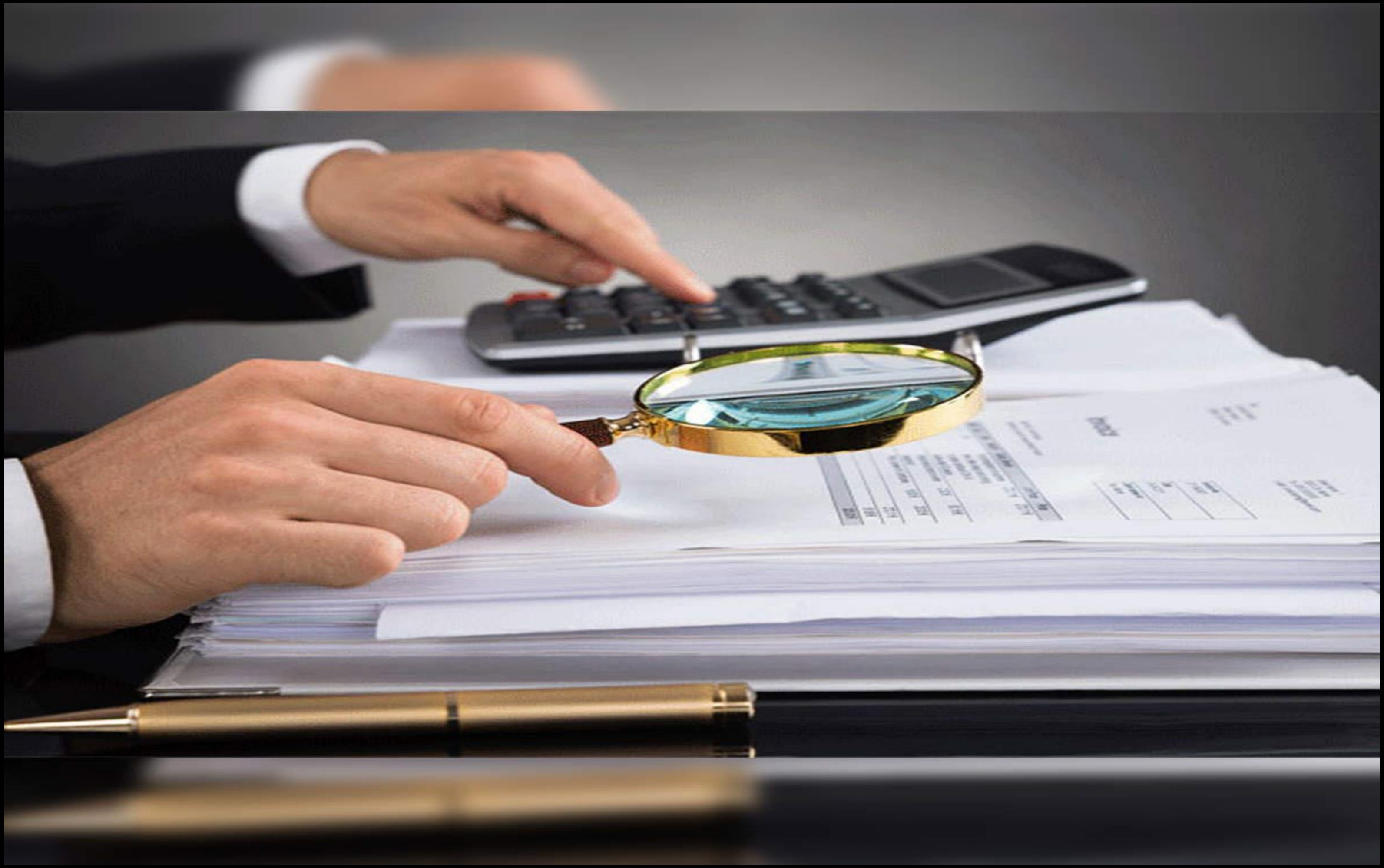
Intricacies of RBI Inspection



OBJECTIVE

The Reserve Bank of India (RBI) conducts inspections of banks and financial institutions to ensure

- *(i)* ***Stability of the cooperative banking system.***
- *(ii)* ***Adherence to all regulations.***
- *(iii)* ***Maintaining financial discipline***
- *(iv)* ***Safeguarding depositor's interest and trust.***

Approach to Inspection

The RBI uses a structured approach to inspections that involves a deep dive into various operational, financial, and compliance aspects of banks.

