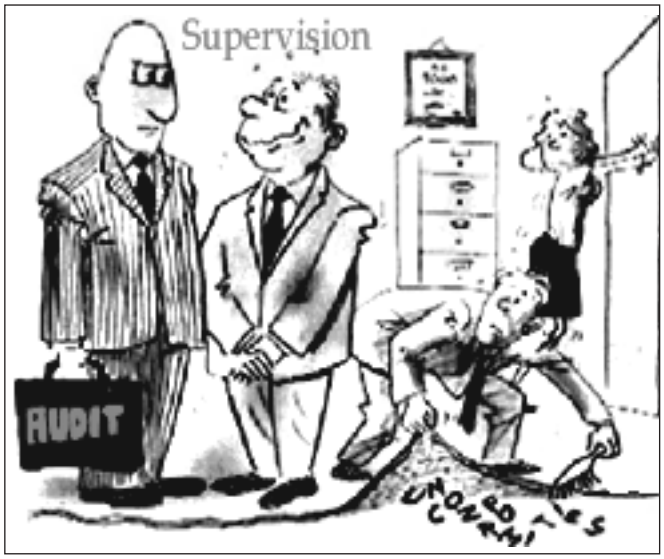
Banking is the locomotive that drives nation's economy and so the effectiveness of bank supervision is a public concern. The key supervisory objectives are protection of depositors and safeguarding integrity and soundness of the financial system. The Risk Based Supervision has evolved out of on-going supervisory pursuit to address the issues that were unanswered in traditional method of supervision.



Risk-based Supervision and Risk-focused Audit in Banks

R.S. Raghavan

Risk is inherent in any walk of life and more so in the business of banking as the fundamental economic function of a banking organization is to assume and manage risk.

The Reserve Bank of India (RBI) has been mandated with the task of overseeing the banks in the performance of its duties enshrined u/s 22 of Banking Regulations Act, 1949. When it comes to exercising control and supervision of banks, the RBI has its supervisory mechanism by way of on-site inspection and off-site monitoring (OSMOS) on the basis of the audited balance sheet of a bank, year after year and under CAMELS approach (Capital adequacy, Asset quality, Management aspects, Earnings, Liquidity and System controls), it primarily covers scrutiny of systems and procedures in the indicated areas.

In order to enhance the supervisory mechanism, the RBI decided to put in place a system of Risk Based Supervision (RBS). The RBS may be defined as a process by which the risk facing each supervised entity is analysed and an appropriate supervisory strategy is developed. Under the RBS, which is gaining ground now, supervisors are expected to concentrate their efforts and optimize their resources to ensure that Financial Institutions, more particularly banks, use the process necessarily to identify, measure and control risk exposure. The system is formulated to ensure continuous monitoring and evaluation of risk profile of banks, in relation to business strategy and exposure through self-assessment process by means of risk matrix, followed by final assessment by RBI. The supervisory cycle would vary depending on the risk profile of each bank under the broad view of higher the risk, more the frequency for supervisory exercise. Reduced supervisory scrutiny may include infrequent examination and minimal or no transaction testing. Thus, RBI would customize their supervisory programmes.

In the post-Basel II environment, the Risk-Focused Audit (RFA) would be an additional tool of assessment, as it would be the basic mechanism to judge performance in risk management area and to convince RBI that the bank has a risk management system that functions effectively. The onus would be on the banks' part to convince that RFA system is sound and the off-site data is quite reliable.

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The RBS is expected to focus supervisory attention in accordance with the Risk Profile of the bank. The RBI has already structured the Risk Profile Templates to enable the bank to make a self-assessment of their risk. It is designed to ensure continuous monitoring and evaluation of risk profile of the institution through risk matrix. This, apart from optimizing the utilization of the supervisory resources of the RBI, may also minimize the impact of a crises situation in the financial system.

The transaction based audit and supervision is slated to, slowly and steadily, graduate to risk focused audit. The institutional mechanism set up to attend to the requirements of RBS should be kept separate and distinct from the institutional mechanism attending to risk management functions.

The supervisory programme would be tailored to banks focusing on high-risk areas and specifying the need for further scrutiny in the identified problem areas. It would comprise off-site surveillance, structured meeting with the banks, commissioning of external audits and issuance of supervisory directions through Monitorable Action Points **(MAP)**. The Risk Profile would highlight the strengths and weakness or vulnerabilities of the Bank so as to provide proper foundation to determine the procedures to be adopted during the inspection. The quarterly up-dated Risk Profile document of the Bank would be a subject matter for deliberations and discussions at the Board of Directors or suitable sub-committee of the Board, as the case may be.

