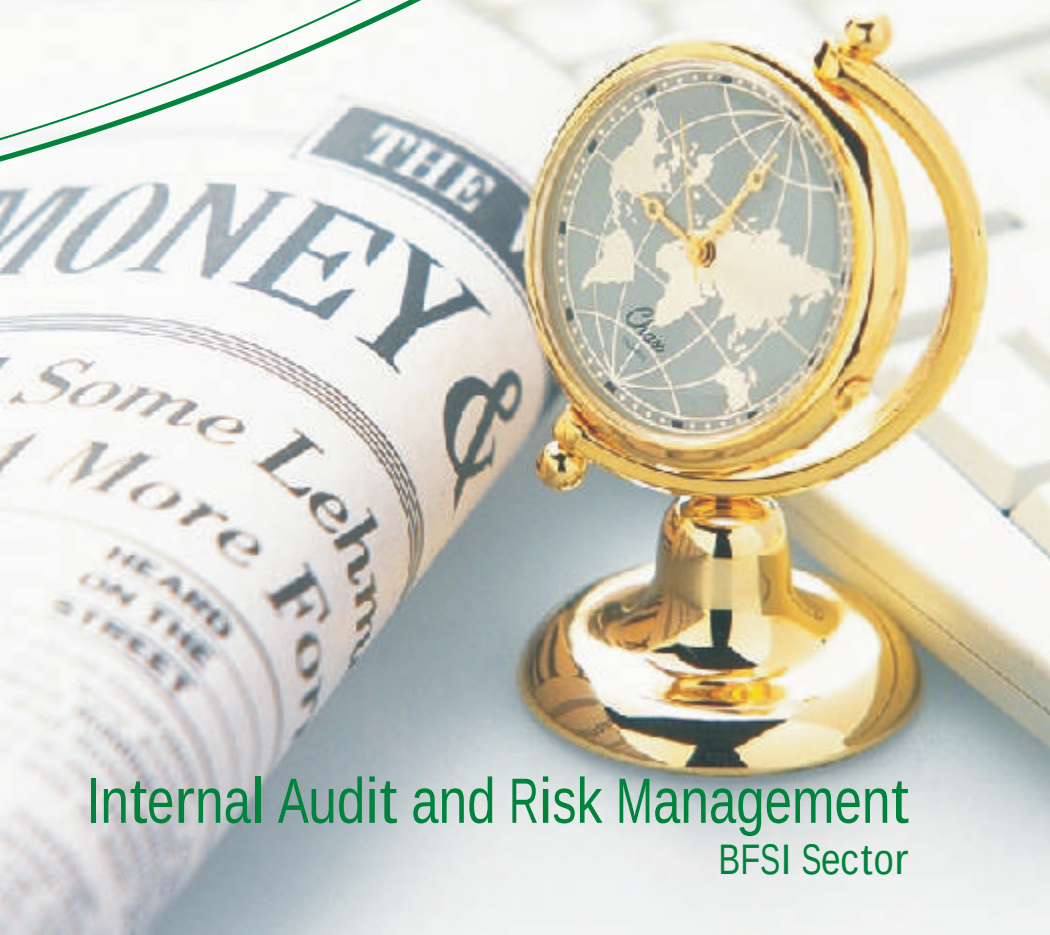


RSM Astute Consulting



Internal Audit and Risk Management
BFSI Sector

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Ranked as the 6th largest accounting and consulting group in india
(Source : International Accounting Bulletin, August - 2008)

Nation-wide presence in 10 cities

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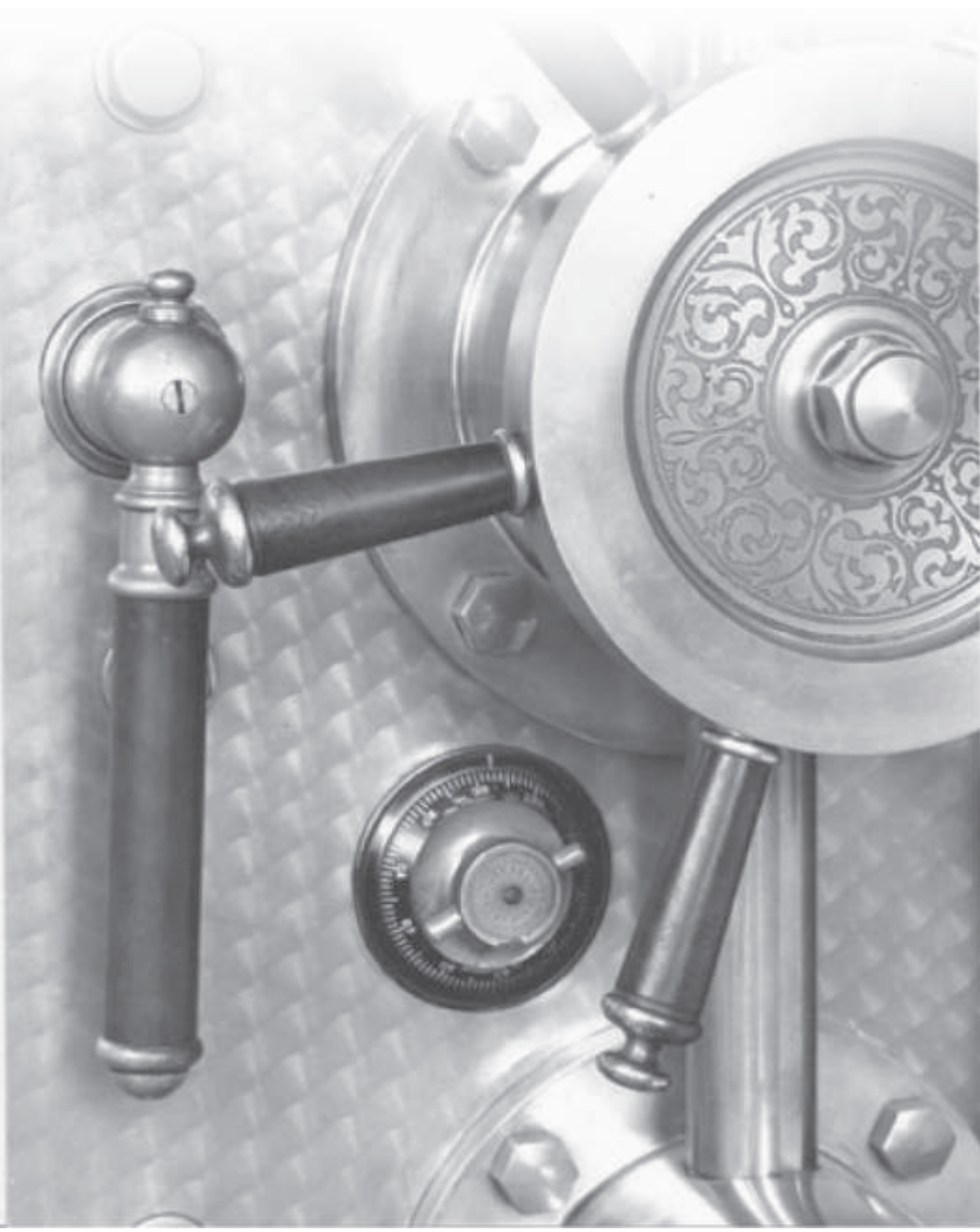
Annual revenue of US\$ 3.87 billion

736 offices across 76 countries

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Internal Audit and Risk Management BFSI Sector

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Internal Audit and Risk Management

BFSI Sector

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Chapter 1

Background



Chapter 1: Background

Banking, Financial Services and Insurance (BFSI) sector is set to grow exponentially in India due to growth in Gross Domestic Product, rising per capita income, introduction of new products to meet the emerging requirements, innovation in technology and expanding distribution network.

BFSI sector in India has demonstrated resilience in the midst of global financial turmoil of last 2 years due to its strong regulatory and compliance framework and prudent monetary and fiscal policies. However, the extreme volatility in the global markets and the vulnerability of the BFSI sector makes it imperative to have an appropriate risk management framework. The increasing role of technology and e-banking requires contemporary and real time controls. The increasing role of financial instruments such as options, futures and derivatives warrants new governance and risk management tools as evidenced by the recent US regulations on financial reforms.

BFSI sector is the backbone of the fiscal system and a strong BFSI sector is a pre-requisite for sustainable economic growth.

Important regulators in the BFSI sector include:

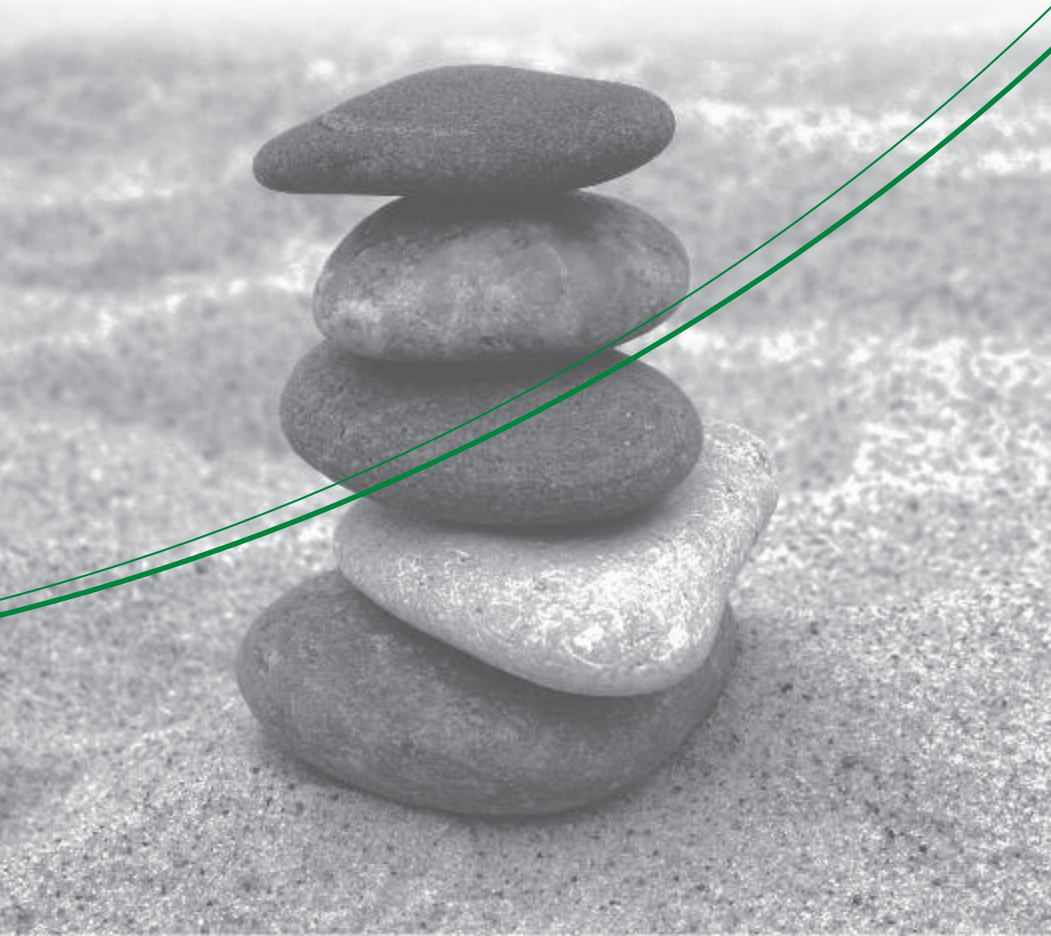
- ▶ Reserve Bank of India (Banking)
- ▶ Securities and Exchange Board of India (Financial Services)
- ▶ Insurance Regulatory and Development Authority (Insurance)

