

# Risk Based Supervision

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## ABSTRACT

*Under the Risk Based Supervision (RBS) mechanism, supervisor is expected to concentrate its efforts on ensuring that financial institutions use the process necessarily to identify as well as measure and control risk exposure. The RBS is expected to focus supervisory attention in accordance with the Risk Profile of the bank, in the structured Risk Profile Templates (RPT) to enable the bank to make a self-assessment of their Risk Profile. It is designed to ensure continuous monitoring and evaluation of Risk Profile of institutions through risk matrix. This may optimize the utilization of the supervisory resources of the RBI so as to minimize the impact of a crises situation in the financial system. Preparation of Risk Audit Matrix is based on the magnitude of risk and frequency of risk is as per the direction of RBI. Once the Risk Audit Matrix is compiled after the risk based internal audit, Branch Monitorable Action Plan (BMAP) will have to be chalked out for the branch so as to take timely corrective action and also to mitigate any significant risks that may have been identified during the supervisory process.*

## RISK BASED SUPERVISION

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. The RBI has been constantly endeavouring to enhance the sophistication, efficiency and effectiveness of its supervisory mechanism over banks. The R B I has its supervisory mechanism by way of On-site inspection and Off-Site Monitoring and Supervision (OSMOS) on the basis of the audited financials and under CAMELS approach (CAMELS stand for Capital adequacy, Asset quality, Management aspects, Earnings capability, Liquidity management and System controls).

Under the Risk Based Supervision (RBS) mechanism, supervisor is expected to concentrate its efforts on ensuring that financial institutions use the process necessarily to identify as well as measure and control risk exposure. The RBS is expected to focus supervisory attention in accordance with the Risk Profile of the bank, in the structured Risk Profile Templates (RPT) to enable the bank to make a self-assessment of their Risk Profile. It is designed to ensure continuous monitoring and evaluation of Risk Profile of institutions through risk matrix. This may optimize the utilization of the supervisory resources of the RBI so as to minimize the impact of a crises situation in the financial system.

The RBS approach is an attempt to overcome the deficiencies in the traditional point-in-time, transaction-validation and value based supervisory system. It is forward looking enabling the supervisors to differentiate amongst banks to focus attention only on those having high-Risk Profile. The implementation of risk based auditing would imply that greater emphasis is placed on the internal auditor's role for mitigating risks. By focusing on effective risk management, the internal auditor would not only offer remedial measures for current trouble-

prone areas, but also anticipates problems that may play an active role and protecting the bank from risk hazards.

RBS may be defined as a process by which the risk facing each supervised entity is analysed and an appropriate supervisory strategy is developed. The system is formulated to ensure continuous monitoring and evaluation of Risk Profile of bank, 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 coupled with minimal or no transaction testing. In the bank specific Basel 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 function effectively. The onus would be on the banks' part to convince that RFA system is sound and the off-site data is quite reliable. The RBI has structured the Risk Profile Templates to enable the bank to make a self-assessment of their risk. Apart from optimizing the utilization of the supervisory resources of the RBI, it 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 distinct and separate 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.

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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 the subject matter for deliberations and discussions at the Board of Directors or suitable sub-committee of the Board. The implementation of risk based auditing would imply that greater emphasis is placed on the Internal Auditor's role for mitigating risks. By focusing on effective risk management, the internal auditor would not only offer remedial measures for current trouble-prone areas, but also anticipates problems to play an active role in protecting the bank from risk hazards.

## 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 a prelude and part of moving towards switching over to RBS, the RBI had 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 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 5 risk parameters viz. Credit Risk, Market Risk other than Liquidity Risk, Liquidity Risk, Operational Risk & Group Risk and Control Risk containing 3 risk parameters viz. Organisation Risk, Management Risk & Compliance Risk, in all comprising 8 areas for capturing entire gamut of the banking activities.** Matters pertaining to Earnings and Capital are deliberated separately. Business Risk are those risks that are considered inherent in the activities undertaken by a bank irrespective of whether controls are in place, whereas Control Risks enable to arrive at proper judgment as to whether adequate controls are in place.

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 R P T. **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, a very comprehensive document on the functional aspects of banks, consists of three parts, viz Overview of the Bank, Summary Risk Profile and Risk Assessment areas. In respect of the identified 8 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**” for the next quarter. **The Level of Risk is indicated as Low, Moderate, Average & High and the Direction as Decreasing, Stable & Increasing.**

On summarizing the Risk Assessment Templates, under the umbrella of the Business Risks and Control Risks, encompassing all the 8 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 both comprehensive and dynamic one, as a single document covering the entire business as well as control functions of the bank, 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 to review and update the Risk Profile document, at least, on a quarterly basis.

