveness of a bank's internal control, risk management and governance processes
  - Independent of the audited activities
  - Professional competence,
  - Should act with integrity
  - Bank should have an internal audit charter that articulates the purpose, standing and authority
  - Each bank should have a permanent internal audit function.

BASEL COMMITTEE ON BANKING SUPERVISION

- Principles relating to the **supervisory expectations** relevant to the internal audit function:
  - Every activity and every entity of the bank should fall within the overall scope
  - Internal audit should both complement and assess operational management, risk management, compliance and other control functions.
  - The IA function should report to the audit committee or the board of directors and should inform senior management about its findings
  - The internal audit function in a group structure or holding company structure should be established centrally by the parent bank.

BASEL COMMITTEE ON BANKING SUPERVISION

- Principle relating to the **relationship of the supervisory authority** with the internal audit function:
  - Supervisors should have regular communication with the bank’s internal auditors to

    (i) discuss the risk areas identified by both parties,

    (ii) understand the risk mitigation measures taken by the bank, and

    (iii) monitor the bank’s response to weaknesses Identified.

BASEL COMMITTEE ON BANKING SUPERVISION

- Principles relating to the **Supervisory assessment** of the internal audit function
  - Supervisors should regularly assess whether the IA function has an appropriate standing within the bank and operates according to sound principles.
  - Supervisors should formally report all weaknesses identified in the IA function to the board of directors
  - Supervisory authority should consider the impact of its assessment of the IA function on the bank's risk profile and on its own supervisory work.
  - Supervisory authority should take informal or formal supervisory actions requiring the board to remedy any identified deficiencies related to the IA function within a specified timeframe

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FUNCTIONS IN THE BANK

- Structure of a Bank – Typical business groups:
  - Retail Branch Banking
  - Retail Assets business
  - Wholesale Banking
  - Information system
  - Treasury
  - Corporate centre

STRUCTURE OF A BANK

- Retail Branch Banking
  - Typical mass-market banking in which individual customers use local branches of larger commercial banks.
  - Services offered include savings accounts, current accounts, customer service point, Foreign exchange services, locker facilities, ATMs etc.
- Key areas for Internal Audit
  - Customer responsiveness of the branch
  - Inter branch reconciliations
  - Suspense accounts
  - Know your customer norms
  - Cash handling

STRUCTURE OF A BANK

- Retail Asset business
- Lending business where banks lend money to the individual
- Secured loans
  - Auto and Two wheeler loans
  - Home loans
  - Commercial vehicles
  - Loan against deposits
- Unsecured loans
  - Personal loans
  - Credit cards
  - Consumer loans

STRUCTURE OF A BANK

- Retail Asset business
- Agri business
  - Jewel loans
  - Farm Equipment
  - Retail warehouse receipt funding
- Key areas of Internal Audit
  - Loan origination
  - Product and policy design
  - Credit decisioning
  - Documentation (including KYC)
  - Monitoring of Post Disbursal Documents (PDD’s)
  - Delinquency, fraud and Portfolio analysis, etc.
  - Functionalities involved in credit decisioning

STRUCTURE OF A BANK

- Wholesale Banking
  - Infrastructure and manufacturing, project finance,
  - Loan & bond syndication,
  - Capital markets activity, domestic & international trade finance
  - balance-sheet based working capital financing
  - Medium & small enterprises
  - Letter of credits and Bank Guarantees to the corporate

- Key areas of Internal Audit
  - Pre-sanction processes
  - Sanction processes
  - Credit evaluation processes
  - Documentation
  - Post-sanction processes

STRUCTURE OF A BANK

- Information System
  - Channels (ATM , Internet Banking, Mobile Banking, Phone Banking)
  - IT platforms (Operating System, Database, Web Servers and Networking/Security Architecture including the supporting IT Utilities)
  - Business Technology (Core systems)

- Key Areas of Internal Audit
  - IT infrastructure - data centre, network, e-mail, Information Security Architecture
  - User Management, Change Management, IT acquisitions and project management and IT Service management

STRUCTURE OF A BANK

- Treasury
  - Pivotal role in management of bank's funds for the purpose of Balance Sheet management, Hedging and Trading
  - Responsible for managing the currency, liquidity, interest and exchange rate risk of the bank
- Following is the structure of bank's treasury:
  - Front Office (Dealing desk) - The dealers and traders operate in their respective areas. First point of interface with other participants in the market.
  - Bank Office (Settlement desk) - Process and settle the deals
  - Middle Office (Accounting, monitoring and reporting) - record all deals in the books of accounts, closely monitor all deals and transactions done by the front and send regular reports to authorities concerned

STRUCTURE OF A BANK

- Treasury
- Key Areas of Internal Audit
  - Policies for all treasury activity
  - Organization structure
  - Deal execution process
  - Limit monitoring
  - Control over documentation and accounting
  - Risk management
  - Compliance to various guidelines by the regulator

STRUCTURE OF A BANK

- Corporate Centre
  - Infrastructure Management & Administration Group (IMAG)
  - Human Resource Management Group (HRMG)
  - Legal and Compliance Group
  - Secretarial Group
  - Customer Service Group
  - Accounting and Taxation group
  - Risk management Group