The role of Internal Audit and Risk Management will be very critical for organisations to meet challenges of growth, technology and corporate governance through an adequate risk management.

This booklet is intended to provide an insight into the role of Internal Audit and Risk Management in BFSI sector. The booklet is not intended to be a comprehensive document but rather to reflect the emerging trends and the changing role of Internal Audit and Risk Management in the context of BFSI sector.

Chapter 2

Role Of Internal Audit And Risk Management



Chapter 2: Role Of Internal Audit And Risk Management

Internal Audit and Risk Management in BFSI sector is primarily intended to provide the management with clear, comprehensive and unbiased analysis of the adequacy, existence and effectiveness of internal controls and risk management framework of the entity. It reviews the functional efficiency of the organisation with a view to suggest areas for possible improvements. It is an important tool which enables an organisation in achieving its strategic business goals, meeting operational and business environmental challenges, complying with regulatory norms and managing reporting requirements.

Internal Audit includes:

- ▶ Critical evaluation of internal controls, performing GAP analysis and suggesting areas for strengthening;
- ▶ Constructive review of business operations by keeping the organisation's business needs in focus;
- ▶ Identification and recommendation of areas for cost reduction, revenue optimisation and improvement in operational efficiency;
- ▶ Critical evaluation of systems and procedures and adherence to Standard Operating Procedures;
- ▶ Review of Information Technology (IT) controls and Business Continuity Plan;
- ▶ Identification, assessments and control of risks;
- ▶ Review of compliances with the various regulatory provisions and operations manuals;
- ▶ Review of adherence to the corporate governance requirements.

As per the Institute of Internal Auditors 'Enterprise-Wide Risk Management (ERM) is a structured, consistent and continuous process across the whole organisation for identifying, assessing, deciding on responses to and reporting on opportunities and threats that affect the achievement of its objectives'. The responsibility of ERM is with the Board of Directors.

Internal audit is an independent, objective assurance activity and can provide valuable insight in providing assurance that major business risks are being managed appropriately and the risk management and internal control framework is operating effectively.

ERM role shall include the following:

- ▶ Facilitating identification and evaluation of key risks;
- ▶ Evaluating and reporting of key risks;
- ▶ Consolidating risks across the organisation;
- ▶ Developing and maintaining the ERM framework.

However, internal audit should not be involved in setting risk appetite, taking decision on risk response, implementing risk response or taking accountability of risk management.

Internal Audit's core role in relation to ERM should be providing assurance to management and to the Board on the effectiveness of risk management.

Internal Audit and Risk Management in today's global competitive environments depends heavily on Information System for decision making. Business processes are increasingly getting automated and controls becoming less person dependant. In such a scenario, the significance of Information Technology (IT) and Information System (IS) cannot be undermined as these are pervasive throughout the business. Some areas that can benefit include Information System Development, Assessment of risks and its management, Business Continuity Plan and Disaster Recovery Plan, Hardware, Software and Network audits etc.

Internal Audit objectives and approach can be summarised as follows:

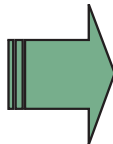
Internal Audit Objectives



Internal Audit Approach

Traditional Approach

- ✗ Accounts oriented
- ✗ Transaction focused
- ✗ Over cautious and bureaucratic
- ✗ Passive detection
- ✗ Compliance oriented
- ✗ Covering all routine areas
- ✗ Critic
- ✗ Manual checking
- ✗ Excessive coverage – time consuming

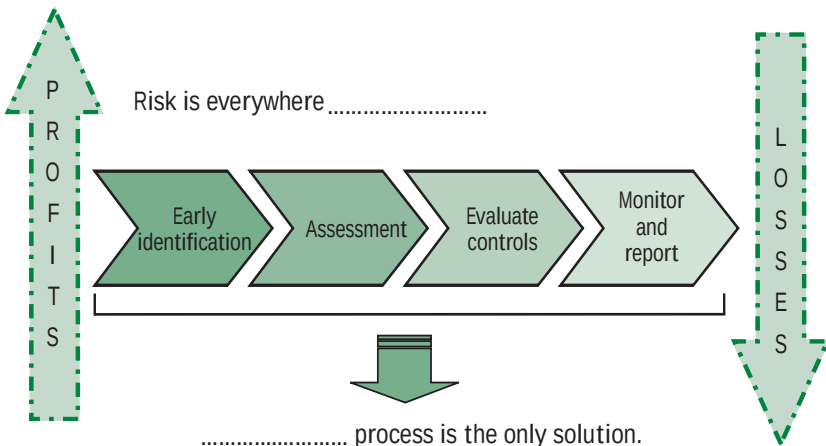


Contemporary Approach

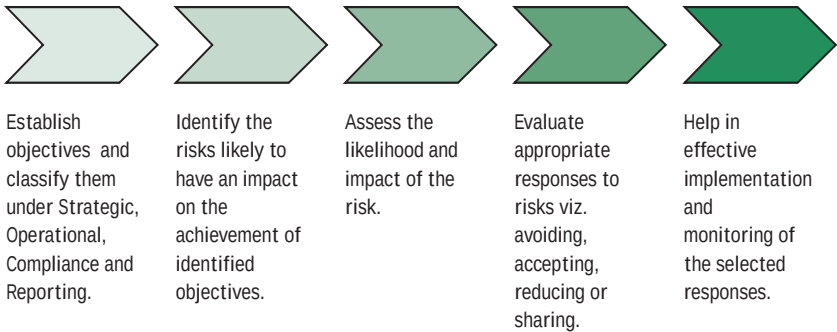
- ✓ Business orientated
- ✓ Process focused
- ✓ Value creating
- ✓ Real time detection
- ✓ Prevention oriented
- ✓ Risk based audit
- ✓ Strategic partner
- ✓ Use of latest techniques (CAATs)
- ✓ Time and cost efficient

The Risk Based Audit (RBA) approach is shown below:

Risk Based Audit Approach

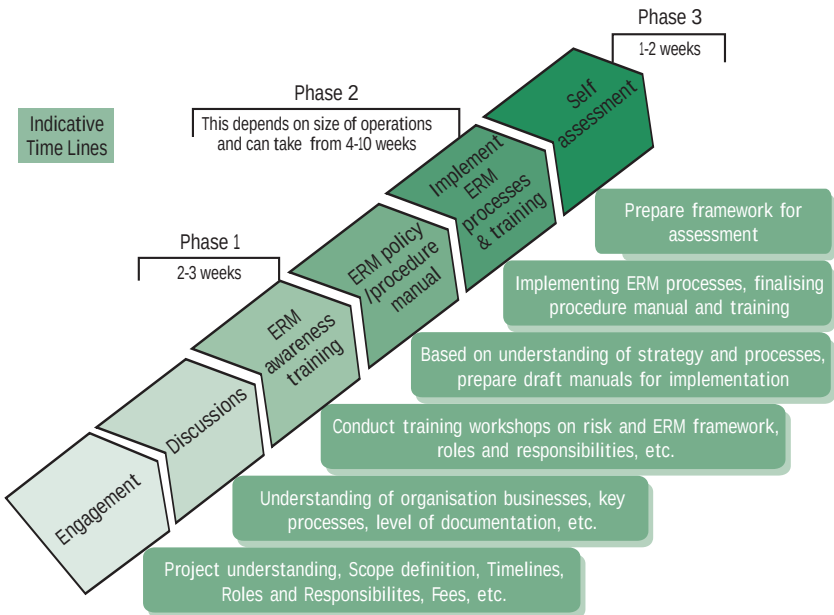


Risk Based Audit Approach

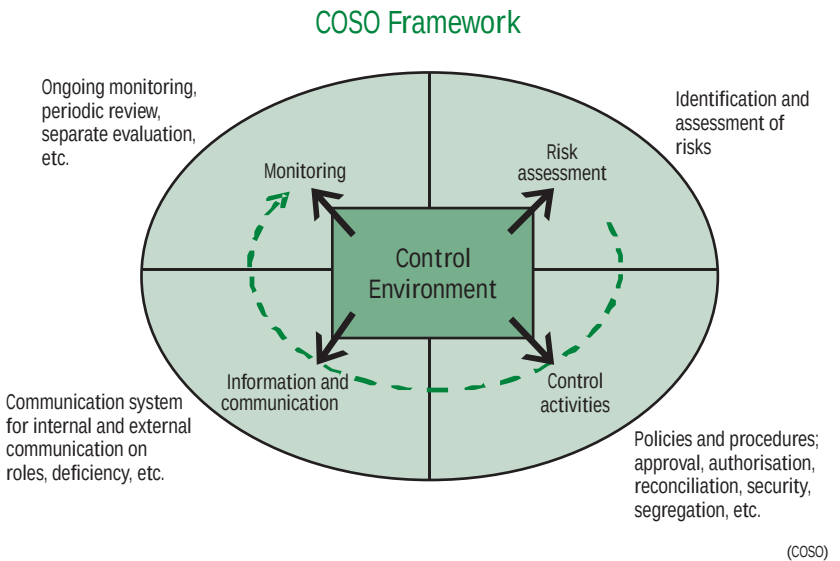


The approach to risk management is depicted below:

