

## Internal Audit in the Financial Services Industry Focus areas for thematic and targeted reviews in 2014







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# Foreword

The role of Internal Audit in the Financial Services Industry is likely to come under the spotlight as the supervisory approach changes from intrusive on-site inspections to off-site risk-based assessments. As the transition takes place, the extent of reliance on Internal Audit, to assure internal and external stakeholder compliance and operational controls will increase. The Internal Audit function is not only expected to monitor compliance and transactions but also develop an integrated view of existing and emerging risks and their impact on business. Developments in the macro-economic environment, systemic risks and inter-connectedness in the Financial Services Industry have made it imperative for the Internal Audit function to put a dynamic audit plan in place. It has also become important that high-risk areas are assessed and reviewed by specialists.

The inter-connectedness within the financial system has made it necessary for institutions to analyse their vulnerability to systemic risks through assessment and analysis of macro-economic factors, industry trends, changes in regulations, risks materializing at other entities and innovation by peers. As the third and final line of defence, the Internal Audit function now has the added responsibility of continuously assessing the impact of external factors and systemic risks on the organization in addition to oversight over transactions and processes.

In its expanded role, the Internal Audit function is likely to provide an independent and objective view on both the first (business and operations) and second (risk and compliance) lines of defence. From being a transaction and compliance oriented function, Internal Audit is

expected to become a pre-emptive risk identification and evaluation function. At the same time, Internal Audit is still expected to retain its role as the central point of assurance for transactions and compliance. This dichotomy in role requires the Internal Audit function to organize itself at two distinct levels. At one level, the Internal Audit function is expected to evaluate emerging risk areas and perform thematic and targeted reviews with a view to assess not just the efficacy of controls but probability of the risks materializing in the given organizational construct. At the second level, the Internal Audit function is expected to continuously improve the efficacy of transactional and compliance audits to provide the requisite level of assurance to regulators and external stakeholders.

This document highlights the focus areas for Internal Audit based on emerging risks and trends in 2014. Thematic and targeted reviews in these areas are likely to help the Internal Audit function in adding value to business through pre-emptive assessments. Focus on thematic and targeted reviews will also help the Internal Audit function in meeting regulatory expectations under the revised risk-based supervision framework.

# Focus areas for Internal Audit in 2014

A relatively uncertain economic environment has put significant pressure on debt servicing capabilities of corporates. It has also created a need to critically assess the existing portfolio and take an account of the related risk management and accounting practices. This situation, coupled with the uncertain economic environment and increased global regulatory scrutiny will require financial institutions to critically evaluate

the quality of their regulatory submissions, model risk, capital related computations and conduct in the financial markets. There is also likely to be an increased focus on conduct with customers and fairness in dealings. Based on the aforesaid developments and emerging trends, the focus areas for Internal Audit are highlighted below:

## Asset Quality

- Quality of past credit decisions
- Quality of existing credit portfolio
- Application of the NPA policy
- Existence and use of early warning system

## Financial market conduct

- Unauthorized and suspicious trading activities
- Potential manipulation of benchmarks and indices

## Data integrity and analytics

- Quality and consistency of data provided for risk based supervision
- Regulatory reports
- Internal data based risk trends

## Risk models

- Use of risk models in decision making
- Model Risks and validation
- Model documentation and governance

## Capital and liquidity

- Internal capital adequacy assessment processes
- RWA computations
- Adherence to liquidity and leverage regulations

## Third party assessment

- Contractual compliances
- Assessment of adherence to service level agreements
- Control framework & environment at outsourced providers

## Customer conduct

- Customer experience and service levels
- Reputation risks arising from customer service
- KYC/ AML

### **Asset quality**

Deteriorating levels of credit quality within the lending portfolios of banks and non-banking finance companies pose a significant systemic risk to the financial system. A weak macro-economic environment and outlook has weakened corporate balance sheets, thereby, impairing their ability to service bank debt in a timely manner. The resultant stress is visible in the form of burgeoning non-performing assets within the banking system. Deterioration in the credit portfolio has necessitated the need to not just focus on the process followed for making a credit decision but also question the quality of the past credit decision made. Historical analysis covering credit concentration across sectors, geographies, sanctioning authorities and varied kinds of collaterals will help pre-empt and isolate pockets on poor credit quality, thereby, enabling early corrective action.

Application and adequacy of the policies in accounting for non-performing assets as well as the application of dynamic provisioning is likely to become an advanced focus of Internal Audit. It is important for Internal Audit to identify inconsistencies in the application of provisioning policies and evaluate the processes and controls related to provisioning.

Early warning systems for credit risk have traditionally focused on customer behaviour based on past relationships. Broadening the behavioural analysis and incorporation of non-behavioural factors into early warning systems is likely to become increasingly important. Going forward, assessment of collateral quality and valuation along with assessment of credit quality will also become an important factor. It is critical for the Internal Audit function to evaluate whether early warning systems are adequate and ensure that their application has been consistent across portfolios.

