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Rating of Indian Banks: Progress In Implementation of Risk Based Approach to Internal Audit

Vijay Kumar Khanna

Abstract

Risk Based Internal Audit (RBIA) in Indian banks was initiated in 2002 and substantial progress has been made in its implementation. Surveys conducted by the author during 2007-08 & 2010-11 indicate that the progress in implementation has not been uniform across banks and several gaps exist in the process adopted. This study makes a comprehensive attempt to determine the reasons for varying progress made in different banks and identification of the important factors/parameters differentiating the effectiveness of organizational preparedness of banks for implementation of RBIA. A Rating framework has been developed by the author to categorize the sample banks in accordance with their organizational preparedness for implementation of RBIA. The paper offer suggestions for the consideration of policy makers and banks in improving the effectiveness of RBIA.

Keywords: *Risk Based Internal Audit, Ratings of Banks, Risk Based Supervision, Risk Assessment, Risk Mitigation*

Introduction

Banks in India initiated the implementation of Risk Based approach to Internal Audit (RBIA) consequent to the issuance of a Guidance note by the Reserve Bank of India (RBI) on 27th December, 2002 (RBI, 2002). Under RBIA, the focus of the audit cell is expected to be on the application and effectiveness of risk management procedures, risk assessment methodology and a critical evaluation of the adequacy and effectiveness of the internal control systems. Hence, the role of the auditor would change fundamentally to one who has to identify areas of potential risk and suggest measures to mitigate the same (Khanna, 2008). RBIA, being an independent input to top management, would assist banks in better risk management by providing checks and balances in the system. RBIA is a tool to conduct internal audit in bank activities/locations to assess risk associated with business, quantify the level and direction of risk, identify potential risks and initiate measures for risk mitigation.

With the introduction of financial sector reforms in the early 90's, banks began operating in a deregulated competitive operating environment adopting interest rates determined by market forces etc. With these changes, risks in banking business increased, both in quantity and composition. In this changed scenario, traditional transaction audit does not fulfill the objective of providing feedback on overall working of business unit with due reference to risk and return. The Report of the High Level committee for Review of Supervisory Processes in respect of Commercial banks in India dated June 11, 2012 (RBI, 2012) recommended changes in the existing supervisory approach to a Risk Based Supervision approach from the audit cycle of 2013. Based on the recommendations of the Basant Seth committee, a Master Circular (GOI, 2011) was issued by the Ministry of Finance, Government of India, in September, 2012 advising Public sector banks to limit the number of different types of audits and strengthen the implementation of a risk based approach for Internal audit, Concurrent audit and IS audit.

Review of Literature

The literature on RBIA in banks in India is inadequate and a lack of a comprehensive assessment of the progress made by banks in implementation of RBIA raises several questions. ***Krishnan & Kaveri, 2003*** in a survey found that there were wide disparities amongst banks in understanding of the concept of RBIA and banks were looking to RBI to provide formats for risk profiling and risk assessment. A study of Indian banks by ***Khanna & Kaveri, 2007*** found that the progress in implementation of RBIA was not uniform in banks. Further, a survey of 40 Indian banks by ***Khanna, 2011*** found that banks have adopted a staggered approach towards the implementation of RBIA spread over the years 2002-2009 and even though all banks have implemented RBIA of branches, but many of them have not considered RBIA in other activities/locations which form a major part of their business activities. Some significant gaps were observed in the process adopted by banks in the implementation of RBIA and the progress made in implementation varies amongst different banks.

No comprehensive study has been made to determine the reasons for varying progress made in different banks and identification of the important factors/parameters differentiating the effectiveness of organizational preparedness of banks for implementation of RBIA. This study attempts to fill this gap in available literature on this subject.

Objective of the Paper

In the backdrop of inadequate literature available on the practical issues associated with implementation of RBIA, the objectives of this paper are to assess the progress made by banks in implementation of RBIA, identify the areas where gaps exist in its implementation by different banks, rate the banks according to the progress made in implementation of RBIA and offer suggestions to make the process more robust and effective. The specific objectives of the research study are listed below.

1. To critically assess the progress made by banks in implementing RBIA as also identify the gaps/deviations from RBI guidelines.
2. Rate and rank the sample banks based on the progress made in implementation of RBIA
3. To identify the distinguishing features amongst banks that have made very good/ unsatisfactory progress in implementation of RBIA and
4. Offer suggestions for the consideration of policy makers and banks in improving the effectiveness of RBIA.

Hypothesis of the Study

Taking the nature of research and specific objectives, the following hypothesis has been set out.

"Effective implementation of RBIA in Indian banks critically depends upon their organizational preparedness measured in terms of:

(a) Formation of a Special Task Force and development of a Road Map for implementation of RBIA

(b) Formulation, approval and review of Policy on RBIA

(c) Identification, assessment and control of risks faced by banks in various activities/locations

(d) Methodology of preparation of a detailed Annual audit plan

(e) Process of conduct of on–site RBIA , preparation of RBIA report, preparation, implementation and follow up of the Monitor able Action Plan based on audit findings (including steps for risk mitigation) and closure of audit reports

(f) Quality, quantity and training of manpower in audit departments and adequacy of infrastructural facilities, including off-site data base & IT systems support for conduct of RBIA.

