

Internal Audit: A Study of Role, Importance and Risk-based Approach in Indian Banks

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Abstract:

Indian banking system has known in the last year significant changes determined by the implementation of Basel II requirements and governance principles on one hand and assimilation of the Reserve Bank of India Directives for the banking sector on the other hand. The function of internal audit is new in the Indian banks, being implemented as a result of the new regulation established by the National Bank in the effort to align the Indian banking legislation to the international regulations and practice in the field. The dynamic banking environment in the internal audit has a defined and strengthened statute and role. In the new context – regulatory environment for banking system and professional requirements – internal audit become one of the most influential and value added function in the bank. The present paper presents the role of internal audit in the Indian banks and its major areas of interest.

Keywords: Banking Sector, Internal Audit, Value Added Function, Indian Banks

Introduction

The Indian banking sector registered important changes in the last years. These are reflecting in the new regulatory environment and the evolution of the key indicators for the banking sector.

The implementation of Basel III requirements demands a new approach of the banking business; a more important

attention is to be given to the management of the significant risks. Recent years have seen heightened concern and focus on risk management, and it became increasingly clear that a need exists for a robust framework to effectively identify, assess and manage risk.

The Reserve Bank of India has already ensured the implementation of the Basel III requirements in the banking regulations and it is in process to update the adequate means of prudential supervision, adjusting the reporting system for the banks, defining the guidance for the validation of the internal ratings models established by the banks. In brief, Basel implementation steps are as follows

1. Calculation of capital adequacy ratio
2. National discretion/approaches decided
3. Basel framework issued
4. Communication of the reserve bank with local banks and foreign banks for basel implementation methods
5. Improved supervisory framework
6. Validation of internal rating models
7. Validation modules

Potential impact of Basel accord

1. Improvement in risk management and credit approval practices
2. Alignment of regulatory and economic capital

3. Establishment of more rigorous bank supervision and broader disclosure
4. Cost reduction through organizational process improvement
5. Small changes in regulatory capital
6. Efficient capital allocation in the banking industry and the economy
7. No systematic disadvantage for large and small financial firms
8. Overall beneficial outcome for retail and SMEs
9. Enhanced Corporate Governance
10. Reinforcement of risk adjusted performance measurement and pricing. High costs for risk management and IT
11. Acceleration of consolidation trend in the banking sector
12. Improve/maintain credit rating
13. Economical capital savings
14. Identify potentially dangerous portfolio positions and other risk sources.

Role and importance of internal audit in banks

The economical, financial and sometimes even the regulatory environment present both risks and opportunities, with the potential to erode or enhance value. Risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value. Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity's objectives.

Banks survive and prosper by accepting risk, which are their principal economic characteristic. Risk must be well managed and for the banking institutions that task has

become much more difficult and complex. We must also highlight the changing nature of risk management in banking sector and its new implications for bankers and bank supervisors. Banking is a highly leveraged and, in many respects, low-margin business. Losses from a single bad loan or a material breakdown in controls can eliminate the gain on many other transactions. The continued ability to identify and manage risks and to maintain the proper internal controls is critical in banking organizations even as they seek to increase profits and profitability.

Internal audit function in banks has known important changes in the last years. The assimilation of the international internal audit standards is one of the most important one. We can say that in the new context – regulatory environment for banking system and professional requirements – internal audit has the potential to be one of the most influential and value added function to the banks' Board of administrators. We can sustain this opinion by the following arguments:

1. It is seen as a value adding resource
2. It is characterized by process driven/value added approach
3. It is risk orientated
4. It is seen as a training ground for future managers.

The Institute of Internal Auditors define the primary role of an internal audit function as providing reasonable assurance to executive management and the Board about the adequacy and effectiveness of the risk management control framework in operation. The secondary role is to strengthen and improve the risk management and control framework through the promulgation of best practice.

An international study realized in different organizations analyzing the management perception on internal audit function have highlighted the fact that CEOs and CFOs in banks expect internal auditors to fulfill an active management supporting role, by contributing to the continuous improvement of the risk management and internal control system as well as the operational processes and also expressing their opinion regarding strategically important projects in the bank. An important number of the CEOs and CFOs questioned in the studies expect internal auditors to play an important 'signaling' role with respect to internal problems and inefficiencies. Internal auditors also are expected to create a sufficient level of risk and control awareness throughout the organization. [Sarens, Belde, 2005, 3-4].

As a corporate governance request executive management is responsible for establishing the framework of internal controls as part of its management of risk and for updates it as risks change. Management also should ensure itself that the controls are working. Internal audit function is asked to provide objective assurance on the effectiveness of the organization's governance processes, how well it manages the risks, and whether internal control processes are operating, as required, to manage risks to an acceptable level, this acceptable level, in case of the banks' being evaluated according to the approved risk profile. Internal auditors also support management by providing consulting services, which contribute to the establishment of sound risk management processes.

In order to become a valuable support for senior management in the effort of continuous monitoring and improving risk management, the internal auditor should focus on the provision of assurance

regarding the risk management and internal control system. Internal auditor must to play a more pro-active role in the improvement and formalization of the risk management and internal control system. The internal auditors are expected also to improve the processes in the main business areas in the bank.