### **Financial market conduct**

Weak global market infrastructure for administering financial benchmarks has led to rate manipulation across markets. The current system for providing market data leaves itself open to the risk of moral hazard for market participants. With the revamp of financial benchmark administration underway globally,

risk factors associated with contribution of rates will continue to persist. Further, regulatory scrutiny on rate contributions and administration is likely to increase over time. Financial market-centric businesses have also come under significant regulatory scrutiny on account of instances of market manipulation through front-running, unauthorized trading and circular trading. Given the complexity of financial markets and diverse infrastructure for trade execution, financial market conduct should become a key focus area for Internal Audit to mitigate the risk of potential regulatory fines and reputational impact from market manipulation.

### **Data integrity and analytics**

The Reserve Bank of India has rolled out a new supervisory framework to address emerging risks in the banking sector. While the earlier framework was focused on intrusive on-site inspections of banks, the revised framework focuses on a risk-based off-site monitoring model. The off-site monitoring model pre-supposes that all the data points, as required by the regulator, will be readily made available and data quality will be maintained. However, the Banks are facing significant challenges in sourcing the information and making them available to the regulator. Banks are also struggling with assurance on the integrity of the data submitted. Given the evolving nature of the supervisory framework, technology investments are likely to lag regulatory developments. Accordingly, Internal Audit would need to play the pivotal role of providing assurance on the integrity of the data submitted to the regulator. Regulatory reporting platforms are also expected to converge over a period of time, providing regulators with the ability to reconcile multiple submissions. The Internal Audit function would be required to supplement assurance during this transaction to ensure consistency in data submitted.

The role of analytics in Internal Audit has been steadily increasing. However, use of analytics has been sporadic and generally does not follow a defined framework. The Internal Audit function needs to create repositories of test scripts to institutionalize the use of analytics. It is also important that analytical test scripts be used to reduce the time spent and enhance coverage through Internal Audit.





### **Risk models**

The advent of BASEL II introduced statistical models for risk and capital computations. These models have been refined over time and have become the mainstay on decision support and risk quantification processes. As these models become an increasingly integral part of business decision making, capital computations and risk analysis, their integrity is likely to come under increased scrutiny. The role of Internal Audit, in evaluating integrity of models and addressing risks associated with them, has become paramount. While the increasing regulatory affinity for use of statistical models for all aspects of business increases objectivity in decision making, it also brings with it risks relating to data integrity, manipulation, incorrect statistical assumptions, sub-optimal model calibration and incorrect application of model output. For Internal Audit to provide value in this area along with mitigating model risks, developing the requisite competence will become an important success factor.

### **Capital and Liquidity**

Capital and liquidity have become the key focus areas as banks prepare themselves to transition to the next phase - BASEL III regime. While capital computation and adherence to BASEL III norms are expected to become focus areas for Internal Audit, an often overlooked aspect is the internal capital adequacy assessment process. The process is expected to encompass capital planning, assessment of enterprise risks and use of risk parameters for business decision making. The Internal Audit function is expected to be in a position to validate the ICAAP documentation, validate efficacy of models and critically evaluate the impact of residual risks on the bank.

### **Third Party Assessment**

With tightening of the regulatory environment, the customer product portfolio has become extremely limited, thus forcing the financial institutions to move towards traditional practices from the pre-crisis area of

exotic banking. This has put significant pressure on the bottom line of the business, notwithstanding the fact that the widened regulatory expectations have further increased the cost of compliance. Hence, the Financial institutions have, in an effort to improve their bottom line through rationalized cost of operations, moved to an outsourcing model, where core and non-core activities of the business are outsourced to leverage on economies of scale. Outsourcing models range from captive outsourcing to third party outsourcing. There have been many instances in the recent past, where inadequate oversight over the outsourced functions has resulted into regulatory lapses, operational risks and frauds that have posed significant reputation damage to the financial institution. As the Internal Audit function progresses, its ability to cover outsourced operations will become increasingly critical.

#### **Customer conduct**

Customer service has assumed a lot of importance with reputational risk gaining greater significance. Risks related to mis-selling, legal risks, documentation and mis-representation are required to be evaluated by the Internal Audit function on a concurrent basis. Additionally, the ability to monitor adherence to KYC/ AML requirements is expected to stay at the fore-front of challenges relating to customer conduct. Given that customer conduct is a relatively new area, the techniques and tools used by the Internal Audit function to evaluate this area will need significant development and enhancement.