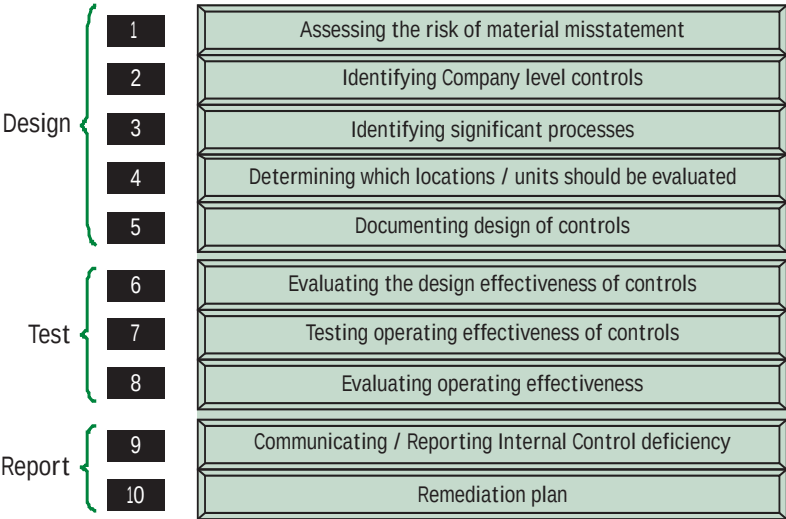
Approach – Risk Management



The Committee of Sponsoring Organisations of the Treadway Commission (COSO) framework is presented below:



**Approach To Internal Control Assessment and Documentation –
CEO / CFO Certification**



Chapter 3

Banking Sector

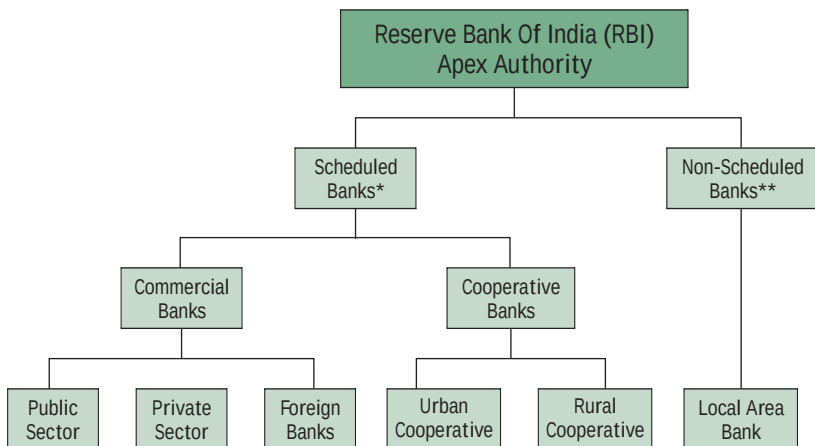


Chapter 3: Banking Sector

3.1 Sector Background

- ▶ The Reserve Bank of India (RBI) Act was passed in 1934 and RBI came into existence in 1935 on the basis of central banking inquiry committee. In 1949, the Banking Regulation Act was passed which gave wide powers to RBI.
- ▶ The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into 3 distinct phases as follows:
 - Early phase from 1786 to 1969 of Indian Banks. The government's Regulatory Policy for Indian banks since 1969 has paid rich dividends with the nationalisation of 14 major private banks of India.
 - Nationalisation of Indian banks and up to 1991 prior to Indian banking sector reforms.
 - New phase of Indian Banking System with the advent of Indian Financial and Banking Sector Reforms after 1991.

Banking Structure In India



- ▶ *Scheduled Banks are those, which are included in the second schedule of the Reserve Bank of India Act, 1934. To be included in the second schedule, a bank must have a paid up capital and reserves of an aggregate value of not less than Rs.5,00,000 and satisfy the RBI that its affairs are not conducted in a manner detrimental to the interest of its depositors, shareholders and the society.
- ▶ **Non-Scheduled Banks are not included in the second schedule of the Reserve Bank of India Act, 1934.

3.2 Growth And Size

- ▶ As on 31 March 2010, total deposits of Indian banks stood at Rs. 2,12,66,136 crores and advances on that date were Rs. 1,85,80,819 crores.
- ▶ Total employees in banking sector over last 3 years in India were as follows:

Financial Year	Number of employees
2009-2010	9,78,048
2008-2009	8,85,414
2007-2008	8,40,000

- ▶ Currently more than 44,000 locations in India have ATM access facility and expected to rise continuously.
- ▶ In the Review of Monetary Policy for 2009-10, the RBI observed that the Indian economy showed a degree of resilience as it recorded a better-than-expected growth of 7.9% during the second quarter of 2009-10.
- ▶ The banking Industry has grown at a compounded annual growth rate (CAGR) of 20% over the last decade and has grown by over 5 times in the same period.
- ▶ It is projected that Indian banks will add another 400 million customers in next 10 years. This will necessitate significant scaling up of systems and processes and employee productivity to manage this growth.

3.3 Regulatory Framework

3.3.1 Regulatory Frameworks in India can be classified into two umbrella acts:

- ▶ Reserve Bank of India Act, 1934: governs the Reserve Bank functions.
- ▶ Banking Regulation Act, 1949: governs the financial sector.

3.3.2 In addition to above, the banking operations are also subject to legal provisions of certain other acts as under:

- ▶ Acts governing specific functions
 - Public Debt Act, 1944 / Government Securities Act (Proposed): Governs government debt market.
 - Securities Contract (Regulation) Act, 1956: Regulates government securities market.
 - Indian Coinage Act, 1906: Governs currency and coins.
 - Foreign Exchange Regulation Act, 1973 / Foreign Exchange Management Act, 1999: Governs trade and foreign exchange market.
 - 'Payment and Settlement Systems Act, 2007: Provides for regulation and supervision of payment systems in India'.
- ▶ Acts governing banking operations
 - Companies Act, 1956: (Governs banks as companies).
 - Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 / 1980: Relates to nationalisation of banks.
 - Bankers' Books Evidence Act, 1891.
 - Negotiable Instruments Act, 1881.
- ▶ Acts governing individual institutions
 - State Bank of India Act, 1954.
 - The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003.
 - The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993.
 - National Bank for Agriculture and Rural Development Act, 1981.
 - National Housing Bank Act, 1987.
 - Deposit Insurance and Credit Guarantee Corporation Act, 1961.

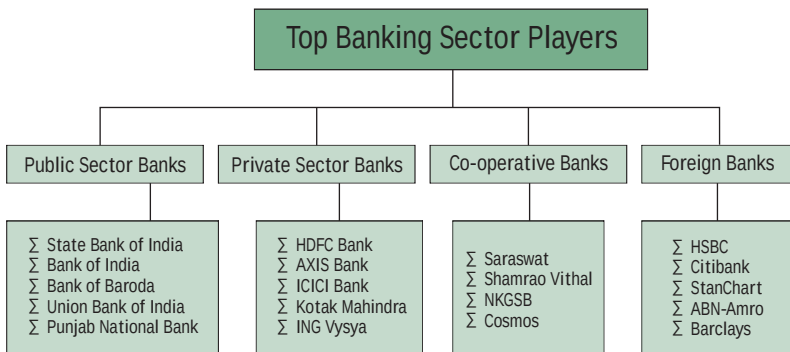
- Co-operative Societies Act, 1912.
- Regional Rural Banks Act, 1976 State Bank of India (Subsidiary Banks) Act, 1959.
- Prevention of Money Laundering Act, 2002.
- Credit Information Companies Regulation Act, 2005.
- Information Technology Act, 2000.
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

3.3.3 Role of RBI

- Reserve Bank of India (RBI) is apex governing body in the Indian Banking industry. It formulates, implements and monitors the monetary policy to ensure a robust and healthy banking environment. It is responsible for overseeing the activities of other banks. It issues licenses to other banks to start new branches, install ATMs, etc. It also conducts regular checks to ensure that all guidelines are being adhered to. It is responsible for issuance of currency, regulation of currency and acting as banker to state and central governments and maintains banking accounts of all scheduled banks.

3.4 Key Players

- Currently, India has 96 scheduled commercial banks (SCBs) - 27 public sector banks (that is with the Government of India holding a stake), 31 private banks (these do not have government stake; they may be publicly listed and traded on stock exchanges) and 38 foreign banks.



3.5 Key Elements And Peculiarities

- ▶ Banking institutions are financial intermediaries specialising in the activities of buying and selling financial products, contracts and securities. A bank provides a public good in terms of liquidity and means of payments. A bank is also distinguished from an ordinary firm by virtue of nature of risks it faces. While it is true that existence of an intermediary like bank has a net cost advantage relative to direct lending and borrowing, banks face a double-edged risk, one from the side of the lender and other one from the side of the borrower. This is because the equity base of a bank is typically small relative to the liability.
- ▶ A substantial component of liability of a bank consists of its deposits. Apart from Current and Savings Accounts (CASA), even term deposits can be subject to premature withdrawal. It faces a withdrawal or liquidity risk when creditors are unwilling to extend or renew their credit to the bank, or they are willing to renew at different terms alone.
- ▶ A default risk arises when the debtors of the bank are not able or willing to meet their obligations to the bank at the agreed upon time. A certain amount of control appears to be necessary to ensure that no unwarranted exit takes place in banking industry. Unlike any other enterprise, which can exist without a central control, a bank cannot. The entire banking industry is monitored by the Reserve Bank of India.

