

# THE PROCESS OF MONITORING AND CONTROLLING WITH REFERENCE TO THE BANKING ACTIVITY

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## **Abstract:**

During the last decades, the banking financial sector has evolved. Beginning with the evolution of the products offered by banks, the risks at which a bank is exposed have diversified. By taking into consideration the risks that appeared and the necessity of dealing with them in an efficient way, the banking institutions have had to embrace a strategic approach of their activities on the named markets.

The present paper speaks about the audit activities, the external banking audit, and the internal banking audit as well as about the main features of the audit in the banking activity.

**Key words:** control, internal audit, external audit

**JEL classification:** G21 - Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages

## **The BASEL AGREEMENT 2. PRESENTATION**

Beginning with the evolution of the products offered by banks, the risks at which a bank is exposed have diversified. By taking into consideration the risks that appeared and the necessity of dealing with them in an efficient way, the banking institutions have had to embrace a strategic approach of their activities on the named markets.

A strategic approach of this kind has the role to encourage the adequate management of products and services offered on markets providing companies with efficient and effective choices for assigning the existing resources in order to achieve the targets from different management levels.

Some of the major risks a bank is exposed to are: the credit risk, the operational risk, and the market risk.

The Basel 2 Agreement has been composed by the Basel Committee, part of International Statutory Bank (BSI) with headquarters in Basel. The BSI is formed by the governors of the central banks from the most developed 10 countries (G 10) and it has as a purpose to contribute to the promotion of cooperation between central banks and other institutions or agencies that have as a target the financial and monetary stability.

The Basel 2 Agreement is the 2nd Basel Agreement, both agreements contain recommendations concerning the banking laws and the regulations emitted by the Basel Committee in the banking supervision. The purpose of Basel 2, first published in June 2004, is to create an international standard the authorities dealing with the regulations in the banking system can use in order to create regulations concerning the quantity of capital the banks need to guard against the financial and operational risks that may appear. The lawyers from Basel 2 consider that such an international standard can protect the international financial system from problems that may appear and may lead to the collapse of many banks.

In practice, Basel 2 tries to accomplish these by establishing some rigorous risks and by managing the capital demands created in order to assure that a bank has capital reserves for the risks from the loan and investment activities it is exposed to. This means

that, the higher the risks a bank is exposed to, the higher the capital kept by a bank is for assuring its solvency and economical stability.

The goals of this agreement are:

- The assurance that the capital budget is sensitive to risks;
- The separation of the operational risk from the credit risk and their quantification;
- The essay to range the economical and capital regulations as to reduce the arbitration target in regulations;
- Stimulating banks to use their own internal ways for risk evaluation; introduction of market discipline as appreciation factor of exposure;
- The development of an equitable banking competition;
- The development of some methods that quantify the risk assumed by each banking institution.

The Basel 2 Agreement appeared from the necessity of improvement of regulations from Basel. The final document concerning the Capital Agreement has been published on November 15, 2005. It includes regulations in two new domains, banking supervision and transparency of banking information.

The Basel Committee has three objectives according to the new capital agreement, regarding the establishment of the optimal capital of credit institutions, which can sustain activities with a high level of risk, such as:

- *the safety: protecting the clients against the systemic risk;*
- *hardness: assuring the stability in the banking system and preventing the moral risk;*
- *efficiency: capital designation as a banking risk function.* (Donath, 2006)

The structure of the Basel 2 Agreement is based on the following elements:

1. Minimum demands to be fulfilled by banks with regard to the balance.
2. Harden the supervision exercised by central banks.
3. Market discipline and transparency of banking risk information.

Through the benefits expected after the implementation of Basel 2 Agreement are: the increase of banking perception on markets, higher efficiency in portfolio management, reduction of losses from credits, invigorates of capital regulations, prices of products / services according to risks, operations efficiency / expenses reduction.

The Basel 2 Agreement is composed of three ideas that support each and that resulted from the combination of advantages of the three approaches mentioned before.

No 1. Minimum capital demands: it refers to maintain the regulation capital calculated for the three major risk components the bank confronts to: the credit risk, the operational risk and the market risk. The Basel 2 Agreement speaks about the improvement of credit risk management and of its quantification, the evaluation of client's reliability.

N 2. Control of the supervision process: it imposes the authorities of national supervision to assure themselves that the banks have healthy internal procedures for their own risks. Some of the risks are: systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk, these risks being combined under the title of residual risk. In this case the bank has to revise its system of risk management.

No 3. Market discipline: here is studied the consolidation of the market discipline by banks financial transparency growth.

The regulations impose a total transparency in information report concerning:

1. banks risks and management of its components;
2. stock level;
3. active portfolio (especially credit portfolio);

4. other information concerning the risks, monitoring and counter instruments  
In September 2010, had been discussed the introduction of a new Agreement - Basel III Agreement. This Agreement will enter into force beginning with 2013 and it supposes the embracement of new demands in the banking domain.