In other words, if a bank is organizationally well prepared, effective implementation of RBIA is ensured. Reverse is the case when the bank is inadequately prepared, organizationally".

Methodology

Against the backdrop of set objectives, the information relating to RBIA and its implementation covering public and private sector banks was collected from both primary and secondary sources. The methodology of the study is described below.

1. Review of the available literature on the subject from various sources including reports of the committees appointed by RBI, circulars issued by the RBI etc.
2. To generate the required information, inputs of Survey of 40 Indian banks (27 Public Sector and 17 Private sector banks), Survey of inspectors (122 respondents) and discussions with senior executives of Audit departments of 8 banks, carried out by the author have been used. The respondent banks represent approximately 94 percent of the Total Assets and branch network of Indian banks.
3. In order to test the hypothesis, the author has developed and used a score based rating framework (developed on the primary information collected from 40 sample banks) to categorize the sample banks in accordance with their organizational preparedness for implementation of RBIA. A total of 58 parameters under the 6 headings encompassing all aspects of the organizational preparedness for implementation of RBIA in banks have been considered. The important parameters under each heading are given as Annexure 1.

Framework for Bank Ratings

Each of the 58 parameters has been given a maximum score ranging from 5 marks to 40 marks. The weight ages assigned to parameters under each head are not uniform and have been determined based on discussions with banks. Summary is given in Table I.

Table I: The Framework for Bank Ratings

Heading	*Number of parameters*	*Max. score*
Formation of a Special Task force and development of a Road Map for implementation of RBIA	9	300
Formulation, approval and review of Policy on RBIA	3	50
Risk Identification, assessment & control	12	350
Methodology of preparation of a detailed Annual audit plan	9	130

Heading	*Number of parameters*	*Max. score*
Process of conduct of on–site RBIA , preparation of RBIA report, Monitor able Action plan and closure of audit reports	14	240
Quality, quantity and training of manpower and adequacy of infrastructural facilities for RBIA.	11	130
TOTAL	58	1200

The banks have been rated based on their scores out of a maximum score of 1200 as:

- **Very good** with a score higher than 960 (above 80%)
- **Good** with scores ranging from 828 up to 960 (69% - 80%)
- **Satisfactory** with scores ranging from 708 up to 828 (59% -69%)
- **Unsatisfactory** for a score below 708 (below 59%)

A **Very Good** rating reflects a high degree of organizational preparedness for effective implementation of RBIA in the bank and an **Unsatisfactory** rating reflects poorly on the organizational preparedness scale.

Study Findings: Rating of Banks

Using the above rating framework we have worked out the component-wise score as also composite score for sample banks. The details are in Table II.

Table II. Bank-wise and Component-wise Scores of Sample Banks

Sr No	*Parameters/ Ratings/ Name of bank*	*Setting up of Task Force etc*	*RBIA Policy Formula-tion etc*	*Risk identif-ication, Assessment & control*	*Preparation of Annual Audit Plan*	*Conduct of RBIA, MAP, Audit Report Closure etc Training etc.*	*Organizat-ional Aspects – Quality,*	*Total*	*Score as a Percent-age of Total*
	Max. Scores	**300**	**50**	**350**	**130**	**240**	**130**	**1200**	**(%)**
	Very Good								
1	Syndicate Bank	300	50	320	120	190	110	1090	90.83
2	ICICI Bank	300	50	340	100	180	120	1090	90.83
3	IDBI Bank	285	35	340	120	200	110	1090	90.83
4	State Bank of India	295	35	320	80	200	100	1030	85.83
5	Punjab National Bank	280	50	310	80	160	130	1010	84.17
6	State bank of Mysore	265	35	305	70	220	110	1005	83.75
7	State bank of Travancore	245	35	275	100	220	120	995	82.92
8	YES Bank	270	50	300	110	180	80	990	82.50
9	Bank of India	253	50	280	105	170	130	988	82.33
10	Axis Bank	237	50	300	80	210	110	987	82.25
11	Federal Bank	193	50	260	120	210	130	963	80.25