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WHAT WE DO DIFFERENT

- Risk Based Audit Approach
- Establish Risk Based Audit plans
  - Conduct risk assessments
  - Consider input from relevant stake holders
  - Identify focus areas for the year
  - Identify high risk/concern areas
- Mid year reviews
  - Adequacy of risk based audit plans on account of changes in
    - Business strategy
    - Impact of changes in control environment
    - External factors
    - Trend and direction of risk
    - Emerging risks

WHAT WE DO DIFFERENT

- Integration with risk management
- Correlation of IA risk assessment process with risk appetite of the organisation
- Discussion with RMG – consider input while preparing the plans
- Assurance on the risk management framework
  - Risk management process
  - Correct identification and evaluation of risks
  - Reporting of key risks
  - Management of key risks
  - Advanced approaches

WHAT WE DO DIFFERENT

- Reporting of audit findings
  - Acceptance of issue, corrective measures/timelines
  - Identify root cause (people/process/technology)
  - (Sub categoise root cause amongst 'lack of clarity in process', 'lack of training', 'genuine error' or 'intent'.
- Grade audit findings based on likelyhood/impact on the basis of Financial, Reputational, Regulatory parameters
- Audit opinion to each audit report as ‘Satisfactory’, ‘Needs Improvement’ and ‘Inadequate’

WHAT WE DO DIFFERENT

- Quality assurance
  - Quality assurance reviews conducted by the external agency
  - Once in 3 years
- Annual internal self assessments
- Fulfillment of audit charter requirements
- Annual GAINs (Global Audit Information Network) Benchmarking

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FUTURE TRENDS

- BASEL II
- Applicable in India since March 31, 2008
- Requires bank to maintain minimum capital ratio
- Works on the principles of sound risk management
- Has three pillars of risk management
- Capital to Risk Adjusted Asset ratio (CRAR) is computed

- Total CRAR = $\dfrac{\text{Tier I Capital} + \text{Tier II Capital}}{\text{Credit RWA} + \text{Market RWA} + \text{Operational RWA}}$

- Minimum CRAR ratio is to be maintained at 9%

FUTURE TRENDS

- BASEL II

First Pillar

Minimum Capital Requirements - Minimum capital requirements for 3 types of risks faced by a bank- credit risk, market risk and operational risk

Second Pilla

Internal Capital Adequacy Assessment (ICAAP) document is prepared by the Banks. It provides a framework for dealing with stressed scenarios and other risks faced by a bank.

Third Pillar

Market Discipline - relates to the disclosures banks are required to make depending on the methodologies used to enable the market to better assess their risk profiles

FUTURE TRENDS

- BASEL II

Approach	Credit RWA	Market RWA	Operational RWA
Base	Standardised Approach	Standardised Measurment Model (SMM)	Basic Indicator Approach (BIA)
Advanced	Internal Rating Based (IRB) approach - Foundation IRB - Advanced IRB	Internal Models Approach (IMA)	The Standardised Approach (TSA) Advanced Measurment Approach (AMA)

FUTURE TRENDS

- Changing regulatory expectations
- AMA circular for operational risk by RBI
- Demands written confirmation from the executive officer responsible for internal audit of the bank to state that -
  - The auditors agree with the confirmation by the executive officer responsible for operational risk management; and
  - the bank has conducted an internal and/or external validation and has ascertained that it has the systems, processes and controls necessary for adopting
- The Audit Committee to ensure that the internal auditors are adequately qualified and trained to assume oversight responsibilities of the internal validation process
- In due course, the bank should endeavor to equip its internal audit function with necessary skills to perform the internal audit independently

FUTURE TRENDS

- Changing regulatory expectations
- IMA circular for Market risk states that:
- In view of the **overarching responsibility** and scope of the work of internal audit function it would be necessary for a bank to ensure that this function is staffed with personnel possessing the required qualifications, skills and experience. IAD should at minimum certify:
  - Adequacy of the documentation
  - Approval process for risk pricing models and valuation systems used by front and back-office personnel
  - Consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources
  - The accuracy and appropriateness of volatility and correlation assumptions

FUTURE TRENDS

- Internal Audit reports are required at the time of application, for the Advance models of capital computation, to RBI
- The increasing demand from the capital adequacy circulars to audit all the models before submission
- Demand to perform audits on an annual basis
- Expectation from IAD to express opinions on the adequacy and efficiency of the processes and policies
- Expectation to build in house expertise in the area of risk management
- The Audit Committee and the Bank management are expected to review the efficiency of the IAD that whether an audit can be performed by it

FUTURE TRENDS

- BASEL III
- Applicable in India from April 1, 2013
- New capital requirements
  - More focus on minimum common equity capital Tier I ratio
- Capital conservation buffer
  - Build capital buffer during normal times which can be drawn down as losses incurred during a stress period
  - Aim is to avoid breaches of minimum capital requirements
- Counter-cyclical buffer
  - To protect banking sector
  - Each jurisdiction is given discretion to set counter-cyclical buffer

FUTURE TRENDS

- BASEL III
- Leverage ratio
  - To protect from excessive build of on and off-balance sheet leverage
- Liquidity ratio
  - To maintain high quality liquid assets
  - To maintain liquidity coverage ration and net stable funding ratio

THANKS