3.6 Major Sub-Segments Of The Banking Sector

- ▶ Retail Liabilities (CASA, Term Deposits).
- ▶ Retail Assets (Home Finance, Vehicle Finance, Personal Loans).
- ▶ Rural and Agricultural Banking.
- ▶ Small and Medium Enterprises (SME) Segment.
- ▶ Investment Banking.
- ▶ Trade Finance.
- ▶ Project Finance.
- ▶ Treasury Operations.
- ▶ International Banking.
- ▶ Depository Participant.
- ▶ Cash Management Services.

3.7 Role Of Information Technology

- ▶ Information Technology (IT) continues to be the single largest facilitating force behind the successful transformation of transactions and analytical processing of banking business in the country. Developments which have taken place during the last few years all have IT as the pivotal centre-point.
- ▶ Since the publication of the Financial Sector Technology (FST) Vision in July, 2005, there have been significant changes in the banking sector of the country, as far as IT implementation is concerned. Some of the major developments which have taken place since then are as follows:
 - Core Banking Solution (CBS).
 - Internet Banking.
 - Mobile Banking.
 - Automated Teller Machines (ATMs).
 - Multifunctional ATMs and shared ATM services.
 - Large scale usage of Real Time Gross Settlement (RTGS).
 - Electronic Clearing Services (ECS).

Technological Developments In Banks

- ▶ Banks in India are using Information Technology (IT) not only to improve their own internal processes but also to increase facilities and services to their customers. Efficient use of technology has facilitated accurate and timely management of the increased volumes of transactions of banks, consistent with a larger customer base.
- ▶ During 2008-09, the transmission of clearing data (both for cheque and electronic clearing services) and collation of inputs from currency chests as part of the Integrated Currency Chest Operations and Management System (ICCOMS) was done using secured websites. The prevalent IT system to process the accounting requirements of the State and Central Governments are replaced by the Centralised Public Accounts Department System (CPADS), which is considered more robust and user friendly. To facilitate a smoother and faster bidding in the Primary Dated Securities Auctions held by the Reserve Bank, a new version of the Negotiated Dealing System Auction module, developed and hosted by the Clearing Corporation of India, was developed in 2008-09, leading to its launch with effect from 11 May 2009.

- ▶ One of the major achievements during 2008-09 was the increase in the number of branches providing Core Banking Solutions (CBS). The total number of branches of Public Sector Banks that have implemented CBS increased from 35,464 as on 31 March 2008 to 44,304 as on 31 March 2009.
- ▶ The computerisation of the banking sector, which is regarded as the precursor to other technological initiatives, is almost in completion stage. The proportion of PSB branches that achieved full computerisation increased from 93.7% as of end-March 2008 to 95.0% as of end-March 2009. That continuous progress is being made by banks is reflected in the increase in the number of banks moving into the 'more than 90% but less than 100%' category. During 2008-09, the total number of ATMs installed by banks grew by 25.4%.

3.8 Regulatory Provision Related To Internal Audit And ERM

- ▶ A risk management system is essential in view of the Basel II Accord on Capital adequacy. Under the proposed Accord, a Three Pillar approach is to be adopted for assessment of Capital adequacy.
 - Wherein the first pillar which deals with the minimum capital, heavily relies on the risk assessment in the areas of credit, market and operational risks in banks.
 - Under the second pillar, the supervisor is required to review the risk management processes in the banks in order to satisfy it that the capital maintained by the banks is in relation to the risks being taken by them.
 - Lastly, the third pillar proposes to bring in market discipline on banks by introducing more and more disclosure and transparency.
- ▶ The Clause 49 of the listing agreement (SEBI) states:
 - 'The company shall lay down procedure to inform board members about the risk assessment and minimisation procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.'
 - The clause also makes the CEO/CFO certification on internal controls mandatory.

Risk Based Internal Audit In Banks

- ▶ Risks in banking are classified as follows:



- ▶ Inherent risks are of three types: Credit Risks, Market Risks and Operational Risks.

Credit risks are associated with losses due to erosion in the credit quality.

Examples:

- Interest or principle not paid by the borrower (Direct lending).
- Funds not paid on crystallization of liability (Guarantee or Letter of Credit).
- Free forex funds restricted (cross border exposure).

Market risks relate to losses caused by changes in the market variables.

Examples:

- Inability to meet liabilities (liquidity risk).
- Adverse changes in interest rates (Interest rates risk).
- Adverse forex rates (Forex risk).

Operational risks relate to losses resulting from inadequate or failed processes, people or external events.

Examples:

- People turnover, skill competency (People risk).
- Violation of limits, money laundering (Process risk).
- System failure, communication failure (System risk).
- Non-compliance to laws (Legal and regulatory risk).
- Loss of reputation (Reputation risk).
- Unanticipated Changes (Event risk).

- ▶ Control risk refers to the risk that controls are inadequate to detect weaknesses.

3.9 Important Areas Covered By Internal Audit And Potential Value Additions

Retail Liability

- ▶ Retail Liability includes following:
 - CASA and Term Deposits as per KYC guidelines.
 - NRE / NRO Accounts.
 - Instructions from Customer with applicable RBI norms.
 - Internet Banking PIN & Debit Card PIN.
 - Monitoring of Suspense Account.
 - Exchange House Transactions.
 - Reconciliation of Nostro Account.
 - Lien / OD against Term deposits.
 - Inward and outward remittance under FEMA.

Key Value Additions

- Compliance of AML guidelines and KYC guidelines issued by RBI.
- Identification of fraudulent accounts.
- Identification of revenue leakage related to non collection of charges related to CASA and Term Deposits.

Retail Asset

- ▶ Retail Asset includes application for various loans and advances received from customers, preparation of detailed proposals by credit team, submission of proposal to the credit committee as per delegation or authority matrix, approval by the Board of Directors, etc. Once the decisions are given by the credit committee / Board of Directors then the term sheet / sanction letter is issued to the customer for final acceptance. Retail Assets products include:
 - Home Loans
 - Loan against Property / Real Estate Finance
 - Personal Loan / Business loans
 - Commercial Vehicle loans
 - Term Loan
 - Cash Credit / Working Capital Demand Loan
 - Dealer Funding
 - Agriculture Finance

Key Value Additions

- Compliance to SOP related to Loans and Advances including Authority Matrix and Delegation Matrix.
- Identification of non collection of interests and penalties on a timely basis.

Corporate Banking / Trade Finance

- ▶ Banking services and solutions which are provided to corporate clients and institutions are called Corporate Banking or Trade Finance. The major products under this category include:

Domestic Activities

- Letter of Credit (LC)
- Bill for Collection (Inland)
- Bank Guarantee
- Term Loan and Structured Loan
- Purchase Order Finance
- Bill discounting / Invoice Discounting
- Bill Discounting Backed By LC (LCBD)

Export Activities

- Export Bill for collection
- Advance against Export
- Export Bill drawn under Letter of Credit
- Export Bill for Negotiation / Purchase / Discounting
- Inward Remittance

Import Activities

- Outward Direct Remittance
- Outward Advance Remittance
- Import Collection Bill under Non Letter of Credit (Lodgment and Realisation)
- Import Collection under Letter of Credit
- Letter of Credit
- Buyers Credit

Key Value Additions

- Prevention of revenue leakage due to non collection of processing charges on a timely basis.
 - Enforcing Turn Around Time (TAT) for timely collection of various charges.
 - Enforcing adequate adherence to Delegation Matrix and other policy guidelines issued by individual banking organisation.
- Prevention of frauds in banking sector is one of the key factors responsible for introduction of Concurrent Audits in banks in October 1993 pursuant to the recommendations of the Ghosh Committee on Frauds and Malpractices in banks. Hence, KYC norms were made very stringent and following audits are introduced to effectively monitor banks on a continuous basis:
- Monthly concurrent Audit of Retail Liability Branches
 - Monthly Concurrent Audit of Central Processing Centre and Regional Processing Centre
 - Stock Audits or Security Audits
 - Revenue Audits
 - Expenditure Audits
 - Pre-Disbursement Audit
 - Post disbursement Audit
 - Information Systems Audit
 - Depository Participant Audit

Chapter 4
Insurance Sector



Chapter 4: Insurance Sector

4.1 Sector Background

4.1.1 What is Insurance?

- ▶ Insurance is a contract between the Insurer and the policyholder, whereby the insurer undertakes to pay to the policyholder a sum of money on happening of a specified event within the specified period. The policyholder pays a small sum of money, called premium to the insurer during the specified period towards his services. The maximum amount payable under the contract is called Sum Assured. Normally, the insurer pays lower of the Sum Assured and actual loss incurred by the policyholder. Insurance works on the principal of sharing of losses of few people through small contributions made by large number of people.

4.1.2 Insurance in India - Important Milestones

- 1818: First English Company, Oriental Life Insurance Company Ltd. began its business in Kolkata.
- 1850: First General Insurance Company, Triton Insurance Company Ltd. started its business in Kolkata.
- 1870: First Indian Insurance Company, Bombay Mutual Assurance Society Ltd., formed in Mumbai.
- 1912: Enactment of The Indian Life Assurance Companies Act.
- 1938: Enactment of Insurance Act.
- 1956: Nationalisation of Life Insurance business. Life Insurance Corporation (LIC) of India was formed and it absorbed 245 Life Insurers operating in India.
- 1972: General Insurance Business Act was passed, which resulted in the nationalisation of General Insurance Business w.e.f. 1 January 1973. General Insurance Corporation (GIC) of India with its four subsidiaries viz. National Insurance Company Ltd., New India Assurance Company Ltd., Oriental Insurance Company Ltd and United India Insurance Company Ltd. started its operations w.e.f. 1 January 1973. All 107 General Insurers operating in India were grouped and merged with the four subsidiaries.
- 1993: Government set up a committee under the chairmanship of R N Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector.

- 1994: The committee submitted its report wherein, among other things, it recommended the entry of private sector in the insurance industry. It also recommended that foreign companies be allowed to enter by floating Indian companies, preferably a joint venture with Indian partners.
- 1999: Constitution of Insurance Regulatory and Development Authority (IRDA) to regulate and develop the insurance industry.
- 2000: Incorporation of IRDA as a statutory body. IRDA opened up the Insurance market by inviting application for registration. Foreign companies were also allowed with a cap of 26% of the ownership. In December, 2000, the subsidiaries of the General Insurance Corporation of India were restructured as independent companies and GIC was converted into a national re-insurer. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002.