## **SUPERVISION AND CONTROL PROCESS**

The Basel Basic Principle (BBP) for an efficient banking supervision has been initiated by the Basel Committee for Banking Supervision (BCBS ) and it represents the global key standard for the prudential regulations and banking supervision. BCBS provides the reference against which the efficiency of banking supervision scheme can be evaluated.

*BBP consists of five preliminary conditions for assuring a solid financial system and 25 principles that governs supervision aspects. (Donath, 2006)*

According to BBP, the evaluation of the banking activity allows to identify secure areas that contribute to the stability of the direct financial system, by the improvement of supervision, and indirect, by promoting a robust financial infrastructure. The BBP follows, the guarantee of the supervision institution that it can operate in an efficient way, and that banks are functioning in a secure and stable environment.

From the technical point of view, the BBP defines the following aspects, indispensable to the financial stability:

- preliminary conditions to assure the stability, including legal, accounting and control infrastructure;
- market discipline and ways to solve the banking problems;
- Safety measures;
- The macroeconomic domain necessary for an efficient supervision.

The BBP evaluations offer useful and qualitative information concerning the systemic risk, the integrity of the supervision institution and the system efficacy concerning the systemic risk. Basel Basic Principles include five preliminary conditions for an efficient supervision, such as:

- macropolitical stability and support (a preliminary condition that has the higher effect upon risk exposure and capital adequacy);
- A developed public infrastructure that has the purpose to sustain the applicability of contractual clauses, defining the situations of systemic insolvency, adequate accounting domain, efficient corporate management;
- Market discipline based on transparency and access to information;
- Decisional procedures for the banks that have problems;
- mechanism for the banking system insurance.

The BBP principles cover a large area of aspects, such as: the autonomy and the resources (Basic Principles 1), licensing processes and structure (Basic Principles 2-5), prudential dispositions (Basic Principles 6-15), supervision methods ongoing (Basic Principles 16-20), informational demands (Basic Principles 21), remedial measures (Basic Principles 22) and external banking system (Basic Principles 23-25).

## **BANKING AUDIT**

*The banking audit represents all the evaluations and control actions of the banking activity, of final financial documents (balance, profit and loss account, etc) in order to see if it offers a true image of the activity during a financial year. (Donath, 2006)*

The significance of the audit activity is that of control, and its meaning has enriched once the economical activity became more complex, in conditions with high

risk. The control has been made to all accounting and management, not only to some domains, registrations or evidences. Now it is important to prevent the manifestation of risks, the difficulty being now passed to the internal audit. The area of the audit activity has expand from the administration of the public money to private enterprises, evolutionary process that explains multiple powers offered to the audit nowadays.

The audit is an important part in the cycle bond-performance-liability, and its main forms are the external audit and the internal audit.

*The external banking audit represents the audit activity organized by an independent auditor, a specialized company in the audit activity, company that after receiving the bank's request, and receiving a comission payed by that bank, will control the bank's activity, following the legality of transactions, of the documents made and their accounting.* (Donath, 2006) The commercial banks in Romania are bound to appeal to independant auditors (external auditors) that also offer assistance, that will certify the final financial situations and that will inform the National Bank of Romania about any deceptive practice.

The internal banking audit is the audit activity organized inside a coomercial bank by one of its specialized departments. *The audit department has an independance degree that allows it to formulate objective conclusions concerning the banking activity, conclusions that are given to the management.* (Donath, 2006)

Main characteristics of audit:

- the audit is endogenous - the control is made by a specialized structure from inside the bank;
- the audit has *ex-post character* - the control is made after the finalization of an action or of a decision enforced by the specialized compartments of the commercial bank;
- the audit has a continuous character - the control is made for an year on the global activity of the audited system, with the purpose of identifying the vulnerabilities of the system and taking care of them as soon as possible.

The internal audit missions are of different types because they have to answer to different objectives.

We have:

*The classic missions:* inside an audit program and it covers an area of activity, a departament of the bank, one of its branches. The objectives of this evaluation are: the safety the effectiveness and quality of banking services, the observance of the laws by the Bank, the reliability of the information. The control of the operational services is taking part every year, and the control of the functional services is made once during the multi-year plan.

*The flash missions:* short missions that have as objective the quick enunciation of a diagnostic or the quick, punctual control of some activities. The objectives of such a mission can be:

- the control of compliance with the limits of foreign exchange or of exposure to certain instruments;
- the control of accounts fairness of a department or a branch;
- the control of the amounts existing in the bank's thesaurus, such as cash, securities, precious metals;
- the control on specific procedures (eg: the implementation of a special procedure for an important client of the bank);
- the control on the internal control of a determined entity.

These missions are made upon request of bank's management. These missions can be very effcient because the results are quick, least expensive, and by the frequency and unpredictability checks contribute to maintain a constructive pressure on Bank.

