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The concept of the internal audit of the risk in the context of the bank corporate management assessment

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Abstract. The internal risk audit and the components of the bank corporate management should be considered as the assessment of the bank top management effectiveness. The internal audit is an essential aspect of the corporate management improvement, the defence of the stockholders', investors', creditors' and depositors' rights. While taking into consideration the best international experience recommends to the internal audit department to act following functions: 1) to audit the risk management processes and procedures similar to the audit of any other bank's function; 2) to assess the adequacy and efficiency of the bank internal control in the context of the risk management and to make a motion for its improvement to the Supervision Board and the Board of Directors; 3) to assess the performance and efficiency of the operations, authenticity, fullness and accuracy of the financial statement and managerial information, bank eligibility to the national regulatory framework.

The complexity of the Ukrainian bank risk management is caused by the low level of the corporate management. We mean as follows: a serious conflict of interests and their ineffective solution because of the inadequate judicial system; the superficial understanding the risk management problems by the bank top management and a weak supervision on the managers responsible for the proper committees' functioning; the information disclosure problems; the lack of the national firms able to hold qualified independent external audit.

The adequacy of the organizational structure of the complex risk management should be observed in the context of the realized goals and functions of the corporate and risk management. The last one depends radically on bank's practice of the corporate management.

Keywords: corporate management, risk-management, control, internal audit.

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Концепція внутрішнього аудиту ризиків у контексті оцінки якості корпоративного управління в банку

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Анотація. Розглядаються ключові положення щодо внутрішнього аудиту ризиків у контексті оцінки ефективності виконання керівними органами банку своїх функцій. Запропоновано критерії адекватності системи корпоративного управління ризик-менеджменту банку.

Ключові слова: корпоративне управління, ризик-менеджмент, контроль, внутрішній аудит.

Формул: 0; рис.: 1; табл.: 0; бібл.: 6.



Концепция внутреннего аудита рисков в контекст оценки качества корпоративного управления банка

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Аннотация. Рассматриваются ключевые положения внутреннего аудита рисков в контексте оценки эффективности выполнения руководящими органами банка своих функций. Предложены критерии адекватности системы корпоративного управления риск-менеджмента банка.

Ключевые слова: корпоративное управление, риск-менеджмент, контроль, внутренний аудит.
Формул: 0; рис.: 1; табл.: 0; библи.: 6.

Statement of the problem. Banks are always exposed to the risks due to the context of the banking business. That is why the development and implementation of the riskmanagement and control procedures is the permanent process. Should be noted, that the Ukrainian credit institutions use the foreign banks' risk management experience and the regulation norms of the National Bank of Ukraine. The riskmanagement process consists of such stages: prevention, identification, assessment, analysis, acts' construction, control, monitoring and reporting. The bank riskmanagement system is aimed to realize business goals according to the banks' strategies for the increasing their value and the optimization among the potential market possibilities, risks, capital and growth.

The main instrument of the goals realization is the complex riskmanagement system development that anticipates the coordination among all bank's subdivisions confirmed by the Supervisory Board.

The scientific and training papers give numerous definitions, risks' classification and methods of the risk management. The internal audit efficiency is obligatory assessed by the NBU and the independent auditors so the internal auditors should use regulatory norms of the NBU and the top-management requirements.

The goal of this research paper is to define the methods of the risk assessment for the bank's corporate management improvement.

1. The concepts of the risk management

The risk management includes strategy and tactics of management for the achieving the main bank's business-goals.

The risk management strategy is an art of the risk managing in the conditions of indefiniteness, based on the risk forecasting and the mitigation methods. The management strategy means the directions and methods of the funds use for the goal achieving. The risk management strategy includes the rules of the risky decision-making. For our opinion, it's reasonable to concentrate

on those variants that meet the adopted strategy. After the goal is achieved the strategy as a direction and an instrument stops its existence and new goals stimulate new strategy developing.

The tactics is a complex of the methods and stages for the goal achieving in the particular conditions. The task of the management tactics is the effective decision-making, the rational methods and instruments choosing.