Statutory Inspection carried out under the provisions of Section 35 of the Banking Regulation Act, 1949. This is a comprehensive annual inspection that evaluates the financial health and operational efficiency of the bank.

Annual Financial Inspection

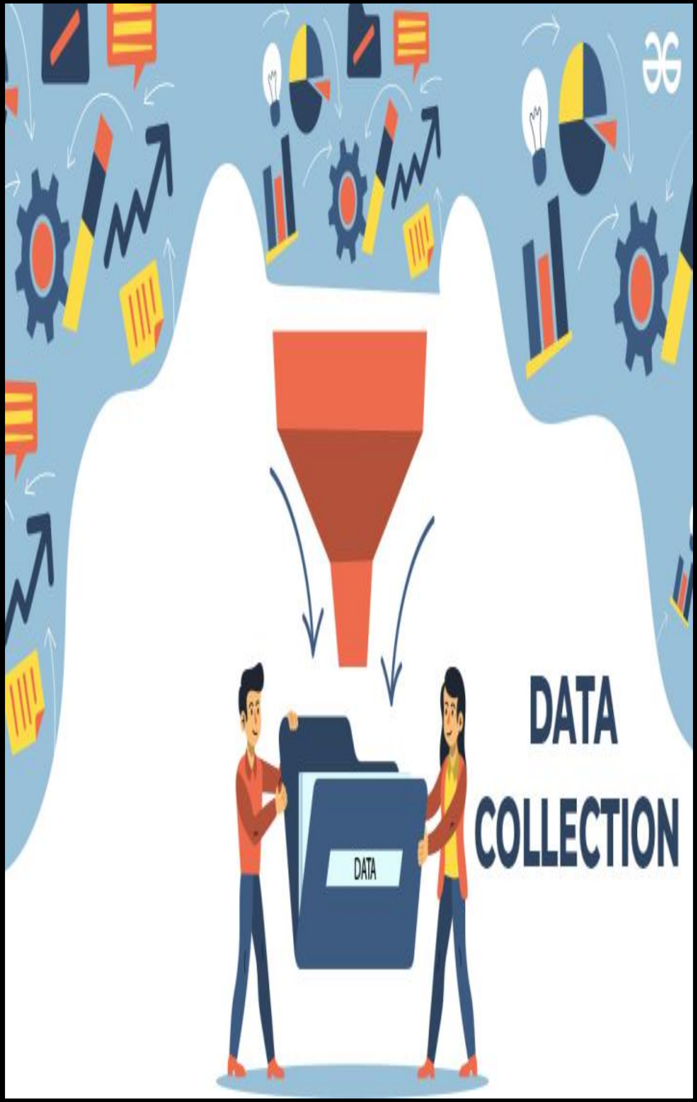
A comprehensive inspection of banks' financials, assessing their overall health, capital adequacy, asset quality, management, earnings analysis, and liquidity.

Apart from these, there are thematic inspections when red flags are raised or as follow-ups to earlier inspections such as on fraud, non-performing assets (NPAs), KYC, and money laundering.

Risk-Based Supervision

A more focused approach targeting specific areas of risk like credit risk, market risk, operational risk, and liquidity risk. This model identifies banks with potential vulnerabilities and focuses on those areas.

RBS involves continuous monitoring based on data/information obtained, assessing risk profiles and addressing critical vulnerabilities.



