



NEW BASEL CAPITAL ACCORD AND RISK BASED SUPERVISION



## **Risk Based Supervision and Bank Level Preparations for Risk Based Internal Audit**

*A Presentation Paper by MVL Consulting*

## INTRODUCTION

Effective Risk Management is the hallmark of successful financial institutions. Due to the nature of the business, the success of financial institutions depends on the security, privacy, and reliability of services backed by robust operational practices.

### Basel II

Effective risk management strategies can be implemented by integrating effective bank-level management, operational supervision and market discipline. It is also imperative for these institutions to update their risk management practices in accordance with prevalent legislation and regulatory environment. With these aspects in mind, the Basel Committee on Banking Supervision published the Capital Adequacy Accord, also known as the Basel Accord, in 1988.

The Basel Accord defines the parameters of risk management and capital adequacy for Banking Sector and Financial Service Providers.

With the growth in the financial services sector, the Committee felt the need to update the Accord in line with new developments. As a result, it proposed the New Basel Capital Accord, also known as Basel 2, in June 1999. With its new risk-sensitive framework, Basel 2 aims to fill the gaps left by the previous Accord.

Basel 2 was devised to improve the soundness of the financial system by aligning regulatory capital requirement to the underlying risks of the banking industry. It encourages banks to conduct better risk management and enhance market discipline. According to the Committee, financial institutions should integrate Basel 2 in their operations by year-end 2006. The regulators would introduced a Risk Based Supervision (RBS) model for supervision and regulation of the banking and financial sector.

For achieving efficient risk management, as outlined by Basel 2, in order to comply with the requirements of regulator in respect of RBS, the banks would have to make many structural and other changes.

The introduction of RBS would require the banks to reorient their organizational set up towards RBS and put in place an efficient risk management architecture, adopt risk focused internal audit, strengthen the management information system, and set up compliance units. The banks would also be required to address HRD issues like manpower planning, selection and deployment of staff and their training in risk management and risk based audit. It is evident that change management is a key element in RBS and the banks should have clearly defined standards of corporate governance, well documented policies and efficient practices in place so as to clearly demarcate the lines of responsibility and accountability so that they align themselves to meet the requirements of RBS

This presentation paper discusses the framework and impact of Basel 2 in financial organizations and highlights the for bank level preparations for a successful Basel 2 implementation.

## BASEL II ACCORD – AN OVERVIEW

### Basel II An Overview

Financial markets have always been sensitive towards incurring heavy losses due to either poor risk management policies or frauds – as both would reduce public confidence, which is the mainstay of the sector. Thus, banking institutions and investment firms felt the need to improve their measures for security and risk management across their enterprise. To achieve this, the Basel Accord was signed in 1988.

The Basel Accord was adopted by the Central Banks of over 100 countries as a basis of risk management within their banking system. It aimed to ensure an adequate level of capital in the international banking system.

However, the regulatory capital requirement set by the Accord proved to be incompatible with the new sophisticated internal measures of economic capital. In addition, the Accord was unable to recognize credit risk techniques, such as collateral and guarantees. This resulted in an inflexible system and ultimately increased the risk for financial institutions.

Basel 2 was devised to plug these gaps. A Basel 2 implementation allows bankers to adequately emphasize their own internal risk management methodologies. Bankers can also provide more incentives and options for risk management, thereby increasing flexibility of their systems. In addition to this, Basel 2 provides a variety of benefits to the banking system. These include enhanced risk management, efficient operations, and higher revenues to the banking community.

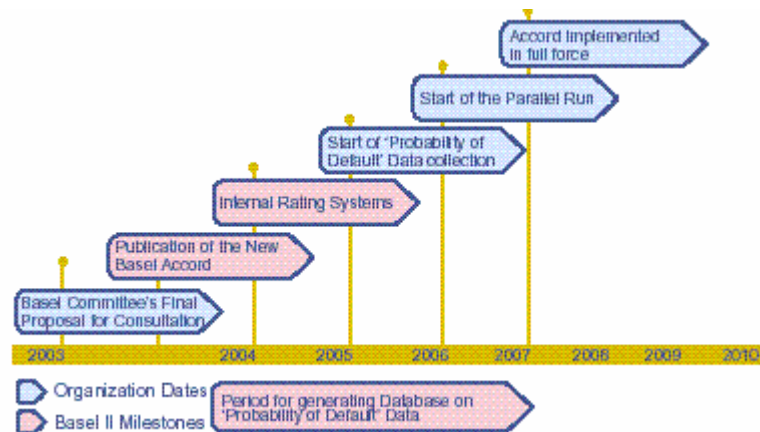
Along with the increased benefits, Basel 2 has also laid down some controls on the international banking system. This is primarily in the form of a higher capital requirement to underwrite mismanagement of risks and lack of infrastructural controls in many economies. All banks in the EU, as well as international banks that operate within the EU will initially adopt Basel 2. It is expected that other central banks will also adopt this accord over a period of time.

