Internal audit hot topics for the banking sector in India

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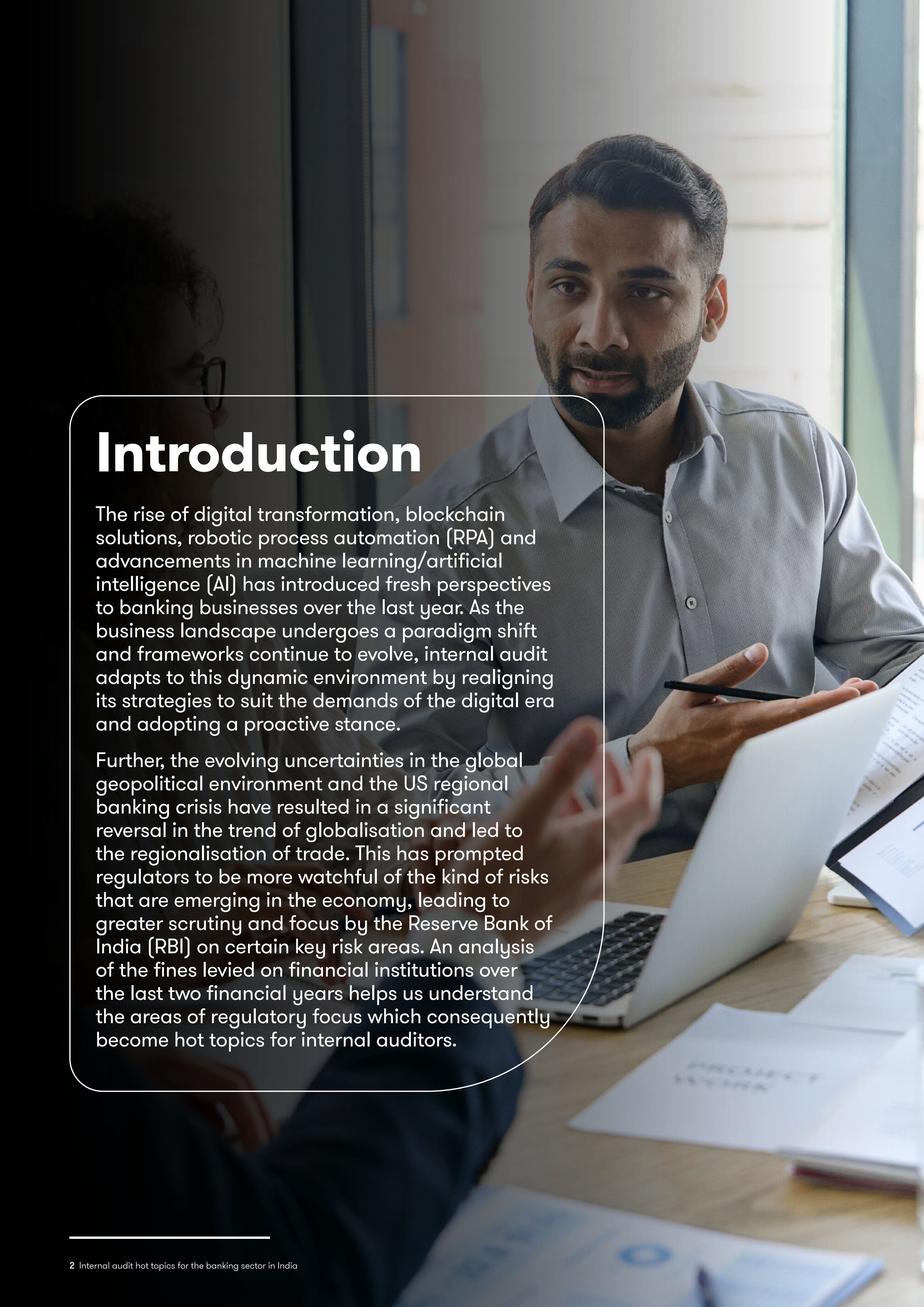

Introduction

The rise of digital transformation, blockchain solutions, robotic process automation (RPA) and advancements in machine learning/artificial intelligence (AI) has introduced fresh perspectives to banking businesses over the last year. As the business landscape undergoes a paradigm shift and frameworks continue to evolve, internal audit adapts to this dynamic environment by realigning its strategies to suit the demands of the digital era and adopting a proactive stance.