Sr No	Parameters/ Ratings/ Name of bank	Setting up of Task Force etc	RBIA Policy Formulation etc	Risk identification, Assessment & control	Preparation of Annual Audit Plan	Conduct of RBIA, MAP, Audit Report Closure etc Training etc.	Organizational Aspects – Quality,	Total	Score as a Percentage of Total
	Max. Scores	**300**	**50**	**350**	**130**	**240**	**130**	**1200**	**(%)**
12	Tamilnad Mercantile bank	245	50	275	110	170	110	960	80.00
	Good								
13	HDFC Bank	245	35	275	120	160	105	940	78.33
14	Indian Bank	180	50	265	110	210	110	925	77.08
15	Indian Overseas Bank	252	50	300	70	130	90	892	74.33
16	IndusInd Bank	205	35	300	80	155	110	885	73.75
17	Catholic Syrian Bank	195	35	275	80	160	110	855	71.25
18	State Bank of Bikaner & Jaipur	255	35	260	70	160	70	850	70.83
19	Jammu & Kashmir bank	185	35	270	90	170	100	850	70.83
20	Andhra Bank	155	50	250	80	190	110	835	69.58
21	State Bank of Indore	190	50	240	110	130	110	830	69.17
22	Corporation Bank	155	50	245	80	190	110	830	69.17
	Satisfactory								
23	United Bank of India	135	50	255	90	145	120	795	66.25
24	Bank of Baroda	205	35	215	70	150	100	775	64.58
25	Dhanalakshmi bank	180	50	210	70	145	100	755	62.92
26	Union Bank of India	145	40	230	90	150	90	745	62.08
27	Bank of Rajasthan	145	35	250	90	155	70	745	62.08
28	Nainital Bank	170	50	240	80	120	80	740	61.67
29	Allahabad Bank	135	35	230	80	150	110	740	61.67
30	Central Bank of India	185	50	235	80	145	40	735	61.25
31	Karur Vysya Bank	133	50	250	60	120	110	723	60.25
32	Canara Bank	190	35	205	60	140	90	720	60.00
33	Vijaya Bank	145	50	195	70	150	110	720	60.00
	Unsatisfac-tory								
34	Lakshmi Vilas Bank	178	35	255	70	70	90	698	58.17
35	Dena Bank	175	50	180	90	130	70	695	57.92
36	Karnataka Bank	155	50	235	60	95	100	695	57.92
37	South Indian Bank	140	35	205	60	160	80	680	56.67

Sr No	Parameters/ Ratings/ Name of bank	Setting up of Task Force etc	RBIA Policy Formulation etc	Risk identification, Assessment & control	Preparation of Annual Audit Plan	Conduct of RBIA, MAP, Audit Report Closure etc Training etc.	Organizational Aspects – Quality,	Total	Score as a Percentage of Total
	Max. Scores	**300**	**50**	**350**	**130**	**240**	**130**	**1200**	**(%)**
38	Oriental Bank of Commerce	160	30	205	70	130	80	675	56.25
39	Bank of Maharashtra	120	50	180	40	130	55	575	47.92
40	United Commercial Bank	103	50	185	50	100	70	558	46.50

From the information given in the above table, we draw the following inferences.

a) Of the 12 banks rated as 'very good' in regard to organizational preparedness for the implementation of RBIA, 50 percent were public sector banks. The composite score in this category ranged from 1090 to 960 and as a percent of maximum score and the same was 90.83 (highest) and 80 (lowest) respectively.

b) Though three banks, namely, Syndicate, ICICI and IDBI bank scored a composite score of 1090 each, we may say that IDBI Bank was a late starter as this bank scored lowest as compared with other two for first two components. However, with respect to risk identification, assessment & control, preparation of annual audit plan and actual conduct of RBIA this bank secured relatively high scores resulting in a composite score equaling ICICI bank and Syndicate Bank.

c) Although SBI was first to set up the Task Force, its composite score is relatively low. However, when it comes to actual conduct of RBIA, this bank is not lagging behind.

d) Of the 10 banks rated as 'good', 6 were public sector banks and the balance private sector banks. Interestingly, most of the mid-sized banks are in this category and absence of large banks is rather noticeable.

e) Amongst the 'satisfactory' category of sample banks with regard to organizational preparedness, United Bank of India scored highest whereas Vijaya Bank scored lowest. However, the presence of large banks like Bank of Baroda, Canara Bank and Union Bank in this category is noteworthy.

f) With respect to sample banks rated as 'unsatisfactory', though the number is relatively low at 7, the average composite score for this category at 654 is about 64% of the group-average for banks rated as 'very good' at 1017. This huge margin, in a way, conveys that the organizational preparedness of different banks in regard to implementation of RBIA varies significantly. Moreover, it is disturbing to note that the gap, in this group, between highest scored bank (58.17 percent) and the lowest scored bank (46.50 percent) is highest as compared with other 3 groups.

g) In order to capture the unevenness within the rating categories, viz., very good, good, satisfactory and unsatisfactory, we used coefficient of variation (c.v). Interestingly, the distribution of composite score is highly skewed in 'unsatisfactory' category with a c.v of

0.092, followed by 0.047 in respect of 'very good' category. However in the case of other two groups the c.v varied between 0.045 (good) and 0.031 (satisfactory).

We now present in Table III a condensed picture of the ratings of sample banks as also distribution of banks in accordance with the groups, viz., public sector, old private sector and new private sector banks.