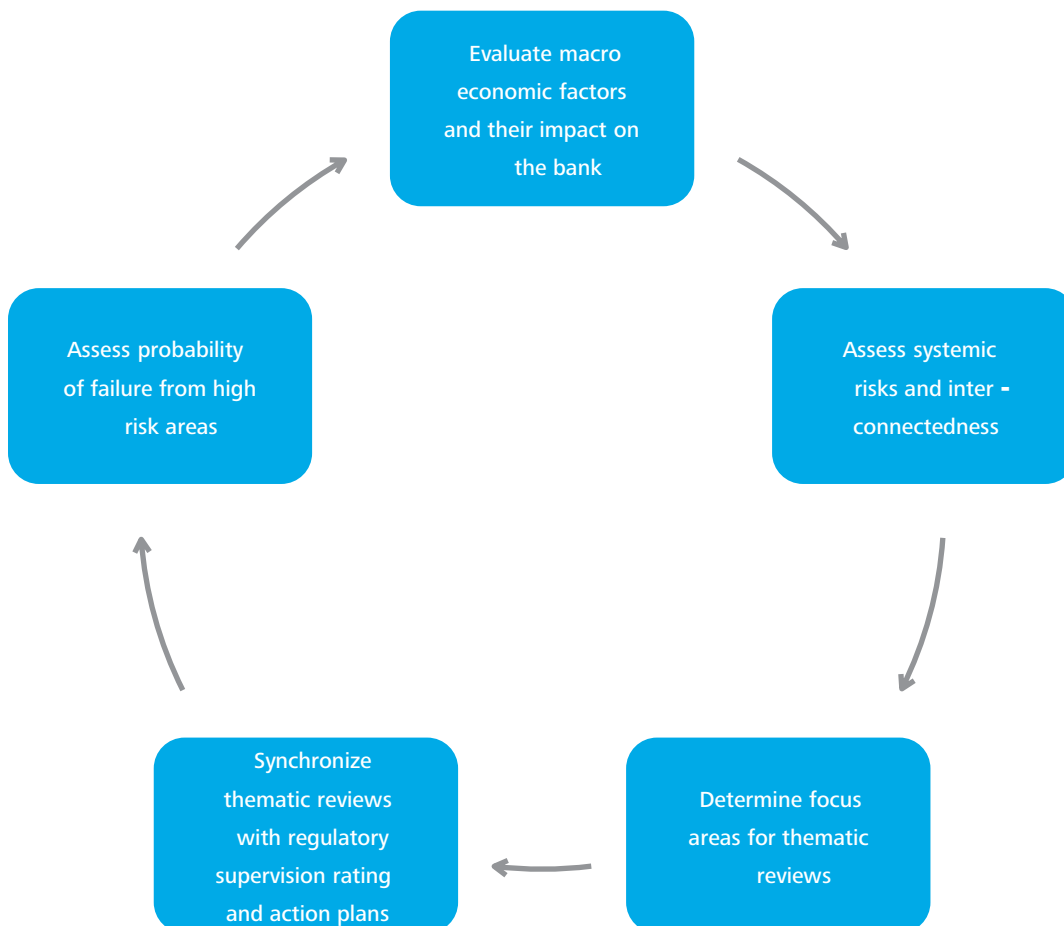


# Re-invigorating Internal Audit to address emerging risks

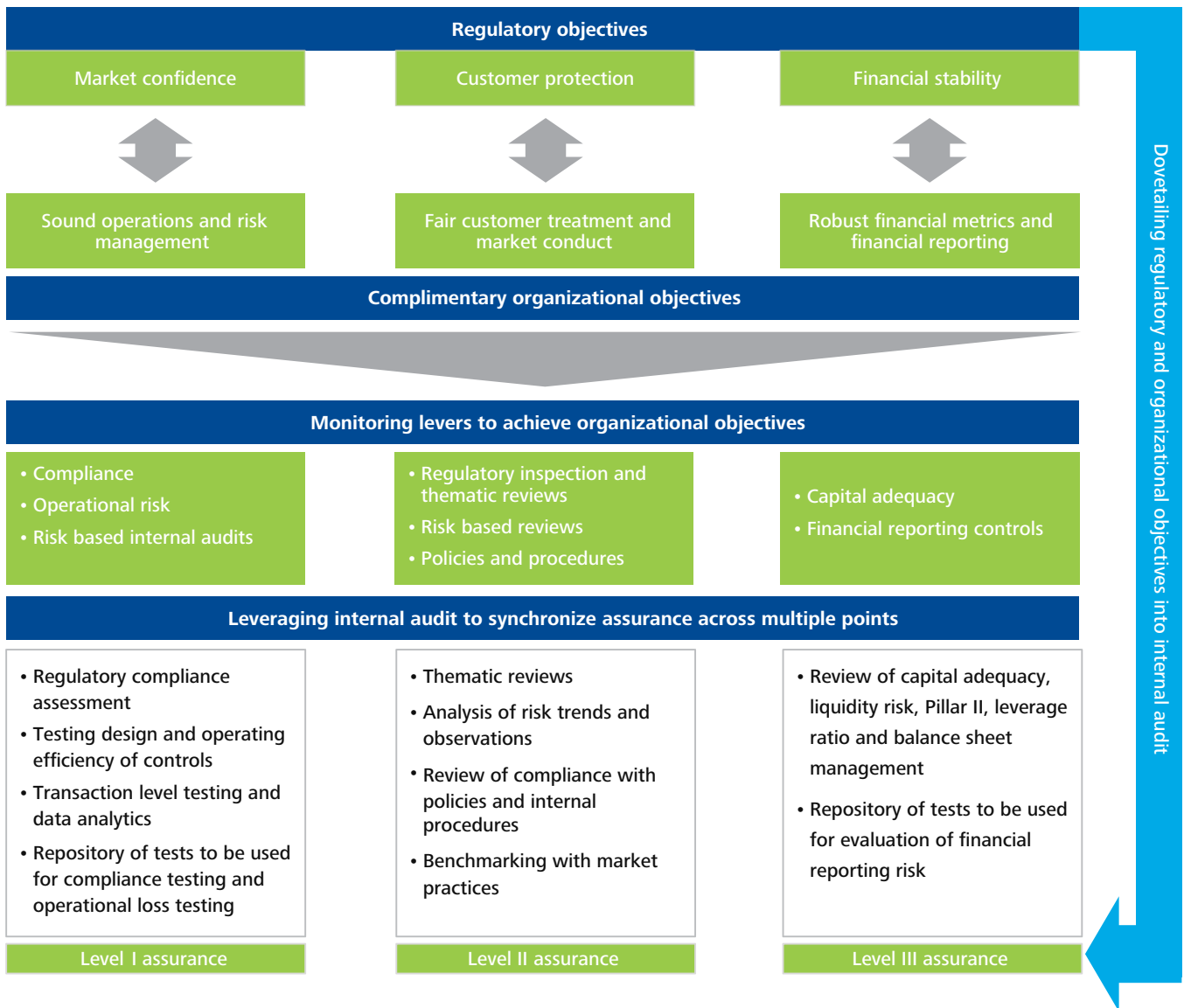
Internal Audit is expected to play a more pro-active and forward looking role. At the same time it is expected to continue providing transactional and compliance assurance. The Internal Audit function is also expected to focus on rationalizing the points of re-audit. The Internal Audit function is, therefore, required to change

its approach towards two aspects: (i) the manner in which emerging risks are continuously identified (ii) the manner in which multiple points of assurance are synchronized and leveraged.

## Internal Audit process for continuously identifying emerging risk areas and conducting thematic reviews



**Synchronizing multiple points of audit and providing holistic assurance**



# Deloitte Internal Audit service offerings for the Financial Services Industry

Deloitte India has a dedicated regulatory and Internal Audit team of 100 professionals providing end-to-end solutions to banks and financial institutions. We have an extensive experience of successfully delivering Internal Audit transformation, concurrent audit and specialized

reviews across a broad spectrum of financial institutions. Our services focus on the deep integration of functional and strategic processes and technology knowledge. A brief overview of our Internal Audit service offerings is contained below:

<b>External factor risk assessment</b>	<ul style="list-style-type: none"><li>• Evaluation of macro-economic risks and their impact on the bank</li><li>• Development of models to monitor systemic risks</li><li>• Assistance in development of internal audit risk assessment framework and audit planning framework</li></ul>