Risk Profile Template

It is mandatory for the banks to set up robust risk management architecture to take care of various risks that run through the functional activities. This would obviously necessitate the banks to carry out a fresh review of their current status of risk management architecture, by an expert team and initiate measures to bridge or fill up the gaps, steadily.

As part of moving towards switching over to RBS, the RBI has advised banks to carryout self-assessment of risk profiling exercise in a structured and comprehensive manner. In order to facilitate smooth transition to RBS as well as ensuring uniformity in the approach among banks, the RBI has come out with a set of standardized Risk Profile Template **(RPT)**. Compilation of risk profile in respect of each bank is the central plank of RBS. Banks are required to document their Risk Profile, containing various kinds of financial and non-financial risks faced by the Bank. These are grouped under Business Risk, containing 8 risk parameters and Control Risk containing 4 risk parameters, in all comprising 12 areas for capturing entire gamut of the banking activities. Business Risks are those risks that are considered inherent in the activities undertaken by a bank irrespective of whether controls are in place, where as Control Risks enables to arrive at proper judgment as to whether adequate controls are in place. The RPT comprises detailed components of various parameters that are to be examined while carrying out the exercise.

Under the Risk Based Supervision mechanism of RBI, supervisors are expected to concentrate their efforts and optimize their resources to ensure that FIs, particularly banks, use the process necessarily to identify, measure and control risk exposure.

As RBI would structure their inspection programme based on the risk profile document, it is imperative that both the qualitative and quantitative details are correctly drawn as input to the RPT. This Risk Profile document is required to be scrutinized by the Quality Assurance Team, consisting of Top and Senior Management executives representing major business as well as control areas of the Bank, constituted for the specific purpose for an independent evaluation of risk assessment of the bank.

The Risk Profile Template consists of three parts, viz Overview of the Bank, Summary Risk Profile and Risk Assessment areas. In respect of the identified 12 risk assessment areas, the RPT should conclude with assessment indicating the level of risk in which the bank is in and the direction of movement of risk. The level of risk is indicated as Low, Moderate & High and the direction as Decreasing, Stable & Increasing. The assessment areas to be covered in the RPT are as follows:

(A) Assessment of Business Risks

- Capital
- Credit Risk
- Market Risk other than Liquidity Risk
- Earnings
- Liquidity Risk
- Business Strategy & Environment Risk
- Operational Risk
- Group Risk

(B) Assessment of Control Risks

- Internal Control Risk
- Organisation Risk
- Management Risk
- Compliance Risk

On summarizing the Risk Assessment Templates, under the umbrella of the Business Risks and Control Risks, encompassing all the 12 critical assessment areas, the issues requiring immediate corrective action with medium term objective are identified. This self-assessment exercise is perused by the RBI to enable them to chalk out plan for their supervisory action under the concept of Risk Based Supervision.

As the risk profile document is intended to be a dynamic one, all changes and developments within and outside the bank that may have an impact on the risk profile, are to be tracked on an on-going and continuous basis. On the happening of certain significant developments in between two exercises, revision/update is also undertaken, when the situation warrants. It may be pertinent to note that while improvement in risk profile normally occur over a period of time, deterioration in the risk profile could occur suddenly or for that matter, in short span of time. Hence, it is desirable that review and updation of the risk profile will have to be carried out, at least, on a quarterly basis.

Risk-based Internal Audit

In tune with the objectives of RBS, banks should put in place a system of Risk Based Internal Audit **(RBIA)** so that inspecting officials would focus their attention accordingly. Internal Inspection/ Audit Department in banks will have to be made independent from the internal control process and be given an appropriate standing within the bank so as to carry out its assignments with objectivity and impartiality. The internal audit is expected to capture the application and effectiveness of risk management procedures as well as risk assessment methodology, in a larger way, covering critical evaluation of the adequacy and effectiveness of the internal control systems. Banks should move gradually from transaction-based auditing to risk- focused auditing by placing greater emphasis on the role of internal auditors and concurrent auditors.

Though transaction testing has served the system well till recently, it cannot keep pace with the continuous changes occurring in banks' risk profiles. It also imposes unnecessary regulatory burden on banks and forces them to devote precious resources to unproductive areas. In addition to the selective and random transaction based auditing, banks should move gradually towards risk focused auditing. The one-size fits all approach of transaction testing has increasingly been found to be insufficient and untenable in a world where banks dramatically vary in terms of size, business mix and risk appetite.

The Internal Audit, focusing on operational risk areas, is important in view of the following:

- Failures of many banks were the result of internal control problems.
- Operational risk is not generally measurable and is often pervading all through an entity on 24 X 7 basis, implying all the time.
- It reduces unexpected losses to improve profits.