Internal audit and risk based approach

The new approach of internal audit, risk-based oriented approach, has a new concept of planning and conducting internal audit activity. Starting with planning and ending with internal audit reports' missions internal auditors focus on risks' items. Standard 2010.A1 statutes that internal audit activity's plan of engagements should be based on a risk assessment. Applying these requirements and the banking regulation, the internal auditors elaborate a multi annual plan, split in annual plans, each one containing the business lines and processes with high potential risk: corporate credit, retail credit, cards, IT etc. The priorities for audited areas are determined taking in consideration criteria as for example: the importance of that area in the bank activity, the impact of the activity on reaching the strategic objectives, the complexity of the activity.

The head of internal audit department must ensure that the internal audit resources are directed at those areas most important to the bank. Risk based approach is applied in executing internal audit process. Internal auditors have good knowledge on business specific processes. That's why they are asked to participate to the mapping processes and controls' assessment. Another important task is that based on the results of the risk assessment, the internal audit activity should evaluate the adequacy and effectiveness of controls (this being as we

have already seen also one of the management expectation) encompassing the organization's governance, operations and information systems.

The internal control system contains several successive steps:

1. Establishing business areas
2. Defining risks
3. Risk assessment
4. Controls' assessment and presenting suggestions for improvement.

These processes imply good knowledge on the assessed areas, practice experience and solid documentation in order to identify and assess specific risks. The control assessment covers manual and automate controls. So internal auditor has to be well documented regarding the information systems used in the bank and to prove skills on IT domain. It is important for the auditor to identify and assess with all the attention the standard controls, their adequacy and efficiency in the current activity. In the same time it is important to find out if exist alternative controls and to evaluate their efficiency. Based on these assessments is important to suggest concrete ways to improve the existing controls. Cross controls can represent alternative solution. It represents the evaluation process of the internal control system specific for business areas.

Internal auditors give a special attention to the operational risks because these are generated by the breakdowns in established processes, failure to follow processes, or inadequate process mapping within business lines. Finally, external events can include natural disasters, terrorism, and vandalism. The bank is a dynamic organism, knowing permanent growth (in order to maintain or conserve its position in the market), developing new products and services more complex and using more sophisticate IT

infrastructure, operating in a dynamic regulatory, financial and economic environment. All these elements are source of potential operational risks. In this context we can identify some areas where operational risks are emerging:

1. Extend use of automated technology mapping the potential of manual processing errors into system failure risks. It is also necessary to emphasize the great reliance placed on globally integrated systems
2. Proliferation of new and complex products
3. Extend of e-banking and m-banking transactions needing related business applications which expose the bank to potential new risks (e.g., internal and external fraud and system security issues)
4. Need for continual maintenance of high-grade internal controls and back-up systems
5. Development and use of risk mitigation techniques (e.g., collateral, insurance, credit derivatives and asset securitizations) optimize a bank's exposure to market risk and credit risk, but potentially create other forms of risk (e.g., legal risk)
6. Extension of the outsourcing arrangements of all kinds. Participation in clearing and settlement systems mitigate some risks while increasing others. We can conclude that the key elements in the operational risk management process include
7. Appropriate policies and procedures
8. Efforts to identify and measure operational risk
9. Effective monitoring and reporting the operational risk events and their impact

10. A sound system of internal controls ensuring the limitation of the operational risk events
11. Adequate testing and verification of the operational risk framework and continuous improvement of the operational risk framework.

Internal audit task is to provide an opinion regarding the entire internal control system of the bank seen as a whole. The assessment must take into consideration the fact that risks action is interrelated and their consequences must be evaluated. Risk doesn't recognize organizational charts. It doesn't confine itself to functions and units, processes and roles; it travels through the bank in an interdependent and connected way. It is therefore not safe to practice risk management on an exposure-to-exposure: risks must be recognized and managed holistically across the entire bank. For the evaluation of the internal control system the auditor will present its opinion, following COSO requirements:

1. Control environment
2. Risk assessment
3. Information and communication
4. Control and monitor.

According to Basel III requirements the banks' management also the division of Reserve Bank follow up the way in which are observed the capital requirements according to the risk profile of each bank. The capital requirement established is directly influenced by the level of credit risk, market risk and operational risk. As expected, supplementary capital requirements were determined for many small and medium Indian banks. The internal auditor task is to evaluate the risks' level and the way in which are observed the capital requirements. It is important also to

assess the risk of concentration of financial sources.

We have already mentioned the significant changes in the regulatory banking environment. In this context, the banks have to implement all these requirements in their internal regulations, the internal audit role in assessing the conformity of the internal regulation being very important.

Conclusions

The effort of the Indian banks to implement the new regulatory requirements will continue and the internal auditors will continue to take part in this huge project. The internal audit role and importance will be recognized according to value added function in the bank and will strengthen in time. The internal audit in the bank is a direct result of its effort and involvement, professionalism and capacity to respond to the requirements.

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