This indicates that global acceptance is not far and most banks across the world will soon come under the purview of this accord.

Major key issues in Basel II are risk management and risk based supervision. The introduction of RBS would require the banks to reorient their organizational set up towards RBS and put in place an efficient risk management architecture, adopt risk focused internal audit, strengthen the management information system, and set up compliance units. The banks would also be required to address HRD issues like manpower planning, selection and deployment of staff and their training in risk management and risk based audit. It is evident that change management is a key element in RBS and the banks should have clearly defined standards of corporate governance, well documented policies and efficient practices in place so as to clearly demarcate the lines of responsibility and accountability so that they align themselves to meet the requirements of RBS

## BASEL II ACCORD – IMPLEMENTATION TIME SCALE

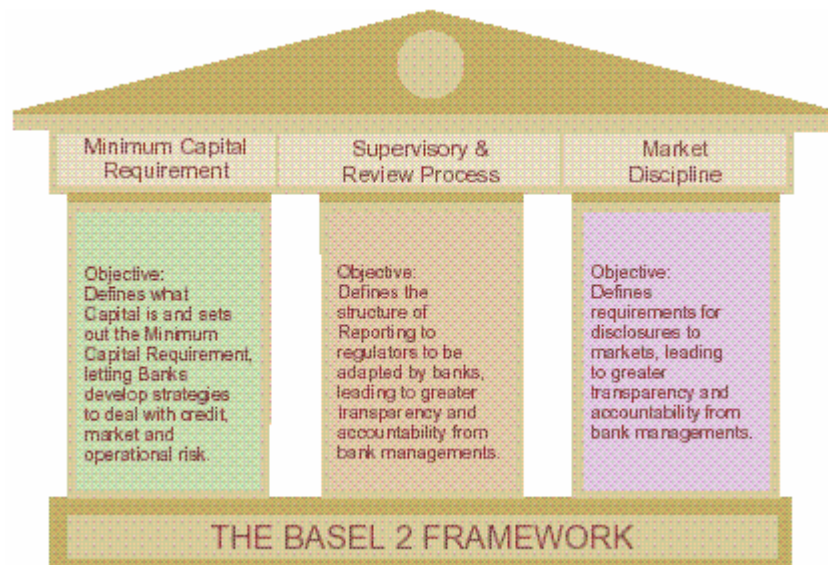
Road Map to  
Basel II and Mile  
Stones in  
Implementation



After a series of revisions, Basel II is expected to be finalized by the fourth quarter of 2003.

During this three-year period, banks and supervisors must develop the necessary systems and processes to comply with the standards laid down by Basel II. For instance, financial institutions have to maintain a history of vital data sets built prior to the implementation date of Basel II. This will help them seamlessly “migrate” to Basel II. In addition, many countries have already started work on draft rules that would integrate Basel capital standards with their national capital regimes.

## The Basel 2 Framework



The Basel II Accord intends to provide more risk-sensitive approaches while maintaining the overall level of regulatory capital within the financial system. This is proposed to be achieved through its frameworks of three reinforcing pillars shown above.

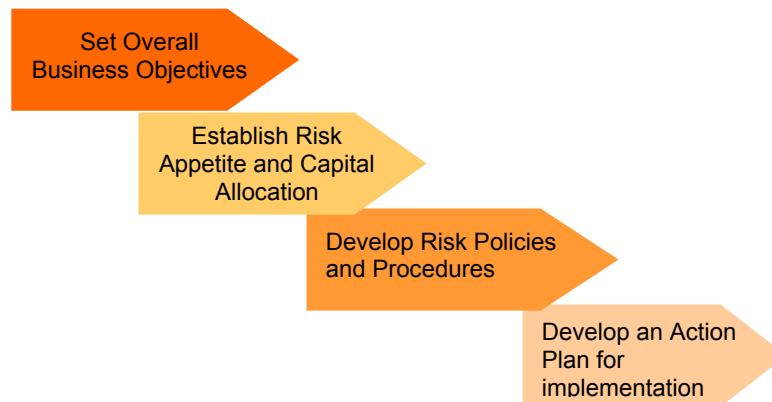
## BASEL II IMPLEMENTATION IN DEVELOPING COUNTRIES

Many Central Banks in developing countries like India, Sri Lanka, Bangladesh have already started moving towards compliance of Basel II and introduction of Risk Based Supervision model in their countries.

