Commercial Bank Audit– Need For A Multidimensional Approach With Focus on Disclosure Requirement Under Basel Accord II

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Audit traditionally implies transaction audit i.e. verification of accounts based on accounting transaction flows over a specified period of time which is generally a period of 12 months. The utility of such transaction audit will remain beyond any doubt for all times to come – be it for a trading/non trading concern or a commercial bank. But as banks deal in money, and money alone, which has been and which will continue to be the main attraction, the traditional transaction audit system in commercial banks needs to be revisited with the changing order of time– more so in the new risk management regime arising out of Basel Accord II that has been planned to be implemented across the world by the year 2007. Risk- based audit system is going to be the order of the day. This article comprehensively focuses on this concept.

Commercial Banking business across most of the countries has witnessed major changes since 1970's. Earlier on, it was believed that commercial banks were only there to mobilise funds from "Surplus Units" (Savers) and deploy the funds so mobilised to the 'deficient units' (those requiring funds for productive/approved purposes) and, thus, were to perform only intermediary role. However, since 1970's commercial banks started embracing changes in the economic cycles all around. It was gradually felt that mere deposit-taking and on lending function can no longer be the survival kit. They were required to transform themselves into a multi faceted financial services business and to that extent were to enter into new vistas of remunerative businesses, investment banking, treasury functions, project consultancy services, executor – executrix business and even altogether new area of insurance business.

As a result of this dimensional change in banking business the age-old view of risk-reward started gaining prominence– banks geared themselves up to reap higher revenue/profit, and alongside, the threats of new breed of risks occupied center stage. Transactional audit has its virtues for audit of commercial banking business but it has, over a period of time, has proved to be inadequate mainly in view of the following:

- Transaction Audit vouches existence or otherwise of specific accounting flows in the business and has hardly any concern for the propriety of such transactions from the angle of the well-being of the banks.
- Transaction audit in banks does not provide real comforts to the stakeholders– depositors, shareholders and employees as to the long-term solvency in the light of business risks in place with any bank. Accounting profit on accrual system on annualised basis may at best be of short-term shine. History of commercial banking is replete with cases that short-term profits evaporate overnight if a particular bank overshoots in the assumption of larger risks in uncharted areas for the sake of higher order revenue/profit.
- Transaction audit does not have risk assessment perspective. It does not have the scope of analysing risk characteristics of various banking business segment – it is primarily concerned with True and Fair view of the state of affairs of a bank as on a particular date.
- Treasury income flows of commercial banks in India have significantly grown over the years. Asset Liabil-

ity Management (ALM) is the kingpin of such treasury income. But transaction audit does not take an integrated view of a Bank's ALM function. So long as the accounting inflows/outflows are backed by verifiable and duly authenticated records/ documents, transaction audit is deemed to have completed its course.

- Probability of loss due to inadequate system, process, procedure or legal issues is not in the domain area of transaction audit though the aforesaid aspects are very important from the point of view of a bank's overall business.

The aforesaid inadequacies in general have given rise to the emerging concept of an all inclusive bank audit known as Risk-Based Audit together with continuing with transaction audit, which remains to be vital for forming true and fair view of the banks.

What Will Be Achieved By Risk Based Audit System?

Banking risk is different from a normal trading/business risk. It is true that any risk involves probability of loss expected as well as unexpected and in that context auditing function cannot, and should not be different. But it is also equally true that banking being a financial services business, often for reasons beyond any imagination/ perception, losses can come over to the institution (e.g. losses suffered by some banks in various countries on account of recent Tsunami outbreak) and there lies the question of the emerging concept of risk based audit. This, however, does not mean that a clearance from risk based audit angle is an all time 'certificate of merit' because risk ingredient in any business is not a stable element. It is ever changing in content, shape, structure process and, above all, timing aspect.

Risk-based audit mechanism is the outcome of a variety of risk a bank faces in the contemporary banking environment. Basel Committee on Banking Risk Managements, for the first time in the year 1988, identified only one group of risks in commercial banking, credit risk to be precise. Arising out of the exercise by the Committee, Basel Accord (now known as Accord I) came into being in 1988 with a simple 12- page document. Therefore, Credit Risk since then became the banking talk Worldwide.