The effective riskmanagement consists of the management system; the system of the identification and assessment; the monitoring and control system. The risk management functioning pursues as follows:

- the risks are to be clear and be aware by the bank and its top-management;
- the amount of risk should be comfortable taking or be able to handle by the bank;
- the risk taking decisions are to be clear, concrete and in accordance with the bank's strategic goals;
- the expected rate of return must cover the risk;
- the capital allocation is to be agreed with the risk capacity that the bank must take on in order to reach the financial goals;
- the stimuli for the reaching excellent results must be coordinated with the risk tolerance.

The main executors of the risk management are:

- the Supervisory Board functions within its responsibility on the stockholders, counterparties and Banking Supervision agencies;
- the Board of Directors functions within its responsibility on the Supervisory Board, stockholders, counterparties and Banking Supervision agencies;
- the risk management department identifies, assesses, controls and monitors the risks;
- back-offices carry out functions of the regulatory compliance;
- front-offices carry out functions like the risk taking due to the given authorities.

The Board of Directors has a direct responsibility for the organization and risk management realization.



2. The role of the internal audit in the bank risk management

The priority of the internal audit is the risks identification. As the banking activity is highly sensitive to the funds losses and reputation level, so the risk assessment should take it into the consideration and the internal audit must verify the spheres of the highest risks as a top priority. The risks can be considered as an interdependent factors and the internal audit gets the preliminary opinion about each risk's level. The components of the general risk are assessed while the internal audit strategy is developing and the individual risk – during the planning of the audit's conducting of any banking department or any operations.

The risk assessment is a complicated process that based on a mass of the subjective valuations.

The risk assessment of each banking business process and bank's department should be considered on the following factors:

- the value of the bank's activity type;
- the influence of the mistake on the material losses of the bank;
- the influence of the mistake on the decline of the bank's reputation;
- the reliability of the control mechanisms;
- the characteristics of the information and accounting systems;
- the access to the information system of the wide publicity;
- the level of the managerial and executive personnel professionalism;
- the number of the made mistakes in the past.

Each factor must be weighed according to its importance and impact on the bank's performance. The correct set of the weights for each factor affects the results of the risk assessment as well as the priorities of the internal audit choosing.

The next stage is to define the actual risk level by the expert analysis by the scaling techniques. The next step is to weight the experts' quantitative valuations on the level of importance of each business-process or business department, or financial operation for their next integration (e.g., summing). In such way the level of the sectoral banking risk is determined. While comparing the risk of different banking sectors the internal auditors get an information for the effective resources use (the material and human resources are meant). Of course, the sectors with the highest risks are to be the objects of the heightened attention of the internal audit and banking management.

The fund and reputation losses are the highest risks and can be caused by some cases that form the second level of the top priorities of the internal audit. From our point such cases as the fraud, mistake, theft, wrong decision, inadequate strategic planning, infraction of the law, the information loss, the forfeit of the estate property, insolvent counterparty, the lack informed Board of Directors, ineffective computerization of the banking processes, computer viruses etc. can be considered the secondary risks. The importance of each secondary risk depends on the sector it occurs.

That is why the internal risk audit and the components of the bank corporate management should be considered

as the assessment of the bank top management effectiveness. But at the same time the internal audit is an essential aspect of the corporate management improvement, the defence of the stockholders', investors', creditors' and depositors' rights.

The requirements for the risk management and the organization of the corporate management are set in the Law of Ukraine «About banks and banking activity» [1], Methodology of organization and risk management system functioning in banks of Ukraine [2], Methodology of the corporate management improvement in banks of Ukraine [3].

Each bank is obliged to have special department to act the functions of the risk management. This department is subordinated to the Head of the Board of Directors or any other chief of the highest executive committee.

The internal audit is not a direct participant of the risk management. Its role is to assess the system's adequacy to the banks requirements. The chief of the internal audit department and the Head of the audit committee are to be tightly connected with the external audit and banking supervision department for the timely identification and eliminating the possible problems and faults in the bank risk management.