### Risk Management and Risk Control

With the progressive deregulation of the financial system as also to address systemic concerns on the safety and soundness of the banking system, the Basel II accord requires putting in place an effective and comprehensive Risk Management System. It is envisaged that banks would set up proper organizational structure, policies, procedures, limits for credit, market and operational risk management. The emphasize is mainly confined to three major risks – Credit Risk, Market Risk and Operational Risk. The Banks are also required to have an integrated approach to risk management so as to cover extent of risks undertaken by individual business units as well as by the bank as a whole. The banks face various challenges in identifying and measuring risks for all activities and for all locations on a bank wide basis.

### Risk Management Flight Plan



### Meeting the Implementation Challenge

Meeting the standards for advanced risk measurement approaches under the New Basel Capital Accord will ultimately require sophisticated risk analysis and modeling methods. However, improving risk analysis methods is not the major challenge for achieving the Accord's advanced risk measurement approaches. In many banks these methods are already in use for market risk. The most important challenges lie in the large scale sourcing and integration of data about credit exposures and connected borrowers that are currently housed in multiple unconnected systems and in identifying and measuring operational risks much more accurately and comprehensively, again sourcing the required data from many different transaction systems. The Accord requires that this data be linked not only for risk measurement, but that it also be used in management reporting and external financial performance reporting and that it be actively utilized in day to day management processes. Banks also need to develop databases that maintain five to seven years detailed historical risk data. These challenges surpass the complexities of most customer profitability and customer relationship management initiatives attempted by banks to date. Intelligent strategies are needed for sourcing, cleansing and linking the data, for enhancing key business processes, for leveraging the financial systems architecture already in place to best effect, and for managing the effort on an enterprise-wide basis.

## RISK BASED SUPERVISION AND BANK LEVEL PREPARATIONS

### Integrated Risk Management Architecture

The need for integrated risk management architecture also arise from the requirements of new Basel Capital Accord which is more closely aligned to risk. The Minimum Regulatory Capital will have linkages with the level of credit risk, market risk and operational risk. A higher level of risk would result in the need for higher capital level.

Under the New Basel Accord, the banks will be responsible to assess their own capital requirements. It would be very essential for the banks to set up an appropriate risk management framework to support an internal assessment of capital, both regulatory capital and economic capital.

The New Basel Accord provides an option to the banks to develop their own risk management systems. Under the New Accord, the banks are required to:

- Develop an Internal Rating Based Approach.
- Develop an Internal Model for Risk Estimation.
- Develop own capabilities in building up credit risk, market risk and operational risk models.

### Requirements of Risk Based Supervision

In order to comply with Basel II requirement, the banks would be required to carry out a fresh review of their current status of risk management architecture by an expert team and initiate measures to bridge the gaps. The requirements of risk based supervision model in this respect are:

- The risk based supervision will not be transaction based – it will be systems based inspection by the regulator/supervisor.
- The regulator and supervisor will go into details of the systems and procedures for managing and controlling risks.
- Need to review and develop systems and procedures for undertaking transactions and the reporting and the controlling systems
- Need to properly document systems and procedures

### Bank Level Preparations

To comply with Basel II, the banks will be required to undertake actions in following five areas to meet the requirements of risk based supervision:

- Setting up risk management architecture
- Adoption of Risk Based Internal Audit
- Strengthening of Management Information System and Information Technology
- Addressing HRD issues
- Setting Up Compliance Units

## RISK FOCUSED INTERNAL AUDIT

### Risk Focused Internal Audit

The global banking sector is undergoing a progressive de-regulation and liberalization. With the rapid changes occurring in the financial risk profiles of banks and with the evolution of new financial instruments and markets, the risks faced by banks has multiplied manifold. Though the transaction testing method of internal audit remains an essential and reliable examination aspect of internal auditing, a greater need is normally felt by the Regulator to widen the scope of internal audit and improve the quality of internal auditing. The Basel II Accord has stipulated that the internal audit would have to capture in a larger way the application and effectiveness of risk management procedures and risk assessment methodology and critical evaluation of the adequacy and effectiveness of the internal control systems.