Pre-inspection process

- *Before the actual inspection, RBI collects financial data, reports, and returns from the UCB. This includes:*
- *Off-Site Surveillance Data : UCBs submit periodic returns covering capital adequacy, asset quality, profitability, liquidity, etc. These are analysed to identify red flags or trends before the inspection.*
- *Previous Inspection Reports: The findings of earlier inspections, compliance status, and action taken by the UCB on past deficiencies are reviewed.*

On-site inspection

Visit to the bank. During this stage, the inspectors scrutinize:

Books of Accounts: Reviewing balance sheets, profit & loss accounts, schedules LFAR and other financial records

Loan Portfolio: Evaluating credit risk, including checking loan documentation, collateral adequacy, end use of funds and asset classification

On-site inspection

Internal Control Systems: The efficiency of internal control systems, internal audits, concurrent audits the role of the Board, Board level committees and the management's capabilities are assessed to ensure that the bank is operating safely and soundly

Assessing the bank's IT systems, cybersecurity controls, assessing various business risks and control gaps

Compliance Systems: Ensuring adherence to statutory requirements like CRR , SLR, KYC norms, anti money laundering measures, submission of returns etc

On-site inspection

Capital Adequacy and Liquidity- The inspection ensures that the bank maintains the necessary capital adequacy ratio

The findings of the inspection are used to classify the bank based on their performance on Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Systems. Banks that receive lower ratings are subject to closer and continuous supervision and follow-up actions

Follow-up actions

Based on the severity of the findings, RBI may initiate corrective actions. These could range from issuing warnings to placing the banks under Supervisory Action Framework (SAF) if certain thresholds related to capital adequacy, NPAs, or profitability are breached. Under SAF, restrictions could be placed on the bank's operations, including lending, expansion, or dividend distribution

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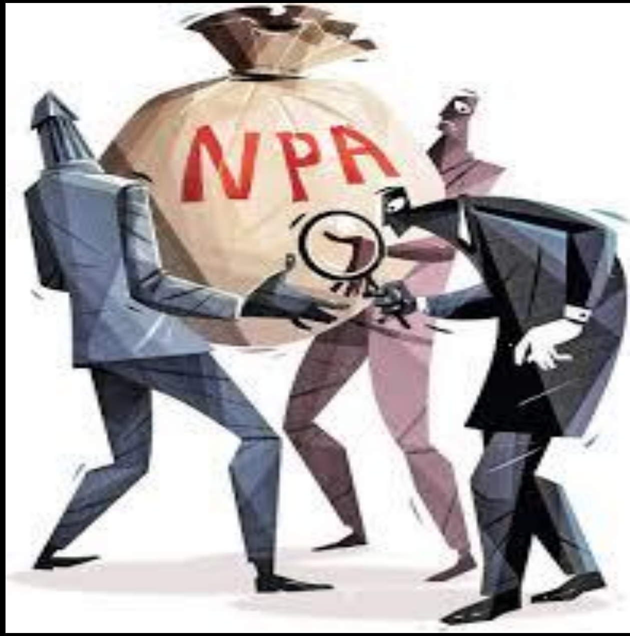
Common Areas of concern

Weak Governance : Governance issues, such as poor oversight by Boards of directors or Board committees, BOM, lack of control of the senior management etc.

High NPA Levels: Many banks have historically faced challenges in managing asset quality, often dealing with higher NPAs compared to other commercial banks



Common Areas of concern

Inadequate risk management: *Small banks lack sophisticated risk management frameworks, making them vulnerable to financial shocks.*

Compliance gaps : *Many banks struggle to comply with evolving regulatory requirements due to resource constraints or lack of expertise*

Governance risk

Appointment of professional directors

Concentration of power with a few Directors

Involvement of the Board in the day-to-day administration which is the work of the CEO

Deficiencies in bye-laws- Appointment of auditor, amendments, PMS etc

Inappropriate policies -Review of existing policies

Non-adherence to the calendar of reviews

Governance risk

Board of Management: Lack of personnel with expertise and practical experience in banking

Not providing expert advice to the Board/Committees

Proceedings of Board/ ACB and other sub-committees

Lack of clearly spelt action points/directions from the Board/sub-committees-

No alignment with the action plan for SAF banks.