Further, the evolving uncertainties in the global geopolitical environment and the US regional banking crisis have resulted in a significant reversal in the trend of globalisation and led to the regionalisation of trade. This has prompted regulators to be more watchful of the kind of risks that are emerging in the economy, leading to greater scrutiny and focus by the Reserve Bank of India (RBI) on certain key risk areas. An analysis of the fines levied on financial institutions over the last two financial years helps us understand the areas of regulatory focus which consequently become hot topics for internal auditors.

Grant Thornton Bharat Analysis

RBI penalties on banks in FY 23-24 and emerging trends in the internal audit landscape

- Recent trends in the internal audit landscape have surfaced due to two pivotal factors - both intertwined with the current Indian financial and economic landscape and global geopolitical scenarios.
- First, the RBI imposed regulatory fines and penalties, necessitating a closer examination of banks' compliance frameworks and risk management practices. Secondly, new regulations and focus areas based on market trends, as seen in line with discussions with key market players, have prompted internal auditors to adapt their strategies and priorities commensurate to the business's size, scale and nature.
- The RBI has rigorously monitored the banks through periodic inspections to verify their adherence to relevant regulations. An independent assessment done by Grant Thornton Bharat on the penalties levied by RBI through a review of the press releases in FY 23-24 has shown that the cumulative amount of penalties levied on banks in India is est. INR 44 crore. These penalties have not only affected the banks' financial health but also their reputation in the market. Further, through its "Report on Trends and Progress of Banking in India 2022-23", RBI reiterated that banks must prioritise enhancing the quality of governance, anchored on the three pillars of compliance, risk management, and internal audit.
- On further analysis, it has been noted that while penalties have been levied across the private sector, public sector, cooperative and small finance banks, the regulatory areas of concern are often similar and reflect the key focus areas of RBI in line with the emerging risks as seen globally and in the Indian economy. These focus areas consequently become hot topics for internal auditors to build into their gamut of audits to ensure process excellence and regulatory compliance through effective audits of departments and their processes.
- The penalties levied have been primarily for non-compliance with the KYC/AML guidelines, inadequate controls over data integrity and privacy, incorrect furnishing of information to CICs, failure to comply with interest rates on advances, vendor risk management, fraud on account of sanctioned/committed loans, and inaccuracies with respect to customer service norms.

Hot topics

- Digital Personal Data Protection Act
- Third-party risk management
- Operational resilience assessment
- Digital lending ecosystem
- Independent quality assurance
- Thematic reviews & conduct risk management
- Reporting to Credit Information Companies (CIC)
- Customer service

Kindly refer to the next page for details

Digital data protection

Key aspects : Data privacy, security, storage, and maintenance

Our rationale

- The enactment of India's Digital Personal Data Protection Act (DPDPA) will introduce compliance requirements and pose certain challenges for regulated entities regarding handling customers' personal data.
- Consequently, REs must reevaluate their methods for collecting and processing personal data within their systems. Conducting a thorough internal audit will assist entities in gauging their preparedness and addressing the associated risks that arise throughout the data lifecycle.

Operational resilience assessment

Key aspects : Readiness assessment from a operational disruption standpoint

Our rationale

- The recent measures taken by the Reserve Bank of India against a leading private bank in India underscored the necessity for all regulated entities (REs) to strengthen their risk management and operational resilience, particularly given their increasing reliance on third-party providers.
- These assessments assist banks in verifying their operational resilience and in evaluating whether their third-party providers or intra-group entities maintain a comparable level of operational resilience to their own, both in regular operations and during disruptions.