Widening the range of tasks and activities the external auditors perform, RBI may use them as a supervisory tool and initiate dialogue with ICAI as well as bank management to chalk out methodologies and action plans.

In post-Basel II environment, the Risk-Focused Audit will be an additional tool of assessment, as it would be the basic mechanism to judge performance in risk management area and to convince RBI that the bank has a risk management system functioning effectively.

- Unlike credit risk & market risk, which follows typical Risk – Return relationship, operational risk results only in loss.
- Internal control is to accomplish Transaction testing, accuracy & reliability of accounting records, integrity of control reports and checking compliance to regulations.
- Operational risk arises from human or technological error and therefore has innumerable points to emanate.

Whereas, the purpose and utility of Risk Based Internal Audit is to ultimately enable banks to allocate capital for operational risk.

Risk Based Internal Audit should ensure that policies and procedures of the bank are complied with besides looking into the adequacy of these policies and procedures to ensure risk-optimisation. By prioritizing risk areas, RBIA should capture the application and effectiveness of risk management procedure and risk assessment system.

While ensuring Risk Based Internal Audit at the branches, it may be appropriate to keep the following in mind:

Branch Profile, covering volume of business, inspection rating, issues of serious concern covered in the synopsis, etc should be complied and branches are to be grouped into different categories. The risk profile of a branch should be complied after taking into account credit risk, market risk and operational risk covering the following aspects.

Credit Risk

- Extent of excess outstanding beyond 30 days in the account over and above limit/DP, on account of arrears in the interest/principal, TOD, devolved liability; 'Operative borrowal account' not put into active operation.
- Expired credit limit in the case of operative credit limits that are neither renewed nor extended by the competent authority. This is to be classified into three categories such as: (a) expired within three months ago, (b) expired beyond three months ago. The period is of importance, as expired limits of more than 90 days require different treatment of classification. Reference date is the risk based audit date.
- Exercise of Delegated powers at the branch for sanction and fixation of interest rate.
- Quality of credit appraisal for the sanction at the branch and the proposals recommended to higher authorities
- Increase in the Non-Performing Assets
- Industry/business sector-wise distribution of loan assets.

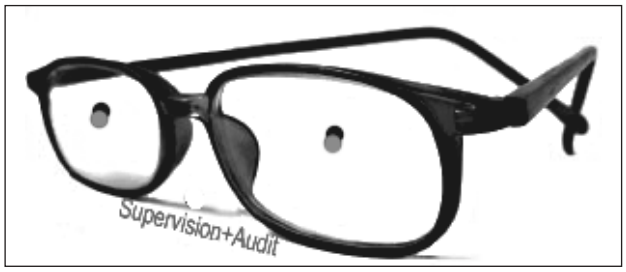
- Assessment of risk rating of borrowal accounts and its application.
- Violation of RBI guidelines on credit matters and Lending Policy as well as the Risk Management policies of the Bank.

Market Risk

- Composition of Deposits to be studied to find out whether there is any bulk deposits that are likely to expose the bank to liquidity risk.
- Deposit mix to be examined to ascertain substantial imbalance between long term and short term deposits; presence of low cost deposits, etc.
- Adherence to the ALCO, Market Risk Management & Country Risk Management policies of the Bank.

Operational Risk

- List out pending comments of RBI inspection/LFAR audit/internal inspection/concurrent audit/stock audit
- Serious defects in documentation regarding legal



enforceability as pointed out in the Legal Audit/inspection.

- Occurrence of Fraud and similar events
- Odd/special features observed in certain sensitive accounts.
- Violation observed in the procedures while entertaining a new customer - Deposit/Advance.
- Quantification of income leakage during the last three years.
- Compliance level of Operational Risk Management policy guidelines of the Bank by the field functionaries.

The above aspects can be covered under the following broad parameters in respect of the operations carried out during the risk-based audit.

Credit Management	Forex Risk
Credit Risk Management	Liquidity Risk
Operational Risk	Earnings Risk
Information Technology Risk	Control Risk
Business Strategy Risk	

Based on the above and other similar features, the Risk Profile of the branch is required to be structured to assess the Risk Level of the Branch, (Minimal Risk, Low Risk, Moderate Risk, Average Risk & High Risk) and in which direction (increase/ stable/ decrease) it is likely to move within a foreseeable time frame of maximum of six months, unless corrective measures are initiated.