Table III: Group-wise and Rating-wise Distribution of Banks

Ratings	*Public sector Banks*	*Old Private sector Banks (OPSBs)*	*New Private sector Banks (NPSBs)*	*Total*
Very Good	6	2	4	12
Good	6	2	2	10
Satisfactory	7	4	-	11
Unsatisfactory	4	3	-	7
Total	23	11	6	40

These ratings indicate that 12 of the responding banks are very well prepared, organizationally, for effective implementation of RBIA. Another set of 21 banks get a Good/Satisfactory rating on the organizational preparedness scale and only 7 banks are rated as unsatisfactory being organizationally not well prepared for effective implementation of RBIA. Approximately 83 percent of the total sample banks have obtained a Satisfactory and above rating. Further from within the categories of banks 100 percent of NPSBs, approximately 83 percent of PSBs and 73 percent of OPSBs have obtained a Satisfactory and above rating. These ratings indicate that on an overall basis banks in India have made good progress in implementation of RBIA.

Identification of Differentiating Parameters Between Banks

To identify the important parameters responsible for the differentiations in ratings/scores which implicitly convey the level of organizational preparedness for effective implementation of RBIA in banks – a further analysis was undertaken of the Ratings information. The averages for the 6 headings used for the four Rating levels were computed to identify the headings which could possibly differentiate between the banks with Very good and Unsatisfactory ratings. These are indicated in Table IV below

Table IV. Average Scores of Rated Banks under 6 Headings

Rating	*Score*	*Setting up of Task Force etc*	*RBIA Policy Formulation etc*	*Risk identification, Assessment & control*	*Preparation of Annual Audit Plan*	*Conduct of RBIAMAP, Audit Report Closure etc*	*Organizational Aspects – Quality, Training etc.*	*Total*
	Maximum score	300	50	350	130	240	130	1200
Very good	Average score	264	45	302	100	193	113	1017
12 banks	% of Maximum	88	90	86	77	80	87	85
Good	Average score	202	43	268	89	166	103	869
10 banks	% of Maximum	67	85	77	68	69	79	72

Rating	Score	Setting up of Task Force etc	RBIA Policy Formulation etc	Risk identification, Assessment & control	Preparation of Annual Audit Plan	Conduct of RBIAMAP, Audit Report Closure etc	Organizational Aspects – Quality, Training etc.	Total
Satisfactory	Average score	161	44	229	76	143	93	745
11 banks	% of maximum	54	88	65	59	59	72	62
Unsatisfactory	Average score	147	43	206	63	116	78	654
7 banks	% of Maximum	49	86	59	48	49	60	54

An analysis of the table above indicates that for the heading of RBIA Policy formulation etc there are no material differences in the averages between the two groups. A finer analysis of the determinants of ratings such as for instance, Very Good rating or Unsatisfactory rating of banks reveals certain interesting as also critically important aspects. An analysis of this nature would also facilitate in identifying the reasons for laggardness in some banks receiving Unsatisfactory ratings. The key differentiating factors are;

1. Setting up of Task Force emerged as a key differentiator between banks which have made substantial progress and those lagging behind in regard to implementation of RBIA. In other words, banks rated as 'Very Good' had set-up Task Force much earlier as compared with banks which are rated as 'Unsatisfactory'.
2. Effective functioning of the Task Force which is responsible for preparation of roadmap for the implementation of RBIA in banks is critical to the successful implementation of RBIA. Our study reveals that the Task Force did identify the transitional and issues associated with change management in 83% of the Very Good rated banks. In a way, Task Force was not effective in its functioning in the case of Unsatisfactory rated banks as it identified issues in implementation of RBIA, in particular those associated with migration from traditional inspection to RBIA in only 28% of the banks.
3. Another important factor differentiating 'Very Good' rated banks from that of Unsatisfactory rated banks relates to the coverage of RBIA. To put it differently, Very Good rated banks have covered all activities/locations under RBIA and therefore, scored high. Conversely, in banks which are not organizationally well prepared, as reflected in their ratings, the coverage of RBIA has been comparatively low. Furthermore, of the total 7 banks with Unsatisfactory ratings only 2 had covered all branches under RBIA and in the remaining 5 banks, not even $3/4^{th}$ of the branches were brought under RBIA as at the time of survey.
4. Risk assessment, which is an integral and critical component of RBIA, is undertaken in all 'Very Good' rated banks for all the activities/locations/branches, whereas in 'Unsatisfactory' rated banks the same is confined to only branches. Thus, risk assessment emerged as an important differentiating factor influencing the progress in implementation on the one hand, and indirectly the usefulness of RBIA on the other. Related to risk assessment is 'off-site risk assessment'. Off-site risk assessment has been a part of RBIA implementation in banks which are organizationally well prepared and well progressed in implementation of RBIA. It is rather disturbing to note that this off-site risk assessment mechanism is altogether absent in all the seven banks rated 'Unsatisfactory' in regard to their preparedness.