Functionally, Basel Accord I prescribed risk weights for assets (mainly credit assets) e.g. 100% risk weight for loans and advances not covered by Government. guarantee/cash collateral and minimum 8% thereof (in India minimum 9%) is required to be held in the form of capital base as net owned fund (Capital + Reserves) of the bank. Furthermore, off Balance Sheet items such as Letter of Credit, Guarantee, etc. were also brought within the framework of risk weights as laid down for holding capital base of 9%.

It will appear that a mechanical application of stipulated risk weight (one size fits all approach) and computation of minimum level of capital base does not demand any professional audit regime. The computers are good enough to do the job.

On a follow up of vistas of new risks facing banks world over from the beginning of 90's, especially in the area of investment and market risk exposures, Basel Committee came out with a set of further guidelines for market risk exposures in the year 1996 as addendum to Accord I as above. Those guidelines were additive in the sense that additional risk weights were stipulated for market risk exposures over and above credit risk.

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Now, on a combined view of credit risk weight and market risk weight, the question of introduction a professional risk audit system again did not merit consideration.

But as the adage goes "change is the only constant aspect in life/business/society," Basel Committee kept a watch on the operations of Banks– especially internationally active commercial banks in various countries. Surprisingly, in mid 1997 Asian Crisis (fraudulent banking operations) came to the surface proving that mere focus on credit risk and market risk exposures in bank was not enough to insulate banking system from the multitude of risks. This caught the attention

of International Authorities towards the need of a thorough overhaul of risk management system in commercial banking. As a result, Basel Accord II (Accord) was born on 24.6.04 after series of discussions/negotiations at Basel Committee in Switzerland over 8-9 years. This accord may be viewed in short hereunder as a forerunner to the possible role of the proposed risk based audit system:

- Basel Accord II has encapsulated all commercial banking risks into three risk categories:
  - i. Credit Risk
  - ii. Market Risk
  - iii. Operational Risk (which includes legal risk but does not include strategic and reputational risk)

Three pillars form the core of the Accord:

a) Pillar One: Minimum Capital requirement of 8% of Risk Weight Exposures – (in India minimum being 9%).

b) Pillar Two: Supervisory review process (of banks' minimum capital holding, risk management architecture, etc.)

c) Pillar Three: Market discipline (transparency & disclosure). Each bank is to make periodical disclosure of its capital base, Risk Weighted Exposures, etc.

The print media is the most appropriate mode to make disclosures. However, it is left for each bank to decide on the exact mode as it suits its major operational area.

For Credit Risk Assessment, risk rating of borrowal accounts with appropriate granularity must be made by each bank by following one of the prescribed methodology (standardised approach, IRB approach etc.) and accordingly, economic capital level is to be set up. For market-risk assessment also a similar methodology suiting market risk exposure assessment is to be made.

- Most interestingly, the Accord has conceived a new gamut of banking risk christened as "Operational Risk". Failure of system, process, procedure and human action/ inaction (fraud) and legal restrictions, etc. in the operation of banks is also need to be subjected to capital back up. In this respect, out of the three approaches – Basic indicator approach is most convenient in terms of which a bank is to maintain specified minimum Capital level tacking into its past average earnings of 3 years.
- The Accord (together with 1996 guidelines on market risk) has laid down sound principles of Credit Risk Management, Market Risk Management, (with special focus on interest rate risk management) and Operational Risk Management.

In the above-mentioned background, if we consider Basel Accord Guidelines as fundamental truth of maintaining a sound, robust and healthy banking system, it is absolutely necessary that 'nuts and bolts' of the directives as applicable to any bank must be appropriately fixed, monitored and rectified when necessary. This, therefore, demands a different ball game in the auditing architecture of commercial banks.

Under the intended risk-based audit system, however, it is not suggested that periodical transaction audit as prevailing now should be dismantled totally. But it would be appropriate that professional risk-based auditing should be placed at the center-stage and to that extent the complete dependence on transaction audit, as at present, would stand suitably softened. But both must exist in the larger interest of the stakeholders.