4.2 Size Of The Industry

- Insurance Sector has shown phenomenal growth over the last decade. The size of the Industry in terms of Investment as on 31 March 2009 reached Rs. 9,75,257 crores. The table below gives key indicators about the size of the industry.

Particulars	Life Insurance	General Insurance
Annual Premium for 2008-09 (Rs. in crores)	2,21,791.26	31,428.40
No. of Policies underwritten in 2008-09	5,09,23,377	6,70,60,087
Total Investment as on 31 March 2009 (Rs. in crores)	9,16,365	58,893
Contribution to GDP (2008-09)	4.17%	0.57%

Source: IRDA Annual Report 2008-2009

4.3 Global And Indian Scenario

- As per Swiss Re, global insurance premiums in calendar year 2008 were US\$ 4,270 billion. Life business accounted for US\$ 2,491 billion; and non-life insurance accounted for the remaining US\$ 1,779 billion.

- ▶ Even after recent growth in the Indian insurance industry, the density and penetration by the industry still remain at very low level compared to other developed and developing countries. Those figures on the other hand indicate vast opportunity in the Indian Insurance Sector.

Following are the figures published by Swiss Re. All the figures except for India are for calendar year 2008. For India, figures for the financial year 2008-2009 are taken.

- ▶ Insurance Density is measured as ratio of premium to total population.

International Comparision Of Insurance Density (in US\$)

Country	Life	Non-Life	Total
Australia	2,038.0	1,348.6	3,386.5
Brazil	115.4	129.1	244.5
Canada	1,442.7	1,728.0	3,170.8
France	2,791.9	1,339.2	4,131.0
Germany	1,346.5	1,572.7	2,919.2
Netherlands	2,366.0	4,483.5	6,849.5
Russia	5.4	268.1	273.5
Switzerland	3,551.5	2,827.9	6,379.4
UK	5,582.1	1,275.7	6,857.8
US	1,900.6	2,177.4	4,078.0
India	41.2	6.2	47.4
Hong Kong	2,929.6	380.8	3,310.3
Japan	2,869.5	829.2	3,698.6
Malaysia	225.9	119.5	345.4
Singapore	2,549.0	630.0	3,179.0
Indonesia	20.1	9.4	29.5
Iran	4.0	54.8	58.8
Pakistan	2.8	4.0	6.8
China	71.7	33.7	105.4

Source: Swiss Re, Sigma volumes 3/2008 and 3/2009

- Insurance Penetration is measured as contribution of the sector to GDP.

International Comparison Of Insurance Penetration (in %)

Country	Life	Non-Life	Total
Australia	4.4	2.9	7.3
Brazil	1.4	1.6	3.0
Canada	3.2	3.8	7.0
France	6.2	3.0	9.2
Germany	3.0	3.5	6.6
Netherlands	4.5	8.5	12.9
Russia	0.0	2.3	2.3
Switzerland	5.5	4.4	9.9
UK	12.8	2.9	15.7
US	4.1	4.6	8.7
India	4.0	0.6	4.6
Hong Kong	9.9	1.3	11.2
Japan	7.6	2.2	9.8
Malaysia	2.8	1.5	4.3
Singapore	6.3	1.6	7.8
Indonesia	0.9	0.4	1.3
Iran	0.1	1.1	1.1
Pakistan	0.3	0.4	0.8
China	2.2	1.0	3.3

Source: Swiss Re, Sigma volumes 3/2008 and 3/2009

4.4 Growth In Past Few Years

- In spite of lot of initial reservations about the privatisation of insurance industry , we have witnessed a huge growth in the industry since 2000-01. Even during the period of world wide recession, the sector registered growth of 10.15% and 9.09% respectively in Life and General Insurance segments.
- Growth in the Life Insurance was particularly significant. The annual premium collection increased from Rs. 34,898.48 crores in the year 2000-01 to Rs. 2,21,791.26 crores in the year 2008-09. Number of offices of Life

Insurance Companies also increased from around 2,200 in the year 2000-01 to 11,815 in 2008-09. Number of individual agents were 29,37,435 as on 31 March 2009 as compared to around 10,00,000 in the year 2000-01.

4.5 Regulatory Framework

- ▶ Insurance Act, 1938: It is the principal act governing the Insurance Business in India.
- ▶ Insurance Regulatory and Development Authority Act, 1999: This act deals with the formation of IRDA as a controlling body of insurance in India. The Act states the regulatory provisions regarding the rights and functioning of IRDA.
- ▶ Life Insurance Corporation of India Act, 1956: Provides for the constitutional framework for functioning of LIC of India.
- ▶ General Insurance Corporation of India Act, 1972: Provides for the constitutional framework for functioning of GIC of India.
- ▶ Companies Act, 1956: All the new Insurance companies being Body Corporates are governed by the provisions of this Act.
- ▶ Insurance Councils: Insurance Councils are formed for Life and Non-life Insurance with all the CEO of Insurance companies as their members. Two members are nominated by IRDA, one of whom is a chairperson of the council. Important matters related to Insurance Business are discussed in Insurance Councils.
- ▶ Insurance Ombudsman: Insurance Councils appoint Insurance Ombudsman to deal with policyholders' complaints related to claims, premiums and policy servicing. They can deal with the matters where dispute up to Rs. 20 lacs is involved. Their report is binding on the insurer, but not on the policyholder. At present, there are 12 Ombudsmen functioning all over India.

4.6 Critical Developments

- ▶ Size of the sector in terms of number of companies: Prior to IRDA there was only one and four companies operating in Life and General Insurance sector respectively. After opening up, the industry has witnessed entry of 41 new players in the last decade.

At present, there are 23 companies each registered with IRDA for conducting business in Life and General Insurance. Apart from them, GIC of India operates as Reinsurance Company.

- ▶ Development of new distribution channels: Prior to privatisation, insurance business was mostly conducted through individual agents. However, the sector witnessed emergence of following new distribution channels:
 - Corporate agents: Corporate entities are allowed to operate as Insurance Agents. They have been quite successful due to huge database, substantial resources and ability to penetrate the market across various segments.
 - Brokers: Normal types of agents are allowed to sell the products of only one company. Whereas, Brokers are allowed to sell the products of all the companies in the market. This allows them to offer wide choice to their customers.
 - Bancassurance: Cross selling of insurance by banks is termed as Bancassurance. Due to existing customer base of the banks, they are better positioned to sell insurance products to their customers.
 - Direct marketing: This is a new channel where the insurers sell their products directly through their employees. In this arrangement, the company saves cost related to commissions paid to agents.
 - Other channels: Apart from the above channels, the companies are now resorting to Telemarketing, Online selling and Mall assurance (selling of insurance in Malls) for distribution purpose.
- ▶ Development of new variety of insurance products: Prior to privatisation, the pace of product development was very slow, as the element of competition was missing. However, post IRDA all the insurers have given a lot of efforts on development of innovative products to stand out in the competitive market. Some of the highlights in this area are:
 - Unit linked products (ULIP) became the mainstay of Life Insurance Industry due to flexibility, transparency and possibility of growth in fund.
 - Riders (Additional optional covers) became important aspect of the insurance product. It gives various options to the customers to go in for products which suit their needs.

- De-tariffing of Motor Insurance.
 - Development of Micro-insurance policies to cater to the need of people in unorganised sector.
- Improvement in customer service standards: One of the objectives behind formation of IRDA was to improve upon standards of service offered to customers. In 2002, IRDA came out with Policyholders' Protection Regulation which specifies, among other things, key standards of servicing. It has issued various guidelines from time to time to safeguard the interests of the policyholders.
- Focus on new marketing segments: IRDA has set mandatory minimum business standards for the insurers, regarding business in rural and socially unorganised sectors. These regulations ensure even spread of insurance across all sections in the society. IRDA has also come out with regulation regarding Micro-insurance, which is aimed at providing benefits of insurance to economically weaker section of society.

4.7 Role Of Information Technology

- There is a quantum leap in the use of information technology that has revolutionised the entire insurance sector. Insurance industry deals with huge data base and thus, there is a need to use the voluminous data for processing, servicing and trend analysis as well as improved customer service.

Some of the key services offered by insurers due to improvement in information technology are:

- Offering policy servicing, premium payment, claims in any branch of the insurer across the country, as per customer's convenience.
- Online issuance of policies in certain cases.
- Provision of online password to the policyholder to access his policy account online and to get some of the policy servicing activities and premium payment done through internet.
- Providing information related to Company on the website.
- Direct credit in bank account in case of claims.
- Portals for employees and sales force where they can log in to get information about their salaries, incentives and commissions.

4.8 Regulatory Provisions

4.8.1 Guidelines on Corporate Governance issued by IRDA

- ▶ Given the risks that an insurer takes in carrying out its operations and its potential impact on his business, it is important that the Board has in place:
 - Robust and efficient mechanisms for identification, assessment, quantification, control, mitigation and monitoring of the risks;
 - Appropriate processes for ensuring compliance with the Board approved policy, and applicable laws and regulations;
 - Appropriate internal controls to ensure that the risk management and compliance policies are observed;
 - An internal audit function capable of reviewing and assessing the adequacy and effectiveness of, and the insurer's adherence to its internal controls as well as reporting on its strategies, policies and procedures; and
 - Independence of the control functions, including the risk management function, from business operations demonstrated by a credible reporting arrangement.
- ▶ The responsibility for the oversight of control functions of an insurer should be entrusted to directors possessing the appropriate integrity, competence, experience and qualifications, and they should meet proper criteria initially and on an on-going basis.
- ▶ For insurers within a group, appropriate and effective group-wide risk control systems should be in place in addition to the control systems at the level of the insurer. It is essential to manage risks appropriately on a group-wide basis as well.

4.8.2 Audit Committee (Mandatory)

- ▶ The Audit Committee shall oversee the financial statements, financial reporting and disclosure processes.
- ▶ The Chairman of the Audit Committee should be an independent director of the Board and should ideally be a Chartered Accountant or a person with strong financial analysis background. The association of the CEO in the Audit Committee should be limited to eliciting any specific information concerning audit findings.