*Investigations:* are triggered by the occurrence of specific problems: losses exceeded the limits, fraud, hijacking funds. Their objective is to investigate the circumstances which led to the emergence of the problem, to establish responsibilities, to make recommendations to ensure that such situations do not arise.

*Thematic missions:* missions aimed at studying the research identified in advance and which is found in several entities: the commercial bank's credit risk management, or risks of interest rate, the efficiency of the control functions of management or management of assets and liabilities.

This type of assignment is a domestic consultations and the audit function constitutes an extension.

The management audit: this type of mission goes beyond the traditional role of audit in accordance with the objectives of the classic add an appreciation based on the ability of the Organization and personnel to act promptly in the existing environmental conditions and of the means available.

As regard to the organisation of the audit, the audit strategy is defined by the auditor. The audit strategy may be defined as a process by which it is determined the orientation of the General audit. (Donath, 2006) For the development of audit strategy are examined the key points of the activity being audited, the financial statements of the audited Department and their incidence on the audit. The strategy is developed for a work programme on the basis of which to be able to make a final opinion on the management of the audited entity. The objectives taken into consideration during preparation of the audit strategy are:

- understanding the activity of the audited Department;
- Identification of risks related to the sector of activity in which activate the concerned Department;
- Identification of critical audit objectives and the elaboration of appropriate audit approach;
- Identification of the opportunity to access the services of some experts;
- examine the possibility of applying the techniques of auditing with computer support.

The Audit Strategy is registered over a specific document handed to the team of Auditors. This strategy serves as a basis for the preparation of the audit plan. Preparing the audit plan presumes the following stages:

- carrying out analytical control procedures, so as to facilitate the planning of the audit;
- identification of important posts from financial situations, of transactions made and of statements contained in the consolidated financial statements;
- definition of the objectives of the audit and confirmation of critical audit objectives identified at the time of the audit strategy;
- evaluation of various risk categories: inherent risk, major error risks for every objective of the audit, the risk of incorrect accomplishment of the internal control towards the objectives of the audit.

The planning phase of the audit is intended to specify the orientation of the audit and to provide instructions for the team designated to carry out the audit. The decisions taken in connection with the planning of the audit are tools in the contingency plan showing the technical and logistical aspects of the mission.

Detailing the content of the plan of action requires deepening technical and logistical aspects.

Technical aspects: refers to how to handle critical audit objectives and internal control audit procedures, selection on the basis of knowledge of customer financial information, analysis and assessment of the risk of errors.

Logistic aspects are examined in order to achieve effective audit procedures and tasks defined in advance. We take into account the following aspects: the personal needed for the execution of the mission, the external auditors who could be involved in the execution of the mission, the use of computers, the place of the audit.

In accordance with the rules of any of the statutory audit, the audit mission plan contains information on:

1. The banking society - Company Overview: name, coordinates, organisational structure, place of work, a brief history, object of activity, and contact management;
2. How to organize the accounting situation, evolutionary accounts of results and of the main items in the balance;
3. Systems and significant areas, determination of the threshold of profitability, risk zones, identify strengths and weaknesses of the system, management's attitude towards internal control.
4. The mission-its nature, the main conditions necessary for carrying out the activity control (documents applied, domains assessed, the date of the physical inventory, receipts received assistance of specialists);
5. The Organization of the mission – the number and skill level of team members, the use of works of external or internal auditors, the calendar of field interventions;
6. Budget-determination of necessary hours on work, costs estimated in the light of the experience of the team members, the number of hours required by the limits set by the rules of professional conduct and explanation of any differences.

Essential Factors to carry out an analysis of relevant risks of a bank are: early recognition of vulnerabilities, selection the most appropriate methods of prevention, elaboration of an action plan, rigorous communication, the existence of expertise, of human and material resources, and up-to-date information on the situation, information systems suited to those needs.

## **CONCLUSIONS**

The diversity, complexity and speed of change in the financial and banking sector have resulted in a reduction in existing barriers between different strategic groups, leading to a redefinition of default positions held within the financial market together with a process of intensification of competition.

In the mentioned context, it often appears the concept of the universality of banks, consisting in extending their interest outside the perimeter of the Bank, by conducting activities on the markets of securities, insurance, leasing, factoring, etc. The changes in the offer of financial services and banking products have been boosted by demand, coordinates changes in incomes and purchasing power of consumers, as well as an improved level of informing consumers about the new financial institutions entrants and their offer.

This development supported by the process of liberalisation of financial markets at European Union level, has generated new opportunities for companies operating in the financial and banking sector, by reducing or removing a set of restrictions, both with regard to the types of products that can be offered, and business markets which can be traded. At the same time, however, national financial markets penetration of powerful international groups, mergers and purchases made by a series of these constitute in threats of maximum severity for all players acting within the economic sector.

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