5. Some of the differentiating factors relate to operational efficiencies of banks in implementation of RBIA. In banks rated Very Good, risk assessment ratings assigned by auditors are subjected to re-confirmation by an independent body/person. In 83 percent of the organizationally well prepared banks this independent quality check of the risk assessment ratings is undertaken. However, we noticed that in only one of seven 'Unsatisfactorily' rated banks this exercise is being carried out.
6. As per the RBIA framework, annual audit plan is an outcome of the off-site risk assessment. In 67 percent of the Very Good rated banks the Annual Audit plan is being prepared on the basis of the off-site risk assessment whereas in the case of the seven banks rated "Unsatisfactory" the Annual Audit plan is prepared based on the previous audit ratings and not the off-site risk assessment. The time gap between conduct of previous audit and preparation of Annual audit plan could result in a change in the risk profile of an activity/ location.
7. In line with the RBIA framework, the formats for both Off-site and On-site risk assessment are the same for 67% of the Very Good rated banks. As Unsatisfactory rated banks do not undertake Off-site risk assessment, this comparison does not arise.
8. Identification of the Acceptable levels of risks from a bank's point of view is a sequel to risk assessment and an integral input for risk mitigation. In 75% of the Very Good rated banks this identification of acceptable levels of risks in different lines of businesses is being carried out and this percent to the total number of Unsatisfactorily rated banks works out be only 28%.
9. We also noticed gaps in regard to the preparation of checklist of Risk mitigation techniques, between banks which have made substantial progress and those lagging in implementation of RBIA. The proportion of banks preparing the checklist of risk mitigation technique worked out to be 75 and 43 percents for Very Good rated and Unsatisfactory rated banks respectively.
10. Effective implementation of RBIA and its usefulness critically depends on the quality and quantity of the audit personnel. Our analysis of the factors influencing ratings reveal that All Very Good rated banks have carried out an assessment of the manpower requirements of the internal audit department in view of the special skill sets required for implementation of RBIA. This assessment of manpower requirement for implementation of RBIA was carried out in only 28% of the Unsatisfactory rated banks.
11. In our assessment, technology will play a very important role in effective implementation of RBIA in banks given that there is greater emphasis on off-site risk assessment and monitoring. The technology support for conduct of RBIA is reported to be adequate in all the Very Good rated banks but is reported to be adequate in only 43% of the Unsatisfactory rated banks.
12. Further, Software for conduct of risk assessment under RBIA has been developed/purchased by 50% of the Very Good rated banks. None of the Unsatisfactory rated banks have such software.
13. As a result of effective implementation of RBIA, the time taken for conduct of on-site audit has been reported to have reduced by up to 15% in 92% of the Very Good rated banks whereas only 28% of the Unsatisfactory rated banks report such a reduction.
14. Another benefit of effective implementation of RBIA is a more focused audit leading to optimal utilization of the manpower resources of the audit department. The manpower requirements of the audit department have reduced in 75% of the Very Good rated banks

whereas only one Unsatisfactory rated bank reports the reduction.

The other 21 banks which have been rated as "Good" and "Satisfactory" exhibit better organizational preparedness than the "Unsatisfactory" rated banks but are not as well prepared as the "Very Good" rated banks. The important differentiating parameters for these 21 banks include the areas of coverage of activities under RBIA (many of them have covered Treasury, Foreign exchange, IT systems in addition to branches under RBIA), are undertaking risk assessment of these activities in addition to branches, some have a system of quality checks, some have identified the Acceptable level of risks and have adequate technology support for conduct of RBIA. 3 of the 21 banks have developed/purchased software for conduct of RBIA.

The above analysis clearly supports the Hypothesis of the study that banks which are organizational well prepared, as reflected by the ratings, have ensured effective implementation of RBIA compared to other banks.

Recommendations

1. Action points for Banks for furthering implementation and effectiveness of RBIA

Based on the above, we may summarize the recommendations for implementation by banks (and more importantly for the banks rated Unsatisfactory) to improve the effectiveness of RBIA as follows:

1. Increase coverage of RBIA to include all activities/locations of bank
2. Discontinue Regular transaction based inspection and replace with RBIA
3. Prepare an Audit Manual for RBIA on priority basis.
4. Undertake revision of RBIA policy document to incorporate changes in formats and methodology of RBIA as per RBI guidance note
5. Form a team of senior executives from Risk management department and Audit department to undertake identification of risks in various activities/locations of bank
6. Simplify and reduce the length of risk assessment formats and ensure that the parameters adequately capture all risks
7. Revise formats for risk assessment at regular intervals taking cognizance of the changing business plans, introduction of new technology, products and processes.
8. Identify acceptable levels of risk for all risk assessment parameters under various activities/locations of the bank. Acceptable levels of Gross risk and Net risk should be separately identified
9. Undertake risk assessment of all activities/locations of bank
10. Conduct Off-site risk assessment (who are not undertaking the same currently) for preparation of Annual audit plan
11. Audit plan must be prepared for the Audit universe as well as for the auditee activity/location by bank
12. Scope of on-site audit should be determined by the off-site risk assessment
13. Independent quality check of risk assessment ratings assigned by auditors must be undertaken by senior executives (at Regional/Zonal/Head office) before finalization
14. Validation of off-site risk assessment should be undertaken during on-site audit

15. Involvement of Inspectorate in implementation and monitoring of audit report/action plan should be reduced substantially. Closure of audit report should be the responsibility of controlling offices/operations/ operational risk management department

16. Regular training of audit and operating personnel should be undertaken for effective implementation of RBIA.

17. Banks should assess the quality of manpower required for conduct of RBIA and ensure deputation of personnel with complete understanding of banking business, risk management and adequate experience and knowledge of banks policies and operational guidelines

18. Technology support for RBIA should be enhanced. Priority should be given for development of software for conduct of RBIA.