## RISK FOCUSED INTERNAL AUDIT

In tune with the objectives of RBS, banks should put in place a system of Risk Focused Internal Audit (R F I A) 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.

The internal audit department should pay special attention to auditing various activities of the bank carried out across the country. The precise scope of work to be

covered by the internal audit team should be determined by each bank as the minimum control aspects over key process by which risks are identified, analysed and managed, should figure in the review report. 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.

The transaction testing has served the system till recently. But, it cannot keep pace with the continuous changes occurring in bank's risk profile. It also imposes unnecessary regulatory burden on banks and constraints 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 & risk appetite

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. If there are material doubts and infirmities on the risk management systems, significant reliance should not be placed on the existing 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. It is obvious that high-risk areas need to be looked into more frequently than the low risk ones.

Risk Focused 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, R F I A should capture the application and effectiveness of risk management procedure and risk assessment system. While ensuring Risk Focused Internal Audit at the branches, it may be appropriate to keep in mind, various aspects such as Branch Profile, volume of business, inspection rating, issues of serious concern covered in the report, etc. Branches are to be grouped into different categories. The risk profile of a branch should be compiled after taking into account Credit Risk, Market Risk and Operational Risk covering all the aspects.

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 & Very 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. Moreover, it may be noticed that Market Risk is best addressed at the bank's Central or Head Office. With regard to branch level functions, the concentration and focus should be on Credit Risk and Operational Risk.

Apart from the branches, the exercise should cover certain sensitive and functional departments like Treasury, Funds Transfer, International Banking, Inter-Branch Accounting, Retail Lending, etc. There should be an Audit Plan for carrying out RFIA drawn in such a manner that over a specified period of time even Minimal Risk category branches will be subjected to R F I A. Risk Audit Matrix will have to be prepared for each branch and audit exercise will have to be prioritized depending on the level and direction of the risk.

Under the R F I A 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, wherever it co-exist along R F I A. The R F I A 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.

## RISK AUDIT MATRIX

The Risk Focused Internal Audit exercise is expected to throw the Branch Risk Profile, which, to start with, needs to be up-dated quarterly. Based on the risk profile of the branch / office, the Risk Profile Matrix is compiled and tabulated in respect of the areas of activity, as indicated below:

### RISK AUDIT MATRIX

Risk Magnitude	Risk Frequency		
	Low	Medium	High
High	High M Low F	High M Medium F	High M High F
Medium	Medium M Low F	Medium M Medium F	Medium M High F
Low	Low M Low F	Low M Medium F	Low M High F

Preparation of Risk Audit Matrix is based on the magnitude of risk and frequency of risk is as per the direction of RBI. Once the Risk Audit Matrix is compiled after the risk based internal audit, Branch Monitorable Action Plan (**BMAP**) will have to be chalked out for the branch so as to take timely corrective action and also to mitigate any significant risks that may have been identified during the supervisory process. The BMAP will, inter-alia, include directions to the branches / offices on the actions to be taken within a specified time schedule. The remedial action relates to the identified areas of high risk. The overall Risk Matrix of all the branches covered under RFIA is depicted in the following table.

		Control Risk			
		HIGH	FAIR	MODERATE	LOW
Business Risk	HIGH				
	FAIR				
	MODERATE				
	LOW				

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 monitoring 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 status. Therefore, banks have to 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.

Cost of Risk can never be correctly assessed, as Risk is very dynamic with an element of suspense always hanging over it. Calculating cost of risk may not be a worthy exercise, as it is akin to solving a non-existing problem and the problem can be gauged only when it surfaces and not otherwise. In this regard, bank may constitute a small Task Force Committee of Executives and entrust them with the responsibility to chalk out an action plan, implement and monitor the progress in adoption of risk management systems and risk focused audit and report to the Top Management and Board of Directors periodically.

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. Only a coordinated effort on the part of banks as well as RBI can result in a quick and smooth transition to RBS, which is nothing but proper blending of old practice of transaction testing and the new mechanism of assessing risks. Ideally speaking, an in-house Change Management Team is to be constituted and institutionalized to monitor the progress of implementation and suggest ways and means to overcome the obstacles. Banks are required to report a comprehensive quarterly report to RBI detailing down the

status of implementation to move towards Risk Based Supervision, in addition to the progress on implementation of ALM & Risk Management systems in the Bank in Basel framework.

**As banking is considered to be the locomotive that drives the nation's economy and is a highly leveraged entity with lot of trust being placed on them by the general public, effectiveness of bank supervision is of public concern,** the basic objectives being protection of depositors and safeguarding the integrity and soundness of the financial system. RBS has evolved out of the ongoing supervisory pursuit to address the issues unanswered by the traditional method of supervision. Though, Cost of Risk and Cost of Banking Supervision are 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 and earnestness.