- ▶ The Audit Committee will oversee the efficient functioning of the internal audit department and review its reports. The Committee will additionally monitor the progress made in rectification of irregularities and changes in processes wherever deficiencies have come to notice.
- ▶ The Audit Committee shall be directly responsible for the appointment, remuneration, performance and oversight of the work of the auditors (internal / statutory / concurrent). In case of statutory audit, the independence of the external auditors shall be ensured (although the approval of appointment, remuneration and removal of the statutory auditors shall be done by the shareholders at the general body meeting).
- ▶ The Audit Committee shall establish procedures to attend to issues relating to maintenance of books of account, administration procedures, transactions and other matters having a bearing on the financial position of the insurer, whether raised by the auditors or by any other person.
- ▶ Any work other than audit that is entrusted to the auditor or any of its associated persons or companies shall be specifically approved by the Board who shall keep in mind the necessity to maintain the independence and integrity of the audit relationship. All such other work entrusted to the auditor or its associates shall be specifically disclosed in the annual accounts of the insurer.

4.8.3 Risk Management Committee (Mandatory)

- ▶ It is now well recognised that the sound management of an insurer as in the case of other financial sector entities, is dependent on how well the various risks are managed across the organisation. In pursuit of development of a strong risk management system and mitigation strategies, insurers shall set up a separate Risk Management Committee to lay down the company's Risk Management Strategy. The risk management function shall be organised in such a way that it is able to monitor all the risks across the various lines of business of the company and the operating head has direct access to the Board. Conventionally this function is under the overall guidance and supervision of the Chief Risk Officer (CRO) with a clearly defined role. The insurers can, however, presently organise the function appropriately to the size, nature and complexity of their business keeping in view the need for operative independence of the Head of the risk management function.

- ▶ Broadly, the Risk Management Committee shall:
 - Assist the Board in effective operation of the risk management system by performing specialised analyses and quality reviews;
 - Maintaining a group-wide and aggregated view on the risk profile of the insurer in addition to the solo and individual risk profile;
 - Report to the Board details on the risk exposures and the actions taken to manage the exposures;
 - Advise the Board with regard to risk management decisions in relation to strategic and operational matters such as corporate strategy, mergers and acquisitions and related matters.

4.8.4 Investment Audits:

- ▶ As per IRDA circular ref:INV/CIR/023/2009-10, guidelines issued in respect of Investment Audits of Insurance Companies are as follows:
 - All the insurance companies having AUM (Assets Under Management) less than Rs. 1,000 crores of their investment transactions every quarter.
 - All the insurance companies having AUM (Assets Under Management) more than Rs. 1,000 crores will be subjected to Concurrent Audit of their Investment transactions to be done by External Auditors.
 - Every insurer will get its systems and processes audited at least once in 3 years by External Auditors.

4.9 Value-Addition Opportunities Through Internal Audit

- ▶ Large network of offices: Insurance business model operates with large number of offices spread across various geographical locations. Having control over the day to day functioning is not possible for controlling Head Office. It relies on periodical statements sent by the offices. The role of Internal Audit becomes very crucial for the top management as it requires independent review of the working of these offices.
- ▶ Large number of financial transactions: Every office of the Insurers undertakes large number of financial transactions related to business. Strict control over these transactions is required to avoid any chances of misappropriation, fraud and mistakes of critical nature.

- ▶ Regulatory compliances: Every office of the Insurer is subject to the compliance of large number of regulatory provisions. The controller has been more and more aggressive on this front to protect the interests of policyholders. Internal Audit plays vital role in ensuring the regulatory compliances.
- ▶ Employee turnover: Private insurance sector is prone to large employee turnover. This results into frequent changes in the overall management of offices of Insurer. Here again, the role of internal audit is very important to appraise the management about the effect of such movements on the overall working.
- ▶ Highly technical processes: Insurance industry requires lot of domain expertise for its functioning. Similarly, the procedures of the insurance companies are subject to constant review due to the changes in regulations and technology. Internal Audit plays very important role in suggesting the changes in procedures followed by the insurer and any deviation observed in implementation of procedures and processes.
- ▶ Use of Information Technology: Nowadays, insurance business is highly automated and uses latest softwares for its operations. Complete review of systems is very critical given the huge amounts invested in information technology and the extent of dependence on technology.

4.10 Important Areas Covered By Internal Audit

▶ New Business

New Business department deals with all the functions starting from receipt of new proposals to issuance and dispatch of policies to the policyholders.

Major New Business function

- Underwriting of new proposals
- Follow up of pending proposals
- Development of medical network
- Issuance and dispatch of policies
- Control over policy stamps
- Reinsurance Arrangements
- Control over undelivered policies
- Refund of excess deposits in case of cancelled/rejected proposals

Important areas covered by Internal Audit

- Turn Around Time observed in respect of policy issuance, conveying pending requirements to customer and refund of excess deposits.
- Procedure followed for undelivered policies, refund of excess deposits and refund of deposits in respect of cancelled/ rejected/ postponed proposals.
- Adequacy of Medical Examiners' network.
- Implementation of AML guidelines for all new proposals.
- Accuracy and adequacy of supporting documents collected from the proposer, as per underwriting manual.
- Adequacy of the mechanism for attending customer complaints in respect of non receipt of policy documents, forged signatures across proposal forms, third party cheques, tampered supporting documents, etc.

Key Value Additions

- Compliance of AML guidelines in respect of new business functions.
- Identification of high risk areas like under-calculation of sum under consideration which will affect decisions pertaining to medical / financial underwriting, reinsurance and KYC documentation.
- Identification of revenue leakages in the form of non recovery of necessary charges from refund of excess deposits.

► Policy Servicing

Insurance contract is generally a long term relationship between the policyholder and the insurer. During the course of contract various types of services are required by the policyholder and such services are provided by the Policy Servicing department.

Major policy servicing functions

- Nomination / Assignment
- Surrender / Partial withdrawal
- Loan
- Fund switching
- Free look cancellation
- Revival
- Change in sum assured / Change in term

Important areas covered by Internal Audit

- Observance of TAT in respect of all policy servicing aspects viz. change of nomination, assignment, partial withdrawals, surrender, loan, change of address, fund switching, free look cancellation, renewal etc.
- Accuracy and adequacy of the supporting documents collected from policyholder.
- Checking the accuracy of calculations.
- Implementation of AML guidelines as per IRDA guidelines in respect of free look cancellations, surrenders, assignments and renewal.
- Adequacy of the mechanism for attending customer complaints particularly in respect of high risk areas viz. misrepresentation, wrong selling, frauds, third party cheques, misuse of policy premium collected from customer, etc.

Key Value Additions

- Compliance of AML guidelines for respective policy servicing functions.
- Identification of revenue leakages in the form of non recovery of necessary charges from surrender / partial withdrawal / free look cancellation cases.
- Identification of areas of operations which require immediate corrective measures to maintain the standards of policy servicing.

► Claims

Claims department deals with all functions related to registration, processing and admission / rejection of claims. The major types of claims for life insurers are death, maturity, survival and disability. Whereas in case of general insurers there are health and other non life claims.

Major claims functions

- Registration of claims.
- Follow up of pending claim cases.
- Development of network of TPA, surveyors and claim investigation agencies.
- Claim investigations.
- Admission and payment of claims.
- Repudiation of fraudulent claims.

Important areas covered by Internal Audit

- TAT observed in respect of registration of claims, claim settlement, conveying pending requirements to claimants, claim investigation, etc.
- Procedure followed for claims registration after receipt of claim intimation, follow up with the claimant for pending requirements.
- Adequacy of the investigations carried out in respect of suspicious claims.
- Checking the accuracy of calculations.
- Checking the accuracy and adequacy of the supportive documents as per Claims manual and circulars.
- Adequacy of the mechanism for attending customer complaints in respect of repudiated claims, delayed claim settlement, etc.

Key Value Additions

- Compliance of AML guidelines in respect of Claims functions.
- Identification of high risk areas like inadequacy of claim investigations and repudiations not conforming to the provisions of Claims manual / Insurance Act.
- Identification of revenue leakages due to wrong calculations, wrong selection of risk at underwriting level, inadequate reinsurance done, etc.

► Sales Administration

Sales administration department deals with the issues related to sales force viz. agents, sales managers, branch managers, etc. of the insurer.

Major Sales Administration functions

- Arrangement of IRDA training.
- Licensing of new agents.
- Renewal of agents' licenses.
- Development of network of IRDA training institutes.
- Commission payouts.
- Sales competition payouts.
- Appraisal of Sales Manager's performance.
- Promotion or demotion or termination of sales managers.

Important areas covered by Internal Audit

- Checking of data related to IRDA training, IRDA examinations, licensing of new agents, renewal of agents' licenses, etc.
- Adequacy of IRDA training institutes.
- Checking the accuracy of payments made to IRDA training institutes.
- Procedure for termination of and reinstatement of agency.
- Checking the accuracy of commission payouts particularly in respect of reinstated agents, terminated agents and agents eligible under section 44.
- Data related sales competition for verifying the accuracy of compilation of eligible agents / employees' list as per the guidelines of scheme circulars.
- Adequacy of the mechanism for attending complaints in respect of non receipt of commission / scheme prizes, non receipt of IRDA licenses, disputes regarding bonuses, promotion criteria, etc.
- Checking of sales promotional expenses, entertainment expenses and sales related reimbursements.

Key Value Additions

- Identification of revenue leakages due to wrong commission payouts, calculation errors in Sales Manager's bonuses, wrong data compilation for competitions, etc.
- Identification of high risk areas such as licensing without proper documentation, non supervision of performance of appointed IRDA training institutes.

► Finance and Accounts

All the matters related to general accounting, banking, budgeting and financial reporting are taken care by Finance and Accounts Department.

Major Finance and Accounts functions

- Cash and Bank Management.
- Preparation of Financial Statements.
- Control over payments made to policyholders, vendors and employees.

- Preparation of Budget.
- Control over expenses under various accounting heads.
- Bank reconciliations.
- Submission of the periodical statements sent to higher offices / IRDA.