Appropriateness and robustness of Business Model

Succession planning- Recruitment policy, Job rotation

Credit risk

Banks offering products in which it has no experience- Entering into consortium loans/MBA, Project loans

Poor credit appraisal - entirely dependent on security brought in by the borrower. assessment of borrower repayment capacity, and business cycles.

Use of CIC information in credit appraisal

Controls in place to monitor adherence to exposure norms

Temporary Over-draft/Adhocs - Monitoring

Credit risk

Non-adherence to IRAC norms, Classification on ongoing basis, Interest reversal on NPAs

SMA classification and monitoring

Borrower-wise classification

BDDR provisions

Delayed recovery procedures

One Time Settlement

Wilful defaulters- Examination of doubtful assets

PSL Misclassification-Advisory to branches

Non-banking Assets-Recovery, issues in enforceability of security, valuation, etc

Market and Liquidity Risk

Controls in treasury

Efficacy of front and back office, mandatory leave

Management of intraday limits

Concurrent audit, surprise check by senior management of investments

Non-SLR Investments- Auditors' comments

Prudential Exposure Limits

ALCO discussions- Cost of funds, excess liquidity, return on funds

Operational risk

Effectiveness of measures to deal with risks due to errors, inefficiency, negligence, compliance failures, grievance redressal process, root cause analysis of customer complaints etc

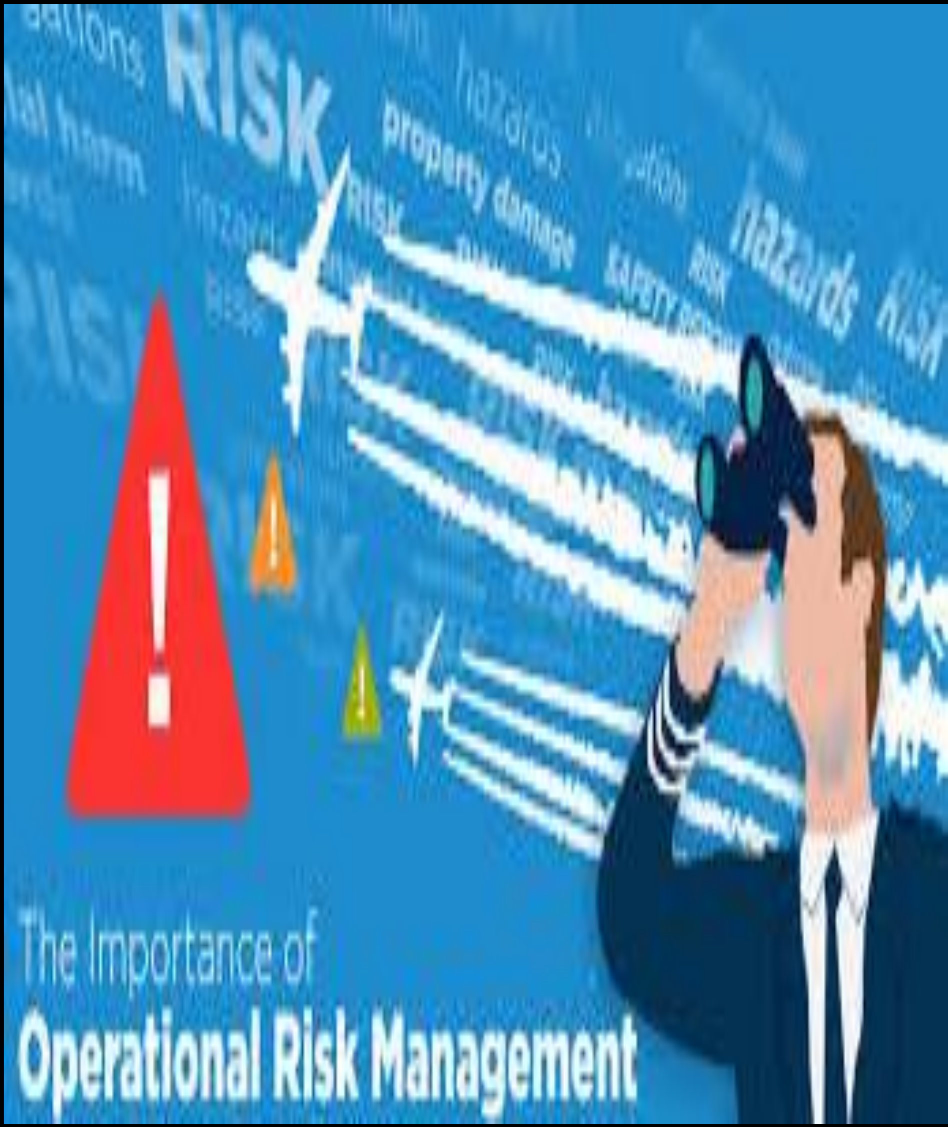
Frauds- Detection and reporting. Further action on frauds. Committee directions on prevention

