

Illustrative Audit Checklist for Basel II

Audit Procedures
Tier I and Tier II Capital
1. Tally the balances in the various elements from the audited accounts
2. Check whether the various instruments comply with the guidelines as laid down in the Master Circular by referring to the Terms of Offer and whether the same are approved by the Board or other appropriate committee
3. In case of foreign banks ensure that the undertaking has been obtained that the bank would not remit abroad the funds received and shown as Capital Reserve or Remittable Surplus
4. Ensure that the various limits upto which individual elements are to be included in Tier I and II capital as laid down in the Master Circular are adhered to.
5. Verify the various deductions with the balances in the audited accounts and check the same for limits and eligibility (e.g. securitisation exposure) as laid down in the Master Circular.
Capital Charge on Credit Risk
<p>The capital charge for credit risk is the sum total of the capital charge to be maintained in respect of the following:</p> <ul style="list-style-type: none">• On balance sheet items• Off balance sheet items• Failed transactions• NPAs• Securitisation transactions <p>duly adjusted for haircuts based on the nature of the collateral.</p>
Risk Weights – On Balance Sheet Items
<p>The risk weights for all on balance sheet items need to be determined based on the credit ratings assigned by the rating agencies chosen by the RBI.</p>

1. Reconcile the balances of various advances and other operating receivables where there is a credit risk and which are considered for calculation with the following schedules in the financial statements to ensure completeness:

- Schedule 6 – Cash and balances with Reserve Bank of India
- Schedule 7- Balances with Banks and Money at Call and Short Notice
- Schedule 9- Advances
- Schedule 11(vi) – Other Assets -_Others

2. Review and document the process of compilation and mapping of the various on balance sheet item based on the categories and their risk weights together with the appropriate ratings and / or other conditions, as applicable.

3. For a sample of transactions verify the ratings with the letters issued by the rating agencies and accordingly check the correctness of the risk weights assigned..

4. In cases where the risk weights are dependent on the fulfilment of certain conditions (other than ratings) verify the compliance therewith based on the appropriate documentary evidence. (E.g. claims on banks, regulatory retail portfolio, claims against residential property etc.)

Risk Weights – Off Balance Sheet Items

The risk weight for all off balance sheet credit exposures is generally calculated as a two step process as under, separately for market and non-market related exposures:

- The notional amount is converted into a credit equivalent amount by multiplying the amount by the specified credit conversion factor (for non market transactions) or by applying the current exposure method (for market related transactions).
- The resulting credit equivalent amount is multiplied by the risk weight applicable to the counterparty or the purpose for which finance is extended or the type of asset, whichever is higher.

Where the exposure is secured by eligible collateral or guarantee the credit risk mitigation guidelines may be applied.

<p>1. Reconcile the balances of the various off balance sheet exposures which are considered for calculation with the financial statements, especially the schedule of contingent liabilities.</p>
<p>2. Review and document the process of compilation and mapping of the various off balance sheet item based on the nature of the instruments.</p>
<p>3. For a sample of non market transactions check the calculations of the credit equivalent amount with specified credit conversion factor based on the nature of the instrument. Check the necessary documentation to confirm the nature of the instrument.</p>
<p>4. For a sample of market related transactions check the necessary documentation to confirm the nature of the contract and accordingly check the calculations for the current credit exposure and the potential future exposure.</p>
<p>Capital Charge – Failed Transactions</p>
<p>1. Review and document the procedures for tracking and monitoring the credit risk exposure arising from unsettled transactions, both on DVP and non DVP basis.</p>
<p>2. For a sample of DVP transactions ensure that the settlement has taken place on a timely basis. In case of delays, check the calculation of the capital charge by multiplying the positive current exposure by the prescribed factor depending upon the number of days delayed.</p>
<p>3. For a sample of non DVP transactions ensure that the settlement has taken place as per the contracted maturity. In case of delays, ensure that any payment made is considered as a loan and the appropriate risk weight is considered. In case of settlement beyond five days ensure that the full amount is deducted from the capital.</p>
<p>Risk weights – NPAs</p>
<p>1. Review and document the procedures for identifying the unsecured portion of NPAs separately for qualifying residential mortgages and others.</p>
<p>2. For a sample of residential mortgages which are NPAs, ensure</p>

<p>that they meet with the qualifying criteria with regard to the LTV ratio and other factors and accordingly check the assignment of the risk weight for the unsecured portion depending upon the level of provisioning.</p>
<p>3. For a sample of NPAs other than residential mortgages check the assignment of the risk weight based on the level of provisioning.</p>
<p>4. IN respect of 3 above for identifying the secured portion ensure that only eligible collateral are considered and the same are properly documented and the bank has a clear and marketable title to realise the same.</p>
<p>Capital Charge – Securitisation transactions</p>
<p>Banks are required to hold regulatory capital after adjusting the prescribed deductions eligible against all securitisation exposures including those arising from provision of credit mitigants, investment in asset backed securities, retention of subordinated tranche and extension of liquidity facility or credit enhancement.</p>
<p>1. Ensure that the securitisation transactions fulfil the requirements as prescribed in the guidelines dated February 1, 2006 to be eligible for deduction from capital.</p>
<p>2. Based on the above, for a sample of transactions / deals ensure that the prescribed deduction from both Tier I and II capital has been correctly done based on the rating and the level of provisions. Review the necessary documentation in support of the same.</p>
<p>3. Based on the above ensure that the appropriate risk weights have been assigned,</p>
<p>Collateral Risk Management and Credit Risk Mitigation</p>
<p>The objective of collateral management is to ensure that only the eligible collateral are considered for netting off which are adjusted for volatility depending upon the nature of the capital and further subjected to various types of hair cuts for different categories of mismatches like currency and tenor mismatches.</p>
<p>1. Review and document the process for collateral risk management as appropriate and relevant including but not limited to:</p>

- Ageing reports
- Confirmation procedures.
- Control of documents
- Compliance with covenants
- Audit of collateral by independent agencies

2. Ensure that the bank has complete legal rights to enforce the security including specific lien and is subject to hair cuts for residual tenor mismatch and currency mismatch. Check the necessary documentation in respect thereof.

