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INTERNAL AUDIT APPROACH IN BANKS

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Abstract

Romanian banking system has known in the last years significant changes determined by the implementation of Basel II requirements and governance principles on one hand and assimilation of the EU Directives for the banking sector on the other hand. The function of internal audit is new in the Romanian banks, being implemented as a result of the new regulation established by the Romanian National Bank in the effort to aligne the Romanian banking legislation to the international regulations and practice in the field. In the dynamic banking environment the internal audit has to define and strengthen its statute and role.

We can say that 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 Romanian banks and its major areas of interest.

Key words: *internal audit, risk based approach, risk management.*
JEL classification: *M42*

1. Introduction

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

The implementation of Basel II 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.

According to the estimations of the Romanian Banking Institute the costs of the Basel II implementation can reach 30 millions Eur for each bank. The most important costs of the implementation are assigned to the management of the credit risk (85%). The costs for the implementation of the operational risk requirements will represent arround 15% from total costs. The same study estimates that 60% of the Basel II total implementation costs is demanded by the IT infrastructure.

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The National Bank of Romania has already enssured the implementation of the Basel II 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 breaf, Basel implementation steps pursued are:

- Capital Adequacy Ratio calculation;
- Main national discretion/approaches decided upon;
- Local Basel legal framework issued 2003 and continous update of norms in compliance with European Directives;
- Enhanced dialogue of the Central Bank with local banks and foreing counterparties (twinning agreements with Western Central Banks) for Basel implementation guidance;
- Supervisory framework improved;
- Timetable for internal rating models validation set;
- IRB validation manuals for Central bank personnel.

We also want to briftly highlight the potential impact of the Basel acord:

- Significant improvement of risk management and credit approval practices;
- Better alignement of regulatory and economic capital;
- Establishment of more rigorous bank supervision and broader disclosure;
- Cost reduction through organizational process improvement;
- Overall small changes in regulatory capital;
- More efficient capital allocation in the banking industry and the economy;
- No systematic disadvantage for large and small financial firms;
- Overall beneficial outcome for retail (especially mortgages) and most SMEs;
- Enhanced Corporate Governance;
- Reinforcement of risk adjusted performance measurement and pricing (linking retur of assumed risks). High costs for risk management and IT;
- Acceleration of consolidation trend in the banking sector;
- Improve/maintain credit rating;
- Economical capital savings;
- Identify potentially dangerous portfolio positions and other risk sources.

2. Role and importance of internal audit in banks

The economical, financial and sometimes even the regulatory environment presents 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:

- Internal audit is seen as a value adding resource
- Internal audit is characterized by process driven/value added approach
- Internal audit is risk orientated
- Internal audit 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 analysing the management perception on internal audit function have highlighted the fact that CEOs and CFOs in banks expect internal auditors to fulfil 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 'signalling' 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 organisation. [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 update 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 organisation'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.

3. Internal audit risk-based approach

The new approach of internal audit, risk-based oriented approach, has fundamental change the way 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 Romanian banking regulation 17/2003, 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. According with standard 2210.A1 risk base 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.

An other important task statutes 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.

As figure no. 1 shows the process of evaluation internal control system contain several successive steps: establishing business areas, defining risks, risk assessment, 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. The figure no. 1 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 generating 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 (as the Romania one is). All these elements are source of potential operational risks. In this context we can identify some areas where operational risks are emerging:

- 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;

- Proliferation of new and complex products;
- 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);
- Need for continual maintenance of high-grade internal controls and back-up systems;
- 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);
- 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:

- Appropriate policies and procedures;
- Efforts to identify and measure operational risk;
- Effective monitoring and reporting the operational risk events and their impact;
- A sound system of internal controls ensuring the limitation of the operational risk events;
- Adequate testing and verification of the operational risk framework and continuous improvement of the operational risk framework.

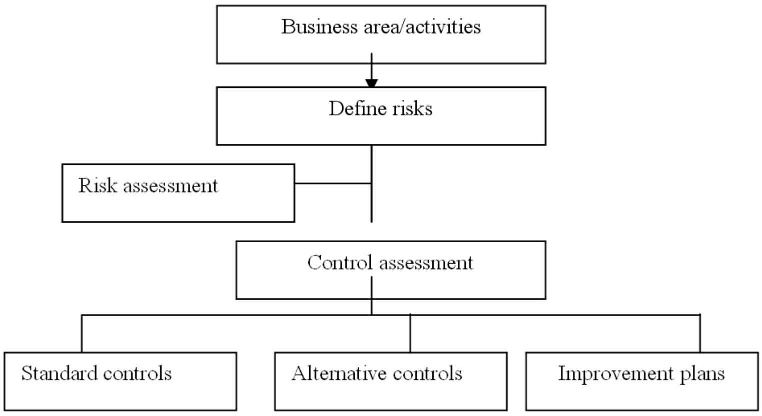

Figure 1. Assessing internal control system process

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 recognize and managed holistically across the entire bank.

For the evaluation of the internal control system the auditor will present its opinion, following COSO requirements: control environment, risk assessment, information and communication, control and monitor.

According to Basel II requirements the banks' management but also the supervision division of National Bank of Romania 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, suplimentary capital requirements were determined for many small and medium Romanian 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.

4. Conclusions

The effort of the Romanian 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 recognize according with its value added function in the bank and will strengthen in time. The image of the internal audit in the bank is a direct result of its effort and involvement, professionalism and capacity to respond to the requirements of the management.

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*** OUG 99/2006 privind instituţiile de credit şi adecvarea capitalurilor.