Risk-based professional audit activity may, therefore, be viewed in the following context:

(i) Each activity of a bank must be looked at with a special lens of risk assumption versus reward for the long-term solvency of the institution. Appropriate categorisation as High Risk, Medium Risk, Low Risk, etc. is to be made.

(ii) Each bank must have an appropriate risk management architecture, managed by professionally qualified/experienced officials and their periodic risk assessment reports should be the basis of specific risk based audit.

(iii) Besides suggesting for holding of needed capital base vis-à-vis risks assumed on an ongoing basis, such risk-based audit system should also suggest remedial measures for management action.

Should Disclosure Audit be a part of Risk-Based Audit?

Disclosure requirements have been for the first time prescribed

Following are the main types of disclosures as prescribed under the Accord:	
Qualitative Disclosures	**Quantitative Disclosures**
1. On Capital Level/Capital Adequacy ● Overall information on main features of Capital instruments especially hybrid capital instrument. ● Bank's overall approach of assessing Capital levels to support current/future activities.	● Bifurcation of Tier I & Tier II Capital Levels ● Amount of Capital required for each risk class i.e. Credit Risk, Market Risk and Operational Risk ● Indication of specific approach adopted for assessing Capital requirements for each risk class.
2. On Credit Risk: ● General disclosures on credit risk covering bank's credit risk management policy, definition of past due and impaired exposures. ● Approaches followed for specific and general allowances etc. ● Collateral valuation together with description of main type of collateral. ● Information on Credit Risk Concentration per party/group	● Geographic description of exposures with break up of major credit exposures. ● Industry or counter party distribution of exposure together with break up of past due amount (NPA) ● Amount of eligible collateral after providing for necessary haircut (margin).
Incidentally, Reserve Bank of India on 10th November 2005 issued guidelines to commercial banks in regard to disclosure requirements for borrowal accounts under Corporate Debt Restructuring (CDR) System. They have directed that Banks must make following disclosures annually: (a) Total number of accounts, total amounts of loan assets and the amount of sacrifice in the restructuring cases under CDR. (b) The number, amount and sacrifice in standard assets subjected to CDR. (c) The number, amount and sacrifice in sub-standard assets subjected to CDR. (d) The number, amount and sacrifice in doubtful assets subjected to CDR. *(The Accord has not prescribed the exact periodicity of disclosure requirement)*	
3. On Market Risk: General qualitative disclosure including the portfolios covered standardised approach. ● Characteristics of models used for each portfolio – methodology of stress testing	● Bifurcation of Capital requirements for each market risk components i.e. Interest Rate Risk, Foreign Exchange risk, etc. ● High, mean and low VAR values for trading portfolio, etc.
4. On Operational Risk: ● Specific approach followed for assessment of operational risk exposure capital requirements.	● Amount of operational risk exposures as assessed and Capital holding for the same.

under Basel Accord II. To examine the issue of any disclosure audit, it may be necessary to have a bird's eye view of the Accord guidelines on disclosures:

The Accord provides that for each of three risk categories– Credit Risk, Market Risk and Operational Risk in addition to the basic parameters on Capital adequacy, two sets of disclosures — Qualitative Disclosures and Quantitative Disclosures, be made by banks to the members of the Public as frequently as possible and the minimum expected frequency in this regard may be once in a year.

The print media is the most appropriate mode to make disclosures. However, it is left for each bank to decide on the exact mode as it suits its major operational area. The spirit behind the disclosure requirements can be summed up *inter alia*, as under:

- Members of the public including the stakeholders have right to information of risks being faced in each bank and safeguard system in place.

- Disclosures system will put constant pressure on the banks to ensure that they assume risks within their risk-bearing abilities and risk philosophy of the bank.
- It would involve a process of sensitising Senior Management and staff at each level on the accountability aspects in their respective assignments.
- Disclosure requirements provide a 'Chinese Wall' in each bank risk management limits/architecture.

There may be two sets of opinions on auditing of disclosures.

First Opinion: This should be an integrated part of risk-based audit since disclosures would be in relation to a bank's risk exposures.

Second Opinion: This should be a special periodical audit with total focus of a bank's transparency and disclosure initiatives and need not be mixed up with any risk-based audit system.