Important areas covered by Internal Audit

- TAT observed in respect of making various payouts, bank reconciliations, submission of trial balance, etc.
- Procedures adopted for deposition of cash in bank, custody and movement of safe keys, maintaining safety of cash counter / cash box, etc.
- Checking of all cash deposits with pay-in-slips.
- Physical verification of cash, stamps, cheque books and fixed assets.
- Checking of all bank reconciliations.
- Accuracy of the periodical statements sent to higher offices / IRDA.

Key Value Additions

- Identification of revenue leakages due to delay in deposits in banks, wrong bank charges, delayed credit by banks, etc.
- Identification of high risk areas like
 - 1) Misuse of cash, stamps, etc.
 - 2) Flaws in maintenance of cash counter / cash box safety.
 - 3) Payments made without proper authorisation.

► General Administration

All matters related to office administration, human resources and salary are handled by General Administration Department.

Major General Administration functions

- Compliance of the requirements under applicable labour and industrial acts.
- Control over expenses related to general administration such as conveyance, postage, rents, taxes, etc.
- Entering into lease agreements and sales agreements for the offices of insurer.

- Making arrangement with the vendors for supply of necessary material required for office administration.
- Salary administration.
- Handling of HR related work such as recruitment, transfers, promotions, retirement, resignation, etc.

Important areas covered by Internal Audit

- Verification of compliance of the requirements under applicable labour and Industrial acts.
- Verification of expenses related to general administration such as conveyance, postage, rents, taxes, etc.
- Verification of lease agreements.
- Verification of all the agreements with the vendors.
- Salary payment verification.

Key Value Additions

- Identification of revenue leakages due to
 - 1) Mistakes in calculation of full and final settlements, bonus calculations, increments, etc.
 - 2) Wrong payments made to vendors.
 - 3) Excessive amounts disproportionate to the level of business activity spent under various accounting heads.
- Identification of areas of high risk such as
 - 1) Lack of control over leave records.
 - 2) Lack of control over inventory.
 - 3) Non compliance of regulatory requirements with regards to labour and industrial acts.

► Actuarial

Actuarial department deals with the jobs related to mathematical basis of the insurance.

Major Actuarial functions

- Development of new Insurance Products.
- Determination of premium tables.
- Valuation of Insurance Business.
- Determination of surplus.
- Maintenance of Solvency Margin.

► Investment

Investment Department deals with the activities related to Investment of monies collected by Insurer as per the statutory guidelines.

Major Investment functions

- Investment of policyholders' fund in accordance with section 27 of Insurance Act, 1938.
- Submission of periodical returns to IRDA.

► Group Insurance and Pensions

Group Insurance deals with the policies issued by insurers to a group of persons viz. employees, members of association, debtors, etc. Contrary to individual insurance policies group insurance policies are tailor-made to cater to the requirements of group.

Major types of group insurance policies

- Group term insurance.
- Group health insurance.
- Group gratuity.
- Group annuity.
- Group saving linked insurance.

Important areas covered by Internal Audit

- Agreement between master policyholder and insurer.
- Underwriting of group policies.
- Claim settlement under group policies.
- Policy servicing.
- Accounting of premiums received.
- Procedure for entry and exit of members.
- Adequacy of data collected from group policyholder.
- Calculation of premium.
- General accounting.

Key Value Additions

- Indication of revenue leakages due to application of wrong premium tables, allowing entry of new members without fulfillment of minimum insurability conditions, etc.

IRDA Compliance

- Observance of regulations issued by IRDA.
- Formations of various committees as per IRDA corporate governance guidelines and their functioning.
- Appointment and functioning of various officers as per IRDA guidelines.
- Submission of periodical returns to IRDA.

4.12 Audit Objectives, Approach And Methodology

- ▶ Study of Business Model: In insurance, business model followed by various insurers varies depending upon size of business, level of expertise available and overall business policy followed by the management. Before the start of audit, thorough understanding of the business model is very important. Identification of key areas, various processes, level of delegation, degree of internal control and regulatory environment must be carefully understood.
- ▶ Classification of risk: Based on the above study, auditors should classify the major risk areas and decide the weightage to be attached to each process. For classification, industry benchmarks and past experiences can be very useful. High and medium risk areas must be scrutinised thoroughly.
- ▶ Use of technically qualified people: There are areas like actuarial, investment, underwriting, claim assessment, etc. which require use of domain experts for audit.

Chapter 5

Financial Services Sector



Chapter 5: Financial Services Sector

5.1 Sector Background

- ▶ India has emerged as one of the fastest-growing economies in the developing world and has shown a constant growth. In 2009, the Global Competitiveness Report ranked India 16th in financial market sophistication, 27th in business sophistication and 30th in innovation; ahead of several advanced economies.
- ▶ Financial Services sector in India has witnessed remarkable changes in the recent past. Policies of the government, rapid development in communication and information technology in financial services created radical changes in respect of innovative financial products and financial markets. In India credit cult is developing very fast. The use of sophisticated and advanced technology could be reckoned as another specific feature of the global financial service industry. The growth of financial sector in India at present is nearly 8.5% per year.

5.2 Size Of The Industry And Economic Aspects

- ▶ The Indian economy is estimated to have grown by 6.7% in 2008-09. According to the latest Central Statistical Organisation (CSO) data, financial services, banking, insurance and real estate sectors rose by 7.8% in the third quarter of 2009-10.
- ▶ The government has taken a number of steps in recent months to revive the economy, including slashing interest rates, lowering factory levies and more than doubling the limit on foreign investment in corporate bonds. The financial services space is rapidly growing in India.
- ▶ As per SEBI number of registered FIs as on 29 March 2010 was 1,710 and the cumulative investments in equity since November 1992 to 29 March 2010, was US\$ 76.74 billion, while the cumulative investments in debt during the same period were US\$ 11.85 billion.
- ▶ The average assets under management of the mutual fund industry stood at US\$ 174.06 billion for the month of February 2010, an increase of nearly 36% from US\$ 111.55 billion in February 2009, according to the data released by Association of Mutual Funds in India (AMFI).

- ▶ Funds raised by the Indian corporate sector via ADRs / GDRs have jumped over 33 times from around US\$ 101.72 million in 2008 to about US\$ 3.50 billion in 2009.
- ▶ Furthermore, with economic outlook on Indian as well global markets being positive, PE funds are closing deals more speedily than last year. The merger and acquisition (M&A) activity has shown similar momentum, with domestic deals ruling the charts.
- ▶ PE funds closed 29 deals in January 2010 compared to only 16 during the same period last year. The value of such deals saw a significant jump of 303%, from US\$ 309 million in January 2009 to US\$ 1.24 billion this year.
- ▶ Also, a study by Project Finance International (PFI), a source of global project finance intelligence and a Thomson Reuters publication has ranked India on top in the global project finance (PF) market in 2009, ahead of Australia, Spain and the US.
- ▶ The study said the main market for PF in 2009 was the domestic Indian market, which raised US\$ 30 billion, accounting for 21.5% of the global PF market. This was up from US\$ 19 billion in 2008.

5.3 Global And Indian Scenario

- ▶ Reforms of the financial sector constitute the most important component of India's programme towards economic liberalisation. The recent economic liberalisation measures have opened the door to foreign competitors to enter into our domestic market which was not the case before. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.
- ▶ Many of the providers and users of capital have changed their roles all over the world. Financial intermediaries have come out of their traditional approach and they are ready to assume more credit risks just like the global organisation. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also. The emergence of various financial institutions and regulatory bodies has transformed the financial services sector from being a conservative industry to a very dynamic one. In this process this sector is facing a number of challenges.

- ▶ Impressive progress in IT and IT-enabled services, both rail and road traffic, and fast addition to existing stock of telephone connections, particularly mobiles, played a key role in such growth.
- ▶ Due to globalisation, financial services industry is in a period of transition. Market shifts, competition, and technological developments are ushering in unprecedented changes in the global financial services industry. Organisations in this highly competitive and increasingly regulated industry will especially need to focus on making themselves more:
 - Adept to face increasing transaction volumes, regulation and the integration of previously disparate global markets.
 - Agile at identifying and managing risk.
 - Operationally efficient and Customer-centric.
 - Optimised in both business and technology.

In this scenario, spearheading IT initiatives has become critically important.

- ▶ Major spending initiative priorities tend to focus on automation to reduce costs and lessen risk, along with using BPO to gain efficiency and allow internal IT organisations to focus on strategic initiatives. Delivery of these capabilities at a high efficiency level but at low costs is one of the major success factors for any financial services business.
- ▶ Growth in financial services at global stage is being bolstered by the opportunities of demography, emerging markets and ever more innovative products and services. Yet, organisations also face the challenges of mounting competition, more complex regulations and ever more meeting customer expectations. Effective growth strategies are therefore likely to cut across all operating processes and functional boundaries. Key priorities include ensuring that the business model takes full account of customers' needs, tax, financial and regulatory considerations and the organisation's capacity to change the way it does business. In turn, the objectives and criteria for success need to be clearly measured.

5.4 Regulatory Framework Governing The Sector

- ▶ All financial service companies need to comply with the legislations enacted by the following regulatory boards of India:
 - Securities and Exchange Board of India (SEBI).
 - Reserve Bank of India (RBI).

- Ministry of Finance (MOF).
- Forward Markets Commission (FMC). The key legislation governing the forward commodities market is the Forward Contracts (Regulation) Act, 1952 (FCRA) which empowers the Central Government (in consultation with FMC) to regulate forward contracts in certain goods.
- Insurance Regulatory and Development Authority (IRDA).
- Ministry of Corporate Affairs (MCA).
- Ministry of Commerce and Industry (FDI Policy).

5.5 Major Segments

► The Major Segments of the financial services are :

- Mutual Funds
- NBFC
- Venture Capital
- Credit Rating Agencies
- Clearing House
- Depositories
- Stock Brokers
- Private Equity
- Foreign Institutional Investors (FII)
- Merchant Bankers
- Underwriters
- Registrars and Share Transfer Agents
- Intermediation or Advisory Services Company
- Conglomerates
- Securities Market

i. Mutual Fund

Mutual Fund is a type of Investment Company or a form of joint investment. The mutual funds are actually huge funds where a number of investors invest their money. This huge amount is invested in several projects and companies that can provide desired growth to money. The mutual funds are managed by the fund managers / portfolio managers.