Multiple UCIC, Re-KYC pendency

Delay in CERSAI

Inoperative accounts

CTR / STR- analysis and delay in reporting to FIU-IND



Operational risk

- Accuracy of information generated from CBS
- Cybersecurity controls implementation
- IS / VAPT Audit- CSITE empanelled auditor, delay in compliance
- Monitoring and analysis of BCP/ DR for all critical applications
- Anti virus, ATM windows upgradation
- Outsourcing- KYC of the vendors
- Cloud services
- Data integrity issues.

Compliance

Importance by RBI on compliance

Lack of robust compliance culture

Identifying and assessing compliance risk issues

Quarterly review of compliance risk by the Board

Addressing issues raised by internal audit/concurrent auditors

Compliances- Delay, not specific, persisting deficiencies, poor resources

Closure of audit reports

CCO-Reporting to the ACB/Board

Ensure sustenance of compliance-compliance testing

Audit

- Board/ACB responsible for internal /concurrent audit- policy and scope
- Absence of approved risk-based audit plan
- Review of performance of RBIA
- ACB- to assess quality and suggest improvement at least annually
- Senior management- appropriate action on internal audit findings and recommendations within specific timelines, periodic reports to ACB on coverage and control issues
- Adequate and appropriate staff
- Independence of IAH-report directly to ACB/Board- pending high-risk medium-risk issues
- Dual hatting

Other issues

Shortage of skilled staff, especially in areas like risk management, compliance, and IT

Wide variations in size, geographic presence, governance structures, and financial health.

Diverse Business Models:- operates at different scales, small community-based banks to larger urban banks. One-size-fits-all inspection approach often does not work

Spread across geographical jurisdictions operating urban, semi-urban and rural regions. Increases the logistical complexity of inspections, especially in remote areas

Often fail to submit timely or accurate regulatory reports due to a lack of internal capacity, leading to delays in inspections and follow-up actions by the RBI.

Resistance to reforms recommended by the RBI during inspections

Other issues

Prioritizing member welfare over financial prudence -leads to reluctance in implementing stricter regulatory measures

Reluctant to invest in upgrading their systems, staff training, or governance structures- cost constraints complicating compliance with RBI's recommendations

Vulnerability to fraud and mismanagement - Delay in identifying and preventing- weak internal controls and governance failures. RBI inspectors to delve deeper