The banks will be required to introduce and implement Risk Focused Internal Audits and Self Audits.

The banks would have to gradually move towards risk focused auditing, in addition to the system of selective transaction based auditing. The implementation of risk based auditing would mean that greater emphasis is placed on the internal auditor's role of mitigating risks. By focussing on effective risk management the internal auditor would not only offer remedies for current trouble areas but also anticipate problems and play an important role in protecting the bank from risk hazards.

The risk based auditing would not only cover assessment of risks at the branch level but would also cover, as an independent assessing authority, assessment of risks at the corporate level and the overall process in place to identify, measure, monitor and control the risks. In order to focus attention on areas of greater risk to the bank, a location-wise and activity-wise risk assessment should be performed in advance of on-site risk based auditing. This would allow identification of high risk areas which would enable prioritising the activities and locations for risk based audit. If initial inquiries into the risk management system raise material doubt as to the system's effectiveness, no significant reliance should be placed on the system and a more extensive series of tests need to be undertaken to ensure that the bank's exposure to risk from a given function or activity is accurately captured and monitored. The high-risk areas need to be looked into more frequently than the low risk areas.

### Benefits of Risk Focused Internal Audit

Risk Focused Internal Audit would result in following benefits:

- Strong risk focused internal audit system means lesser supervisory intervention from the Regulator
- Provides checks and balances to internal control systems
- Highlights deficiencies to the Top Management in time.
- Optimal use of audit department resources
- Potential problem areas are easily identified.

## MVL Consulting's Approach

### Approach

Recognizing the growing needs of consulting services in the Banking and Financial Sector, MVL Consulting's Risk Management, Banking and Financial Sector Consulting Practice provides a wide range of expertise. It aims to offer world-class services in all functional areas of risk focused internal audit.

Since Basel II is a wide-reaching initiative, it is necessary to integrate the architecture with other technologies across the organization. MVL Consulting offers a variety of services including consulting services in risk based supervision and adoption of risk focused internal audits, the assessment of banks IT systems in line with Basel II, Gap Analysis, and consulting on IT architecture to be adopted.

Basel II introduces Operational risk as a part of the capital adequacy requirements, . Due to the increased awareness of risks posed by internal systems breakdown, fraud, and external events, the proposed new operational risk charge has received much attention. As a part of operational risk management, MVL Consulting provides services for internal control evaluation, IT Systems Audit while ensuring security and compliance with new regulations.

MVL Consulting has built up domain expertise in the banking sector through recruitment, acquisitions, and alliances.

Since Basel 2 and Risk Based Supervision would be mandatory for banks, MVL Consulting has already established a Risk Based Supervision Consulting Team for serving bank customers.

### Consulting Team

Our Consulting Team is multi-faceted and includes expertise from the regulators view, from a commercial banker's view and an external auditor's view. The lead members of our Consulting Team include:

**Mr. Amalendu Ghosh:** Mr. Ghosh is the former head of the Project Implementation Group of the Reserve Bank of India for introducing Risk Based Supervision in India. He is also the former Chief General Manager of Department of Banking Regulation and Supervision of Reserve Bank of India. Mr. Ghosh has an extensive international experience of more than 15 years in on-site/off-site banking supervision, banking sector reforms and banking regulations. Mr. Ghosh has 40 years of experience in banking.

Mr. Ghosh has worked as Technical Expert on assessment of compliance with Basel Core Principles of Effective Banking Supervision in the International Monetary Fund Team on the Financial Sector Assessment Programme.

Mr. Ghosh has designed and developed various training programs on risk based supervision.



He is currently a consultant to Bank of Maharashtra on Integrated Risk Management Systems.

**Mr. S. N. Sawaikar**, Former Deputy Managing Director of State Bank of India and currently a director of Discount and Finance House of India Ltd. and former consultant to State Bank of India for introduction of risk management, risk based internal audit, credit audit and management audit in State Bank of India. Leader of McKinsey – In-house Team at State Bank of India for restructuring and re-organisation of State Bank of India.

**Mr. M. V. Lonkar**, Chartered Account and Certified Information Systems Auditor (CISA) with substantial expertise in risk based internal audit, risk management, IRB and portfolio level credit risk modeling, information systems audit and compliance with GAAP.

Mr. M. V. Lonkar has conducted internal/external audits of large complex banking organizations and has also developed skills in information systems auditing in banks.