On a balanced analysis, it may be considered that since disclosure audit is to solely cover risk-exposures which are otherwise subject of study of risk-based audit, it may very well be combined with risk-based audit for the sake of uniformity and speed without compromising on the quality of such audit. However, large banks like State Bank of India and other leading Public Sector Banks besides ICICI Bank and HDFC Bank may like to prefer separate disclosure audit as part of broad-basing their risk-management initiative.

Who Should Undertake Risk-Based Audit

Risk-Based Auditing Function is a special professional activity. Therefore, a senior practicing Chartered Accountants (those in practice for at least 5 years) should, for the present, be entrusted with such audit till such time the activity is further streamlined and stabilised in Indian commercial banking environment. It may be advisable not to undertake this audit in-house in banks to avoid the possibility of conflict of interest and to ensure that objectivity is maintained. However, Banks' Internal Risk Management Departments must review their bank's overall risk position and apprise Board of Directors/Senior Management Periodically.

Indian Commercial Banking– Preparedness Towards External Risk Based Audit

It is commendable that Reserve Bank of India has a very good mechanism of Commercial bank monitoring and control through 'on site and off site' surveillance. In view of the stringent requirements of the RBI, a large number of banks keep facing audit/inspection, besides of course prevailing quarterly/half yearly/annual statutory review/audit as also in case of large branches/offices existence of Concurrent Audit System. As a consequence, banks are generally under enormous pressure of meeting the requirements of audit/inspection, day in and day out. In this scenario, enhancing the dimension of audit through risk-based audit may not be taken well by the banks. But necessity knows no law.

Risk in banking exposure should surely be viewed against reward for the activity but mere profit motive, as a short-term objective, is not an advisable path to follow.

Risk-based audit in commercial banks by practicing senior Chartered Accountants has to be a reality for such a system if adopted. Following suggestions may be considered to ensure utility and effectiveness of such an audit: -

1) Only outside senior Chartered Accountants be entrusted with such audit. Each bank's board of directors may be empowered to decide about such appointment without the need of any prior approval from RBI.
2) The audit may preferably be undertaken soon after bank's annual statutory transaction audit is over
3) The audit should generally be completed within a period of seven working days.
4) Frequency of the audit: Once in a year or more frequently if so deemed necessary by any bank.
5) Gist of report of Risk based audits should be placed in Public domain preferably simultaneously with Statutory Annual Audit Report to the extent considered appropriate.
6) For the sake of uniformity, RBI may design a format of risk-based audit report in consultation with the Institute of Chartered Accountants of India.
7) Within a month or two of the receipt of any risk-based audit report, the concerned bank must place its response to its board of directors for approval/direction.
8) In the Internal Training Programme of each bank, the parameters considered for risk-based audit should be deliberated upon so that the participants are geared up to meet the requirements of risk-based audit promptly and effectively.

Conclusion

Risk-Based Audit System in commercial banks through external Senior Chartered Accountants may serve many purposes so far as enterprise-wide risk evaluation is concerned. The Accord is the pace-setter and appropriate enabler in the process. The Accord's spirit demands that in each country, commercial banking risk is to be viewed in totality and full capital base (both regulatory capital and economic capital) should be held for risk exposures duly risk weighted.

Risk in banking exposure should surely be viewed against reward for the activity but mere profit motive, as a short-term objective, is not an advisable path to follow. Long-term solvency and profitability of each bank must be the driver in the contemporary banking environment. Both 'Risk-Aversion' and 'Risk-Perversion', must be avoided. Transaction Audit, as compared to risk-based audit, continues to have its role in value enabling the authorities to assess a bank from true and fair view angle. But risk-based audit is required to scan a bank's performance from the angle of three specified dimensional risks – Credit Risks, Market Basic and Operational Risk. In that respect, risk-based audit may appear to be akin to management audit as well.

Risk-based auditing process, like any other financial audit, should not be construed as the 'end of the tunnel'. Most importantly, action/initiatives taken by the management on the deficiencies that may come to light in the wake of any risk-based audit report would have to be highly focused. Holding out stakeholder interests is the prime concern and risk-based audit is intended to serve this objective in the new world order of risk management in commercial banking. ❐