Way forward

Need for a robust risk management department

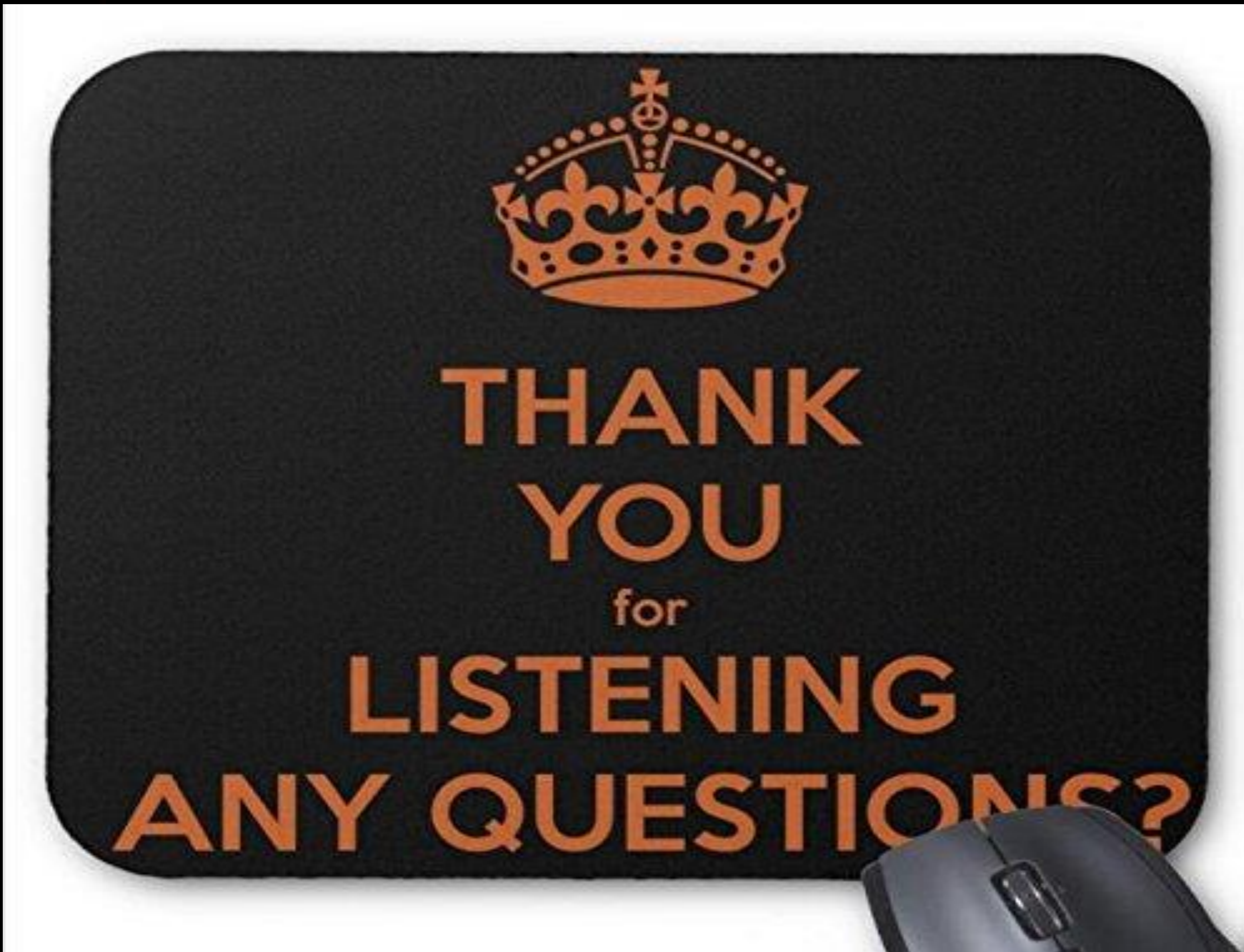
Future RBS- data points, interpretation of data, continuity of personnel

Extensive training in audit and compliance- Directors, senior management and staff

More banks offering internet/mobile to be subjected to IT examination or get a gap assessment done through CERT-In empanelled auditors

Way forward

- Setting-up of cyber range for conducting cyber drill, more phishing simulation exercises
- Onsite inspection for KYC/AML risk assessment
- Introduction of process audit and compliance testing
- Closer examination of the business models- alignment with the stated risk appetite
- RBI's top management to hold meetings with outliers


THANK
YOU
for
LISTENING
ANY QUESTIONS?