Third-party risk management

Key aspects : Reasonable assurance over vendor (P2P) processes and controls

Our rationale

- The Reserve Bank of India recently imposed monetary penalty on one of the leading private sector banks in India, for non-complying with the requirements stipulated under the master direction on code of conduct on outsourcing of financial services.
- Considering the extent of co-sourcing and outsourcing done by entities for cost benefits and leveraging the expertise of consultants/vendors, managing third-party risk effectively is essential for maintaining the integrity and security of a bank's operations and protecting its customers/stakeholders from potential harm.

Digital lending ecosystem

Key aspects : Reviewing the products, channels, systems, platforms and alliances

Our rationale

- Amidst ongoing digital transformation and the growing prevalence of digital lending by financial institutions, the regulator has implemented digital lending guidelines. These guidelines aim to safeguard customer interests, promote transparency, and uphold ethical conduct in the digital lending sphere.
- Regular system audits, techno-functional reviews, compliance assessments, and obtain necessary data privacy and cybersecurity certifications are essential to ensure compliance and fair lending practices is must and should be captured as a part of the gamut of internal audit.

Independent quality assurance

Key aspects : Evaluate, benchmark and strengthen the third line of defence

Our rationale

- According to IIA, independent quality assurance of the internal audit activity is mandated once every five years. Still, with the evolving economic environment, the IA function needs to be benchmarked and evaluated periodically to gauge its effectiveness.
- These assessments enable organisations to strengthen internal controls, risk management and governance practices, thereby enhancing their ability to achieve organisation objectives transparently. The goal is to provide an unbiased evaluation, identifying areas for improvement while affirming quality and compliance.

Reporting to Credit Information Companies (CIC)

Key aspects : Accuracy and timelines of submission of data

Our rationale

- Data reported to CICs often form the base for several decisions taken by stakeholders with respect to investments, borrowings and credit risk assessments. Inaccuracies can have a cascading effect both for the bank and the associated stakeholders.
- These lapses in regulatory adherence prompt banks to revisit their CIC reporting structures to avoid any further non-compliance issues. Carrying out a comprehensive internal audit will aid the banks in ensuring regulatory compliance and enhancing the framework for providing precise information, ensuring timely uploading of rejected data. etc.

Thematic reviews & conduct risk management

Key aspects : Focused internal audits based on key risk areas/processes

Our rationale

- The Reserve Bank of India employs thematic reviews as a supervisory tool, conducting examinations of specific products /markets or practices to evaluate risks emerging within the sector or at a systemic level. Similarly, the internal audit function must utilise thematic reviews to concentrate on high-risk themes.
- Basis regulatory focus areas, the IA function needs to conduct thematic reviews around NPA monitoring, collateral valuation, data reporting etc. and play a pivotal role in assessing a bank's adherence to ethical standards, regulatory mandates, and customer-centric practices.

Customer service

Key aspects : Robust framework to address any customer grievance/inconvenience

Our rationale

- Customer service-related issues not only lead to operational risks but also cause reputational challenges for banks. It has been noted that banks' efforts to address customer grievances promptly have not kept pace with the rapid advancements in technology and product offerings.
- Banks should prioritise the quality of grievance redressal over simply monitoring turnaround time and management information systems for complaints. Conducting internal audits of customer service can help banks establish an efficient, prompt, and technology-driven framework for addressing grievances.

Way forward

Recent trends clearly suggest that there has been a renewed focus on internal audit, as a crucial element of the third line of defense. The role of internal audit is now evolving and the IA function is seen as more of a trusted advisor to important stakeholders within the bank, including audit committee and the Board. Banks, in the industry, are at different levels across the maturity ladder with respect to their internal audit functions but considering the increasing expectations and the associated challenges, it is essential for every organisation to establish a best-in-class IA function. To achieve this, internal auditors will need to adopt a more proactive than a reactive approach while selecting domains and processed to be covered as a part of their risk based audit plan. The plans will need to be dynamic and thematic audits will need to come to the fore. An independent analysis of the regulatory and economic environment in the financial services ecosystem from a banking standpoint will need to be done on an ongoing basis to identify hot topics and conduct an effective internal audit.

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