Capital Charge for Market Risk

Capital charge for market risk involves computation of the capital charge on interest rate related instruments and equities in the trading book and foreign exchange risk, including gold and other precious metals. Accordingly, the following would be covered:

- Securities under the HFT and AFC category
- Open gold and FX position limits
- Trading position in derivatives
- Derivatives entered into for hedging trading book exposures

Interest Rate – General Market Risk

The capital requirement for general market risk is the sum of the following four components:

- (i) Net short (only derivatives) or long position in the trading book
- (ii) Small proportion of matched position for each time band (vertical disallowance)
- (iii) A larger proportion of the matched positions across different time bands (horizontal disallowance)
- (iv) Net change for positions in options where applicable

1. Reconcile the balances considered for calculation of the general interest rate risks trading book positions with the figures reported in the financial statements.

2. Review and document the process for computation of the price sensitivity (modified duration) for each instrument and test check the calculations for a sample of instruments.

3. Review the process of capturing the above data into different time bands based on the maturity and accordingly apply the prescribed change in yield and check the calculations for the resulting capital charge and the consequential vertical and horizontal disallowances

Interest Rate – Specific Risk

The specific interest rate capital charge for different types of debt securities / issuers is prescribed separately for the following categories:

- Central, State and Foreign government bonds under HFT and AFS category
- Banks bonds under HFT and AFS category
- Corporate bonds and securitised debt under HFT and AFS category

1. Reconcile the balances of government securities under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.

2. Review and document the process of compilation of data in respect of various types of government securities under AFS and HFT based on the type of investment and the residual maturity.

3. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the type of investment and residual maturity based on the verification of the relevant documentation.

4. Reconcile the balances of bonds issued by banks under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.

5. Review and document the process of compilation of data in respect of various types of bonds issued by banks held as investments under AFS and HFT based on the following parameters:

- Level of capital adequacy
- Nature of the bank (scheduled or non scheduled)
- Residual maturity

6. For a sample of transactions in respect of the above, verify the

<p>allocation percentage of the specific risk capital based on the various parameters based on the verification of the relevant documentation.</p>
<p>7. Reconcile the balances of corporate bonds and securitised debt under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.</p>
<p>8. Review and document the process of compilation of data in respect of corporate bonds and securitised debt instruments held as investments under AFS and HFT based on the following parameters:</p> <ul style="list-style-type: none"> • Rating assigned • Nature of the investment • Residual maturity
<p>9. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the various parameters based on the verification of the relevant documentation.</p>
<p>Equity – General and Specific Market Risk</p>
<p>A uniform percentage of 9% is currently attracted for the gross equity position for both specific and general risks</p>
<p>Foreign Exchange and Gold</p>
<p>These currently attract a risk weight of 100% which is in addition to the capital charge for credit risk for on and off balance sheet items</p>
<p>1. Check the computation of the net open position in each currency as a summation of the following:</p> <ul style="list-style-type: none"> • Net spot position • Net forward position • Guarantees and similar instruments • Net future expenses / incomes not yet accrued but fully hedged
<p>2. Based on the calculations of the market risk for each of the above check the computation of the aggregate capital</p>

<p align="center">charge of market risks</p> <p>Interest rate risk</p> <p>a) General market risk</p> <ul style="list-style-type: none"> • Net position • Horizontal disallowance • Vertical disallowance <p>b) Specific market risk</p> <p>Specific and general market equity risk</p> <p>Foreign Exchange and gold</p>
<p>Capital Charge for Operational Risk</p>
<p>Currently banks are required to maintain capital charge for operational risk at 15% of the average gross income for the last three financial years</p>
<ol style="list-style-type: none"> 1. Obtain the computation of the gross total income and verify the same from the respective years audited financial statements. 2. Ensure that the various deductions from the net profit are appropriately considered.

- General Provisions for the purpose of Tier II Capital would henceforth also include floating provisions as per the RBI circular dated 9th April, 2009.
- In respect of foreign banks operating in India, the RBI Master Circular also lays down the following additional provisions:

Tier I Capital	
	Interest free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms
	Remittable surplus retained in Indian books which is not repatriable as long as the bank functions in India
	Capital Reserve representing surplus arising from sale of assets in India held in a separate account and which is not eligible for repatriation as long as

	the bank functions in India
	Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books
	Head Office borrowings in foreign currency eligible for inclusion in Tier I Capital

- There are certain specific clarifications with regard to the use of credit rating by banks for the purpose of assignment of risk weights. These deal with the following aspects:

Care should be taken to ensure that the Bank does not use any other rating which the borrower would have obtained for the purposes of assigning risk weights. As directed by the RBI guidelines, the credit rating should be available in the public domain which the bank has access to. While considering the credit rating, the bank has to consider its exposure and not just go by the overall credit rating i.e. in the credit rating letter the name of the bank, the underlying products, and the limits covered.

- For computing the gross income for determining the capital to be held against operational risk, there is a clarification that the same should be considered based on the average of the last three financial years. However, there is no clarity as to whether this includes the current financial year though the better practice would be to consider the average of the preceding three years.