3. The ways for the bank corporate management efficiency increasing through the risk audit mechanism

While taking into consideration the best international experience and the documents of the Basel Committee on Banking Supervision, National Bank of Ukraine recommends to the internal audit department to act following functions:

- to audit the risk management processes and procedures similar to the audit of any other bank's function. The audit should be held in accordance with the national standards of the internal audit and the International Standards for the Professional Practice of Internal Auditing set by the Institute of Internal Audit [6];
- to assess the adequacy and efficiency of the bank internal control in the context of the risk management and to make a motion for its improvement to the Supervision Board and the Board of Directors;
- to assess the performance and efficiency of the operations, authenticity, fullness and accuracy of the financial statement and managerial information, bank eligibility to the national regulatory framework.

In accordance with the Methodology of organization and risk management system functioning in banks of Ukraine the risk management process consists of identification, assessment, analysis, control and monitoring, reporting. The bank risk management system is aimed at the achieving the business-goals due to the development strategy, increasing the shares' value, an optimization between potentialities and risks, capital and the bank's growth dynamics. The main instrument for the achieving the previously mentioned goals is the bank complex system of the risk management, that provides the coordination among all bank subdivisions in the frame of the only risk management strategy affirmed by the Supervision Board.



The conceptional structure of the bank risk management requires the involving of the Supervision Board, the Board of Directors, core committees and special departments of the risk management. The organization structure is dictated by the corporate culture, size and complication of the different business-processes, the risks types and the significance of the potential negative results. That is why each bank has its own approaches

to the risk management methodology. But at the same time the risk management in each bank must penetrate through all structural levels – beginning from the managerial level and finishing by the direct executors of the banking operations.

Due to the regulatory frameworks [1; 3] we present an oriented organizational-and-managerial structure of a bank (Fig.).