<b>Test cases development for audit and audit analytics</b>	<ul style="list-style-type: none"><li>• Regulatory compliance assessments</li><li>• Development of test cases across regulation, operational controls and technology platforms to support concurrent audit, internal audit and compliance testing</li><li>• Development of internal audit analytics framework and implementation of audit automation tools</li></ul>
<b>Internal/ concurrent audit co-sourcing/ outsourcing</b>	<ul style="list-style-type: none"><li>• Concurrent audit outsourcing</li><li>• Internal audit co-sourcing, staff augmentation and skill-set augmentation</li></ul>
<b>Specialized reviews</b>	<ul style="list-style-type: none"><li>• Event-based specialized reviews and evaluations</li><li>• Validation and testing of statistical risk and capital models</li><li>• Pre-audit assistance in case of new product and technology implementation</li><li>• Testing services for technology implementation</li></ul>
<b>Remediation services</b>	<ul style="list-style-type: none"><li>• Ongoing monitoring of implementation of regulatory action plans and management action plans</li><li>• Assistance in addressing gaps identified during reviews, audits and regulatory supervision</li></ul>
<b>Quality assurance reviews</b>	<ul style="list-style-type: none"><li>• Independent review of work performed by in-house audit function</li><li>• Benchmarking of internal audit function, methodologies and tools</li></ul>



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