19. Members of Audit committee of the board and Top management of the bank should be sensitized of the concept and process of RBIA at regular intervals

2. Policy Options for RBI

The specific recommendations for RBI and the policy options are as follows:

1. In the light of the findings of the study, RBI as a regulator may consider the following aspects and issue necessary policy guidelines to banks:
   - All activities/locations of bank should be covered under RBIA in a time bound manner and banks should submit an action plan to RBI accordingly
   - All banks should undertake Off-site risk assessment for preparation of annual audit plan and determining the scope of on-site audit
   - Banks to prepare an Annual Audit plan for the Audit universe as well as for the auditee activity/location
   - Ensure that regular inspection is discontinued and replaced with RBIA in all banks
   - Ensure that the acceptable levels of various risks are well defined at Gross and Net risk level for all risks
   - Technology should be leveraged by banks for effective implementation of RBIA and banks must be encouraged to develop/purchase appropriate software for same
   - Awareness of the concept and process of RBIA should be increased at all levels from the Board/Top management to the operating staff through extensive training/ seminars/conferences.
   - Banks with Unsatisfactory rating may be encouraged to outsource some of the work relating to development of risk assessment formats for various activities of bank , conduct of off-site risk assessment/on-site risk assessment, development of appropriate software etc. to make RBIA implementation more effective
2. A review of the Guidance notes on RBIA issued in 2002 and 2005 should be undertaken for revision, especially in the following areas:
   - Identification of Business and Control risks in various activities/locations of banking business
   - Development of Templates for risk assessment of Business risks and Control risks in various activities/locations of banks

- Indicative range of cut-off scores for different levels of risk
- Procedure for off-site risk assessment for preparation of annual audit plan
- In line with international applications, consider move to 5 levels of risk from the existing 3 levels of Low/Medium/High risk for greater granularity and effective risk measurement
- Modify the Composite risk matrix accordingly
- Clarify the use and application of Audit risk matrix

3. As the introduction of RBIA in scheduled commercial banks has started showing satisfactory results, as evident from the present study, and has improved the understanding and application of risk management practices across the bank, it may be an opportune time to introduce RBIA in the bigger Regional Rural banks and Multi State Urban cooperative banks also.

Conclusion

With the application of the ratings model, developed by the researcher, to assess the organizational preparedness of banks for implementation of RBIA, we have been able to distinguish and differentiate the banks under the survey having a Very Good level of organizational preparedness from the others. Some of the important differentiating parameters between banks having Very Good ratings and Unsatisfactory ratings have also been identified. These differentiating parameters have also been identified in the surveys conducted and have been flagged as important issues to be addressed by both the banks and RBI for effective implementation of RBIA. Recommendations and suggestions have been made for banks and policy makers to address these issues to improve the effectiveness and implementation of RBIA in banks in India.

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ANNEXURE 1

Parameters Assessed Under Each Heading with Score Sheet

1. **Formation of a Special Task Force and Development of a Road Map for Implementation of RBIA:** Under this head, we have used parameters like year of formation of task force, development of a road map for implementation of RBIA, the activities/locations where RBIA is being conducted and the extent of coverage, review of progress of implementation of RBIA and development of an RBIA Manual by the bank.

2. **Formulation, Approval and Review of Policy on RBIA:** Here we have considered the existence of a Board approved RBIA Policy in the bank, whether the policy has been reviewed or modified over the years incorporating changes in bank activities/lines of business etc.

3. **Risk Identification, Assessment & Control:** Under this important parameters comprise identification of the various risks the bank faces in its operations, activities/locations of the bank where risk assessment is being undertaken, when is the risk assessment carried out and who conducts the same, whether risk assessment is conducted separately for business risks and control risks, whether the bank prepares the composite risk matrix and identifies the direction of risk, and whether there is system in the bank of quality control of risk assessment ratings assigned by auditors/inspectors.

4. **Methodology of Preparation of a Detailed Annual Audit Plan:**

   Under this head the parameters assess whether bank prepares an Annual Audit plan and what is the basis of preparation of the plan (whether off-site risk assessment or previous audit ratings are being used). Whether Audit plan is being prepared both for the Audit Universe and each activity/location of bank, as also whether the risk assessment ratings are being used for determining the scope, periodicity and frequency of on-site audit. Does the bank make use of the risk audit matrix and if there a system within the bank to ensure that no activity/location is left unaudited beyond 18 months.