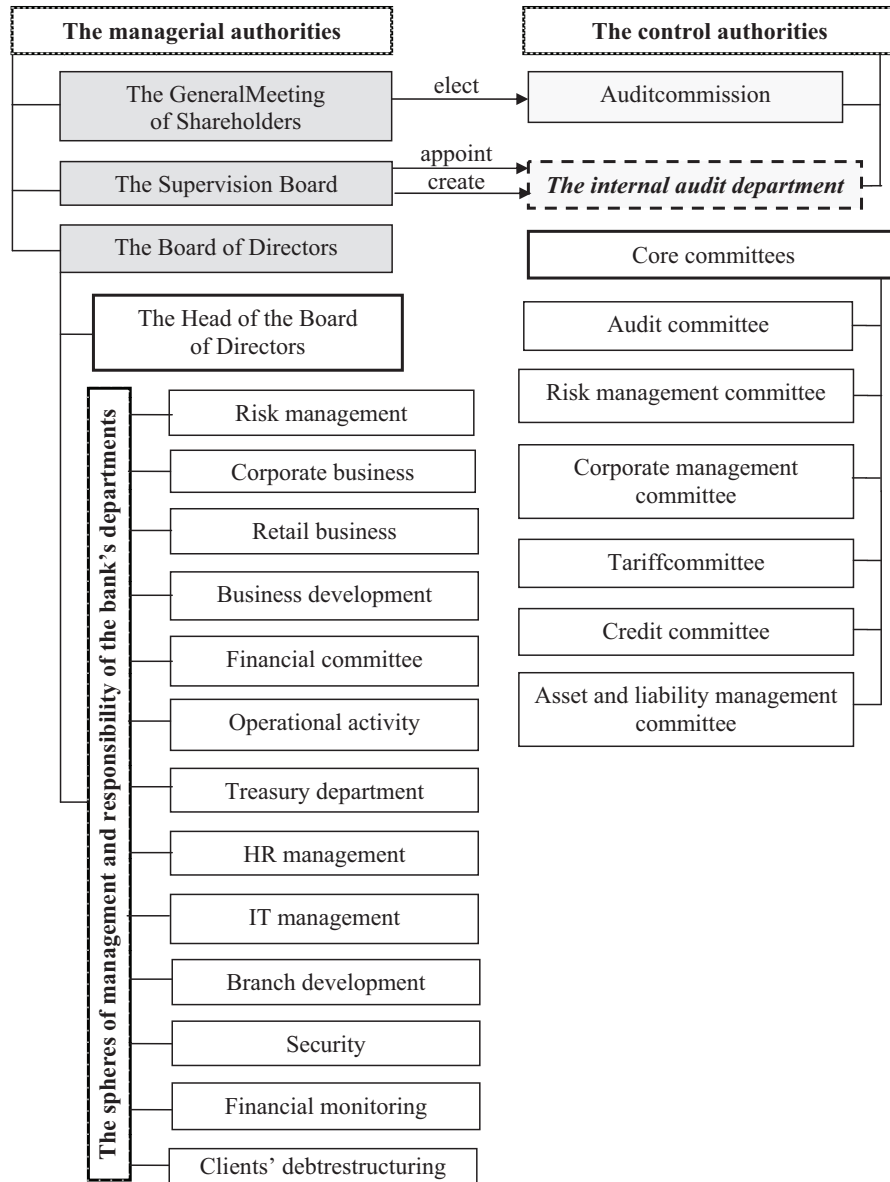


Fig. The generalised scheme of the organizational-and-managerial structure of a bank

In order to distribute the authorities and responsibility a bank must draw up and implement the procedures of management and the risk control. In accordance with the best world and national practice of the risk management organization it's reasonable to follow such recommendations:

- to attract highly skilled personnel from the risk management department and external experts for drawing up the internal regulative norms of risk managing, working out the quantitative and qualitative assessing methods;

- to attract highly skilled personnel from the internal audit department and external experts as consultants for working out the procedures and actions of risks control and monitoring;
- to develop the plan for the anti-crisis management as a list of the recommended actions and to provide with it proper bank workers, to secure timely renewal of such materials;
- to secure a permanent advanced training for the managerial and risk management department personnel.



The internal audit of the risk management efficiency is aimed to assess the acting system of the risk management.

The organizational bank structure depends on the National Bank of Ukraine requirements to the corporate and risk management. Except this banks are to solve mane additional specific problems that nonfinancial enterprises have not to. On our mind the complexity of the Ukrainian bank risk management is caused by the law level of the corporate management. We mean as follows:

- a serious conflict of interests and their ineffective solution because of the inadequate judicial system;
- the superficial understanding the risk management problems by the bank top management and a weak supervision on the managers responsible for the proper committees' functioning;
- the information disclosure problems;
- the lack of the national firms able to held qualified independent external audit.

Conclusions. So, the effective bank risk management and independent bank corporate management are two interconnected aspects of the management system as a whole. Their tight connection is apparent for the way the corporate management quality depends on the risk assessment. At the same time inefficient corporate management causes the increasing of the credit, operational and the risk of the reputation and, as a result, entails the shares value declining.

The risk management is to be held on that organizational level where this risk appears and also using the means of the independent verifying and control. The last one is held on the managerial level and on the Supervision Board as well. That is why the goal of the internal audit is to resolve whether the created and implemented system of the risk management meets the following requirements:

- organizational structure and the control mechanisms satisfy the NBU regulatory norms and the demands of counterparties;
- the corporate culture norms are understandable and are carried out on practice;
- the development strategies are reflected in the internal regulatory documents;
- there is clear distribution of the authorities and duties including rights hierarchy in the sphere of the decision-making;
- the mechanism of coordination and interconnection is efficient among the bodies of the managerial level and the internal audit department as well;
- there is permanent risk monitoring in those spheres of the banking business that are likely to have conflicts of interests. For example, the relations: «stockholders – top management», «bank – affiliated company / insider», «bank – the client of the vital importance»;
- there are financial and career stimuli that create positive business climate;
- there is an adequate information environment correlated with the internal bank demands;
- there is requisite bank transparency expected by the external counterparties;
- there is an abundance of the resources for the creation and holding up the efficient, complex and balanced risk management system;
- bank organizational structure is timely renewed in accordance with the environment changes.

The adequacy of the organizational structure of the complex risk management should be observed in the context of the realized goals and functions of the corporate and risk management. It's also important to account the essential factors for the bank future development. The bank risk management system depends radically on its practice of the corporate management.

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