Banks are required to evolve a policy document for the Risk Based Internal Audit, duly approved by the banks Board and formulate Branch Risk Profile Template for risk profiling and risk assessment of branches. Apart from the branches, the exercise should cover certain sensitive and functional departments like Treasury, Funds Transfer, International Banking, Inter-Branch Accounting, etc. There should be an Audit Plan for carrying out RBIA drawn in such a manner that over a specified period of time even Minimal Risk category branches will be subjected to RBIA.

To begin with, the concept of Risk Based Internal Audit may be introduced on pilot basis in select branches, where there is heterogeneous composition of business. Thereafter, banks may capture a large portion of the business of the Bank through a small number of branches. Under the RBIA approach, banks are expected to re-orient their prevailing system of inspection so as to evaluate adequacy and effectiveness of risk management systems and internal control procedures in the Bank. Till the RBIA is fully implemented across the banks, the existing system of internal inspection or internal audit may co-exist along RBIA. The RBIA would provide quality counsel to management on effectiveness of risk management and internal controls, including regulatory compliance. The focus is to mitigate various risks, instead of inspection/audit serving as a full-scale transaction testing at the branches/offices of Bank.

Monitoring Mechanism

Hitherto, RBI was monitoring their supervisory exercise annually after the closure of year-end financials of the bank under OSMOS. While the on-site examination is done through the Annual Financial Inspection **(AFI),** Off-site examination is done through the system of DSB returns. As the risk profile of each bank is different, now the monitoring needs would also differ based on the Risk Profile of each bank. Moving over to risk based supervision necessitates devising a policy for back up and storage of various databases at regular intervals. This should specify details like frequency of backups, media to be used, off-site storage areas, departments and officials responsible for these actions. In respect of specific databases, Data Managers should be made responsible. As accuracy & timeliness of data are very important, banks would have to ensure the same through up-gradation of Management Information System & Information Technology System, after review of the present

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status. Banks have to, therefore, initiate necessary measures to ensure that RBI data needs as well as reporting systems are streamlined.

The Prompt Corrective Action **(PCA)** framework contains mandatory and discretionary actions. Capital Adequacy Ratio is considered as a trigger point in the PCA framework. This coupled with Monitorable Action Plan would be a part of supervisory action. While banks with a better compliance record and risk management architecture & control system may be entitled with longer supervisory cycle as well as less supervisory intervention, banks which fail to show improvements in response to MAP may be subjected to more frequent supervisory scrutiny as well as higher supervisory intervention, consisting of directions, sanctions and levy of penalties.

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Compliance Unit

In order to coordinate various actions of the bank for compliance and for periodical reporting to RBI and to ensure completion of action within the time period indicated in the Monitorable Action Plan, banks should set-up compliance unit, which should be headed by a Chief Compliance Officer of the rank of not below General Manager who will be responsible and accountable for timeliness and accuracy of the compliance by the bank.

External Auditors

By widening the range of tasks and activities the external auditors perform, RBI may use the services of external auditors as a supervisory tool and initiate dialogue with the Institute of Chartered Accountants of India as well as bank management to chalk out the methodologies and action plan. Instead of duplicating the efforts of external and internal auditors, the supervisory process would seek to leverage the work done by the external agencies. One of the features of the RBS is the use of specialist third parties like external auditors as a supplement to the official oversight by supervisors.

Audit is normally a backward looking exercise as a going concern without an opinion on the future viability, whereas risk-based supervision is forward looking and talks about effectiveness of risk management systems. Though the focus of the external auditor and supervisor may be divergent, there concerns compliment each other. With quality external audit in place, the supervisor can think of doing away with detailed, often burdensome and invasive examination of banks. The communication of the auditors to the management is through Long Form Audit Report (LFAR) commenting on matters relating to loan portfolio, adequacy of internal controls, etc. The format of LFAR needs to be revised to suit risk-focused audit.

The changeover to RBS will not, obviously, be at one go, but in a gradual manner as the inadequacies in the risk management system in the bank are removed and set right.

Ideally speaking, an in-house Change Management Team is to be formed and institutionalized to monitor the progress of implementation and suggest ways and means to overcome the obstacles. Banks are now required to give a comprehensive quarterly report to RBI detailing the status of implementation of the process to move towards Risk Based Supervision, in addition to the progress on implementation of ALM & Risk Management systems in the Bank.

Conclusion

The basic objectives of bank supervision process are protection of depositors and safeguarding the integrity and soundness of the financial system. RBS has evolved out of the on-going supervisory pursuit to address the issues unanswered in the traditional method of supervision. Though cost of banking supervision is rather high due to very nature of operations of the bank spread to the nook and corner of the country, the cost of poor supervision may prove to be higher and riskier to the whole economy. Hence, it is imperative that Risk Based Supervision mechanism is put in place in the banks with all the vigour. ■