5. **Process of Conduct of on–site RBIA, Preparation of RBIA Report, Monitorable Action Plan, Closure of Audit Reports and Risk Mitigation:**

   Under this we assess if separate formats for RBIA report have been developed by the bank and the auditee activity/location is informed in advance the scope and proposed date of on-site audit. Whether the bank has a system of flash/interim reports and conduct of exit meetings with operating heads by the audit team. Whether the bank has identified the Acceptable level of risk and has developed a checklist for risk mitigation. We also assessed if the bank prepares a Monitor able action plan and who implements and monitors this plan. Another set of parameters determined to understand how the audit reports are deemed to be closed and whether validation of off-site risk assessment is undertaken by the bank.

6. **Quality, Quantity and Training of Manpower in Audit Departments and Adequacy of Infrastructure, Including MIS & IT Systems Support for Conduct of RBIA:**

   Under this head the parameters include an assessment whether the change management issues have been identified by the bank and what measures have been undertaken to address these issues. Whether the bank has undertaken an assessment of the training needs of audit and operation personnel for implementation of RBIA. Whether the issues of quality of manpower of audit department for conduct of RBIA been addressed by the bank. We also assessed if the bank has adequate technology support for implementation of RBIA and whether any software has been developed/purchased by the bank for conduct of RBIA. A review of the effectiveness of RBIA in bank been undertaken or not is another important parameter.

SCORE SHEET

S.No	*Title*	*Max. Marks*	*Marks Awarded*
1	**Formation of a Special Task force and Development of a Road Map for Implementation of RBIA:**		
1.	Was a Task Force of Senior executives formed in your bank to chalk out an Action Plan for implementation of Risk Based Internal Audit (RBIA)?	20	
2.	Has your bank drawn up a 'Road Map' for implementation of RBIA?	20	
	If yes, in which of the following locations/activities of the Bank has RBIA been implemented?	100	
	a. Branches		
	b. Currency Chest		
	c. ATMs		
	d. Controlling Offices		
	e. Treasury		
	f. Risk Management Department		
	g. Forex Department		
	h. Centralized Processing Cells		
	i. Merchant Banking & Advisory Services		
	j. IT Systems		
3.	How is RBIA being conducted in your Bank	10	
4.	What is expected to be the coverage of locations/activities under RBIA by **31st March, 2009?** (By number of branches/locations etc)	100	
	a. Branches		
	b. Currency Chest		
	c. ATMs		
	d. Controlling Offices		
	e. Treasury		
	f. Risk Management Department		
	g. Forex Department		
	h. Centralized Processing Cells		
	i. Merchant Banking & Advisory Services		
	j. IT Systems		
5.	Do you undertake a review of the progress of implementation of RBIA in your Bank?	30	
6.	Has the implementation of RBIA in your bank been in line with the identified Road Map?	10	
7.	Has any Manual of Inspection / Audit, containing procedures for conduct of RBIA been prepared by your bank?	20	
	SUB-TOTAL (A)	**300**	

S.No	Title		Max. Marks	Marks Awarded
2	**Formulation, approval and review of Policy on RBIA**			
1.	Have you developed a 'Policy on RBIA?			20
2.	Whether the policy on RBIA has been approved by Audit			10
3.	Has the RBIA Policy initially drafted and adopted by the bank undergone any material changes during its implementation over the years?			20
	SUB-TOTAL (B)			**50**
3	**Risk Identification, assessment & control**			
1.	Has your Bank identified the various Risks it faces in its business, as stated under?			40
	Inherent Risks			
	a.	Capital	5	
	b.	Credit	5	
	c.	Market	5	
	d.	Liquidity	5	
	e.	Operational	5	
	f.	Earnings	5	
	g.	Business Environment & Strategy	5	
	h.	Group	5	
		Control Risks		20
	a.	Internal Control & Housekeeping	5	
	b.	Organizational	5	
	c.	Management	5	
	d.	Compliance	5	
2.	Does the bank carry out Risk assessment of various activities/locations?			20
	If yes, which of these activities are covered under Risk assessment?			100
	a.	Branches	30	
	b.	Currency Chest	5	
	c.	ATMs	5	
	d.	Controlling Offices	5	
	e.	Treasury	15	
	f.	Risk Management Department	10	
	g.	Forex Department	10	
	h.	Centralized Processing Cells	5	
	i.	Merchant Banking & Advisory Services	5	
	j.	IT Systems	10	
3.	When is the Risk assessment carried out?			40
4.	Who conduct the Risk assessment			20