Mr. Lonkar is actively involved in imparting training to bank personnel in the matter of banking supervision, Basel Committee Requirements, Risk Management and KYC Concepts.

Mr. Lonkar has contributed numerous papers on risk based supervision and participated in designing and developing training programmes for risk based supervision in banking.

**Mr. S. A. Bhagali**, Former Chief General Manager of State Bank of India and member of McKinsey Team for restructuring and re-organisation of State Bank of India. He has designed and conducted “Role-Set” and “Role-Clarity” programmes for stabilization of the structural and process changes introduced in State Bank of India and also to facilitate implementation in restructuring of State Bank of India. The participants involved a cross section of the top management and their role sets. He also has substantial expertise in risk management and pioneered the concept of “Take Out” financing in India. Mr. Bhagali is a World Bank resource person for training in infrastructure financing. Mr. Bhagali has also devised and introduced ‘Take Out Financing’ products to enable smaller Indian banks getting into infrastructure financing.

## MVL Consulting Service Offerings

### Consulting Process for Risk Based Supervision

Our Risk Based Supervision Consulting Process includes:

- Design and development of appropriate organizational structure
- Advisory services to document systems and procedures for undertaking business in alignment with the requirements of risk based supervision.
- To identify gaps in management information systems and suggest remedial measures
- To review and strengthen reporting and control system
- To design and develop appropriate risk focused internal audit model
- To assist bank in setting up compliance units

## Consulting Process for Risk Focused Internal Audit

Our consulting service ensure compliance of internal audit with the International Standards on Auditing (ISA), relevant banking regulations and other legal requirements, ensuring the adequate professionalism and conformity with the ethic principles.

Our recommendations will enable the bank to strengthen the maintenance of subjectivity, impartiality and independence of auditing and prevent unqualified or biased audits. Our consulting services will enable creation of an additional source of reliable information on the banks' operations and financial position and transfer of some bank risk control functions from the operations to highly-qualified and professional internal auditors, thus ensuring that professional internal audits prevent risks of the banks' bankruptcy or deterioration of their financial positions and results of operations.

Our Risk Focused Internal Audit Adoption Consulting Process includes:

- Design and Development of Risk Focused Internal Audit Model for the Bank
- Setting up and Re-orientation of Risk Focused Internal Audit Department
- Setting up Risk Focused Information Systems Audit Department
- Preparation of Dynamic Risk Focused Internal Audit Plan
- Introduction of different audit report formats for different risk category branches
- Design, development and implementation of Risk Audit Matrix for easy quantification of risk
- Assistance in preparation of Risk Focused Internal Audit Manual.
- On-site guidance in conducting Internal Audit of a few sample branches
- Training of Internal Audit Executives and Officers in Risk Management with focus on Credit Risk Management, Operational Risk Management and Market Risk Management.

## About MVL Consulting

### Background

MVL Consulting Private Limited (MVL) is a group of banking and finance professionals having accumulated expertise of hundreds of man years. As a professional consulting firm, MVL Consulting has been operating since 2001. We bring to bear a wealth of practical experience of directly operating in and regulating financial markets, and of providing relevant training. We and our Associates have gained this experience in senior positions in Central Bank, large commercial banks, merchant banks, fund management companies, stock exchange and its leading member firms, other international consulting firms etc.

MVL Consulting is registered as a banking and financial sector consultant in India and also with international funding agencies such as the World Bank, Asian Development Bank, DFID UK and FAO of UNO.

## EXPERTISE

MVL Consulting has expertise in following areas:

- *Risk Management including Credit Risk, Operational and Market Risk Management*
- *Risk Profiling and SWOT Analysis*
- *Bank Supervision/Audit Mechanism and Adoption of Risk Focused Internal Audit*
- *Credit Risk Management and Credit Portfolio Evaluation*
- *Customer Due Diligence and Compliance with Know Your Customer Procedures*
- *Project Techno-economic Feasibility Studies and Project Monitoring*
- *Borrower Credit Appraisal and Working Capital Assessment*
- *Borrower Security Evaluation and Stock Audits*
- *Asset and Liability Management System and Management Information System*
- *NPA Management Advisory Services*
- *Business Valuations and Asset Valuations*
- *Information Systems / EDP Audit, Software Evaluation*
- *Bank Staff Training*
- *Preparation of Instruction Manuals for Credit, Audit and other bank functions*

***"It is not the strongest species that survive,  
nor the most intelligent,  
but the ones most responsive to change..."***

**Charles Darwin**

## **MVL Consulting Private Limited**

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