S.No	*Title*	*Max. Marks*	*Marks Awarded*
5.	Is Risk assessment being conducted activity-wise / location - wise separately for Business risks and Control risks?		20
6.	Does the bank assess the level of Business risks & Control risks separately and rate them as 'Low', 'Medium' or 'High'?		10
7.	Does the bank incorporate the magnitude of risk based on volume of business or any other factors in determining the level of risk?		10
8.	Does the bank prepare the Composite Risk Matrix after assessing the level of Business risks & Control risks separately?	20	
9.	Does the bank identify the 'Direction' of risk of activity/ location into 'Increasing', 'Decreasing' or 'Stable' separately for Business & Control risks?	10	
10.	Does the bank determine Direction of Composite risk of activity/location?	10	
11.	Whether there is a system within the bank of an independent quality check of the 'Risk Assessment Ratings' assigned by the auditors?	10	
12.	Does your bank adopt the following 'Risk assessment ratings' for branches/functions/ activities/locations etc?	20	
	SUB-TOTAL (C)	**350**	
4	**Methodology of preparation of a detailed Annual audit plan:**		
1.	Does the bank prepare an 'Annual Audit Plan'?	20	
2.	Is the Annual Audit plan prepared for:		
	The Audit Universe		
	For each activity/location separately	20	
3.	Is the Annual Audit Plan prepared based on the 'Risk assessment Ratings' of the various activities/locations carried out by the bank?	20	
4.	If the bank is conducting Risk assessment specifically for preparation of Annual Audit plan, are the formats presently used for risk assessment the same as those used for on-site audit?	10	
5.	Are the 'Risk assessment ratings' being used in your bank to determine the Priority & Periodicity of audit of various activities/ locations as well as the extent of Transaction Testing during on site audit?	20	
6.	Do you have a system in place to ensure that no activity/ location is left unaudited for a period beyond 18 months?	20	
7.	Do you make use of the 'Risk Audit Matrix' (as indicated in the RBI Guidance Note of 27/12/2002) to determine the areas that need priority of audit Resources?	20	
	SUB-TOTAL (D)	**130**	

S.No	*Title*	*Max. Marks*	*Marks Awarded*
5	**Process of conduct of on–site RBIA, preparation of RBIA report, Monitor able Action plan, closure of audit reports and risk mitigation:**		
1.	What is the scope of 'on-site audit' under RBIA based on: The off-site Risk Assessment Previous Audit Risk Assessment	20	
2.	Is the auditee (such as branch/department)activity/ location informed in advance the schedule & scope of RBIA?	20	
3.	Is the extent of transaction testing during on site audit based on the Risk Assessment?	20	
4.	Whether any separate format has been developed in your bank to report the Audit findings under RBIA?	10	
5.	Do you have a system of Interim/Flash report for: Reporting major Exceptions & Excesses Reporting Negative & Sensitive findings	10	
6.	Before finalization of the Audit report under RBIA, does the audit team have a detailed discussion with the branch manager/ operation head explaining its findings and recommendations?	20	
7.	Has your bank identified the "Acceptable level of Risk" for the various risk assessment parameters?	30	
8.	Does the audit team recommend the measures to be taken to Mitigate the risks faced by the auditee activity/location?	20	
9.	Do you feel any need for preparing a 'checklist for Risk Mitigation Techniques'? If yes, has such checklist been prepared?	10	
10.	Does the bank prepare a time bound "Action Plan" after completion of RBIA for Risk mitigation/rectification of audit findings?	20	
11.	Who monitors the progress in implementation of this Action plan?	10	
12.	Does your Bank undertake a comparison of the Risk assessment for the Audit plan & the Risk assessment under RBIA after 'on site audit'?	20	
13.	When is the audit report under RBIA deemed to be closed by the inspectorate?	10	
14.	Do the Regional or Zonal Offices (Operations) make use of the Risk assessment under RBIA for improving the risk profile of the activities under their jurisdiction?	20	
	SUB-TOTAL (E)	**240**	
6	**Quality, quantity and training of manpower in audit departments and adequacy of infrastructure, including MIS & IT systems support for conduct of RBIA**		
1.	Whether the 'Task Force' of senior executives set up for implementation of RBIA in the bank has identified the transitional and change management issues?	10	
2.	What are the steps initiated by the bank to address these issues?	10	

S.No	Title	Max. Marks	Marks Awarded
3.	Is there a system in your bank of keeping Internal Audit Department informed of any change in business plans, practices, products and services, risk management tools, changes in reporting lines, changes in accounting practices, policies, by the Top Management, etc.?	10	
4.	Whether any assessment has been done by your bank about the manpower required by the Internal Audit Department for conduct of RBIA keeping in view the special skills required?	10	
5.	Whether the executives manning the various activities/functions/ locations are aware of the Risk management Policies & practices of the bank?	10	
6.	Whether officers in your bank have been regularly trained to implement & assess the Risk management practices & policies at the branch / functional level?	10	
7.	Are the officers in the Inspection department adequately trained to arrive at the level of risk of various activities/functions and prepare the Composite Risk Matrix?	10	
8.	Has appropriate training been imparted/awareness created to Branch Managers/operational functionaries/ senior executives of controlling offices for adoption & successful implementation of RBIA?	10	
9.	Is the technology support provided for conduct of RBIA & Risk assessment adequate in your bank?	20	
10.	Has the bank developed/purchased any software for risk assessment under RBIA?	20	
11.	Has the bank undertaken a review of the progress in implementation & effectiveness of RBIA?	10	
	SUB-TOTAL (E)	**130**	
	TOTAL	**1200**	

Dr Vijay Kumar Khanna, Professor, National Institute of Bank Management, Pune, Maharashtra, India