There are a number of mutual funds that are differentiated according to their areas of investment. Some of these types of mutual funds are as follows:

• Open-Ended Funds • Close-Ended Funds • Growth / Equity Oriented Funds • Income / Debt Oriented Funds • Balanced Funds	• Money Market or Liquid Funds • Gilt Funds • Index Funds • Exchange Traded Index Funds
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As on April 2010 there were 45 Mutual Funds registered with SEBI.

Compliances:

- The mutual funds are subjected to a different set of rules and regulations regarding administration and tax structure. They are governed by SEBI (Mutual Funds) Regulation 1996.
- System Audit is Mandatory for Mutual Funds and has to be conducted once in two years.
- Statement of Additional Information (SAI) and Scheme Information Document (SID) to be made available on SEBI website.

ii. Non-Banking Financial Companies (NBFCs)

NBFCs are fast emerging as an important segment of Indian financial system. The NBFCs as a whole account for 9.1% of the assets of the total financial system. It is an heterogeneous group of institutions (other than commercial and co-operative banks) performing financial intermediation in a variety of ways, like accepting deposits, making loans and advances, leasing, hire purchase, etc.

They raise funds from the public, directly or indirectly, and advance loans to the various wholesale and retail traders, small-scale industries and self-employed persons. Thus, they have broadened and diversified the range of products and services offered by financial sector. Gradually, they are being recognised as complementary to the banking sector due to their customer-oriented services, simplified procedures, attractive rates of return on deposits, flexibility and timeliness in meeting the credit needs of specified sectors, etc.

A reclassification of NBFCs was effected in December 2006, whereby companies financing real / physical assets for productive / economic activities are classified as Asset Finance Companies, while the other two categories are Investment Companies and Loan Companies.

The NBFC sector has been witnessing a consolidation process in recent years, wherein the weaker NBFCs are gradually exiting, paving the way for a stronger NBFC sector.

Compliances:

The working and operations of NBFCs are regulated by the:

- Reserve Bank of India (RBI) within the framework of the Reserve Bank of India Act, 1934.

- Regulatory framework of NBFC Guidelines issued by RBI.
- NBFC Prudential Norms Directives.
- Companies Act, 1956.

iii. Venture Capital (VC)

VC is an important source of finance for those small and medium-sized firms, which have very few avenues for raising funds. Venture capital is a commitment of capital, or shareholdings, for the formation and setting up of small scale enterprises at the early stages of their life cycle. Venture capitalists comprise of professionals from various fields.

They provide funds (known as Venture Capital Fund) to these firms after carefully scrutinising the projects. Their main aim is to earn huge returns on their investments, but their concepts are totally different from the traditional moneylenders. They take active participation in the management of the company as well as provide the expertise and qualities of a good banker, technologist, planner and managers. Thus, the venture capitalist and the entrepreneur literally act as partners.

In India, VC firms have invested US\$475 million over 92 deals in India during calendar 2009.

Venture Capital Funds as on April 2010	154
Foreign Venture Capital Funds as on April 2010	144

The venture capital recognises different stages of financing, namely:

- Early stage financing.
- Expansion financing.
- Acquisition / buyout financing.

In India, the venture capital funds (VCFs) can be categorised into the following groups:

- Those promoted by the Central Government.
- Those promoted by State Government.
- Those promoted by public banks.
- Those promoted by private sector companies.
- Those established as an overseas venture capital fund.

Compliances:

- SEBI (Venture Capital Funds) Regulations, 1996.
- SEBI (Foreign Venture Capital Investors) Regulations, 2000. These regulations provide broad guidelines and procedures for establishment of venture capital funds both within India and outside India their management structure and set up; as well as size and investment criteria of the funds.
- FDI Policy.

iv. Credit Rating Agencies

The credit rating agencies are those firms that evaluate different types of financial services companies. These ratings are based on a number of factors like the kind of services, risk factor involved with the services, customer facilitation and many more. The types of Rating are Debenture / Bond Rating, Equity Rating, Commercial Paper Rating, etc. There are 5 credit rating agencies registered with SEBI as on April 2010 .

Compliance:

- SEBI (Credit Rating Agencies) Regulations, 1999.
- In case of Company, under Companies Act, 1956.
- In case of bank, provisions under Banking Regulation Act, 1949 / Approval from RBI.

v. Clearing House

Clearing house is a form of financial institution, which offers settlement and clearing facilities for monetary deals normally on a futures exchange. A clearing house frequently functions in the form of a key counterparty. Clearing houses also extend services related to novation.

Novation refers to the replacement of a new agreement or loan for a previous one, as well as various facilities related to credit growth to its participants. One major instance of a clearing house is the Options Clearing Corporation, which operates with a goal to clear equity options so that to assure the appropriate usage of these devices.

Compliances:

- SEBI Regulations.
- RBI Guidelines.

vi. Depositories

Depositories are establishments with the objective of ensuring free transferability of securities with speed, accuracy and security, dematerialising the securities in the depository mode, providing for maintenance of ownership records in book entry form.

Compliances:

- SEBI (Depositories and Participants) Regulations, 1996.
- The Depositories Act, 1996.
- Securities Contract Regulation Act, 1956.
- Companies Act, 1956.

vii. Stock Brokers

A stock broker is a regulated professional broker who buys and sells shares and other securities through market makers on behalf of investors. Business of stock exchange can only be transacted by a member of the Stock Exchange.

Compliances:

- Securities Contract Regulation Act, 1956.
- SEBI Act, 1992 and various Rules, Regulations and Notifications.

In August 2008, SEBI issued a circular to the various stock exchanges requiring mandatory internal audit for their stock-brokers / clearing members on a half-yearly basis.

The scope of the said audit includes the existence, scope and efficiency of the internal control system, compliance with the provisions of the SEBI Act, 1992, Securities Contracts (Regulation) Act, 1956, SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, circulars issued by SEBI, agreements, know-your-customer requirements, by-laws of the exchanges, and data security and insurance in respect of the operations of stock brokers / clearing members.

During the last few years, there have been substantial regulatory, structural, institutional and operational changes in the securities industry, which has been brought in with the objective of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to the international standards. Some of the

significant changes are listed below.

- Screen-Based Trading in place of physical trading, which has enabled trading to be carried out from various regions.
- Reduction in Trading and Settlement cycle from T+14 to virtually T+2 / T+1 day cycle in a progressive manner.
- Trading in derivatives, options, futures, etc.
- Dematerialisation of securities and virtual discontinuance of trading in physical form.
- Development of Risk Management System in Stock Exchanges like constant monitoring of exposure and turnover, indemnity insurance, on-line monitoring and automatic disablement, virtual surveillance, introduction of circuit breakers etc.
- Globalisation of markets with highly sophisticated and matured players like FIIs, Mutual Funds, High Networth Individuals, etc. entering India and high inter-connect between Global stock exchanges and Indian stock exchanges.

The recent capital market reforms and globalisation of the economy have opened up various business avenues as well as increased the exposure to certain risks for the stock-broking community arising from:

- Substantial increase in geographies operations.
- Considerable increase in scale of operations.
- Polarisation of stock exchanges, with the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) together accounting for over 99.98% of the national turnover of trades.
- Increased use of Information Technology.
- Change in the type and scale of investors, with the emergence of a new class of investors in mutual fund houses (MFs), venture capital funds, private equity players, portfolio managers, etc.
- Increased transparency and media exposure.
- Increased reporting requirements and greater responsibility on the various functionaries.
- Increased volatility in the markets following greater and quicker information flow, and the integration of Indian capital market with global capital markets.

Internal Audit of Stock brokers

The areas that are of the utmost importance wherein the internal audit can add value are:

- Client acceptance and anti-money laundering compliances.
- Client exposure and margin policy aspects.
- Treasury management.
- IT systems' review and IT security aspects including business continuity and disaster management plan.
- Revenue audit based on contractual arrangements with client and revenue sharing agreement with the franchisees / sub brokers.
- Manpower cost review including performance based incentives.
- Review of operating costs, including infrastructure and IT.
- Compliance with applicable regulations, such as those of SEBI, stock exchange regulations, Securities Transaction Tax, Service Tax, Income Tax, and Companies Act (in case of corporate entities).

viii. Private Equity (PE)

Private equity is money invested in companies that are not publicly traded on a stock exchange or invested as part of buyouts of publicly traded companies in order to make them private companies. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event such as an IPO or sale to a public company.

Private equity funds often use leveraged buyouts (LBOs) to acquire the firms in which they invest. The most successful private equity funds can generate returns significantly higher than those provided by equity markets.

Compliances:

- The SEBI (Venture Capital Funds) Regulation, 1996.
- The SEBI (Foreign Venture Capital Investors) Regulations, 2000.

- FEMA (Transfer or Issue of Security by a person resident outside India) Regulations, 2000.
- Income Tax Act, 1961.

ix. Foreign Institutional Investors (FII)

'Foreign Institutional Investor' means an institution established or incorporated outside India which proposes to make investment in India in securities (equity, debt, derivatives, IDR, etc.)

Data sourced from the SEBI as of 31 December 2009 shows that

- Number of registered FIIs stood at 1,706;
- Number of registered sub-accounts rose to 5,331;
- FIIs transferred a record US\$ 17.46 billion in domestic equities during the calendar year 2009.

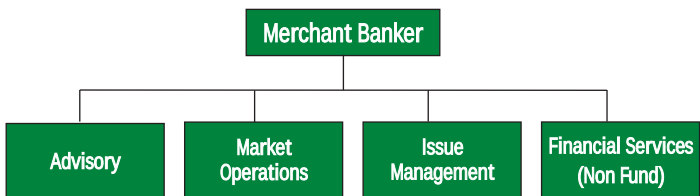
Compliances:

- SEBI (Foreign Institutional Investors) Regulation, 2006.
- RBI Guidelines.
- FEMA Regulations.
- FDI Policy.

x. Merchant Banker

A Merchant Banker is a person who is engaged in the business of issue management either by making arrangements regarding selling, buying or by subscribing to securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management. They act as a total solutions provider as far as any corporate, desirous of mobilising capital is concerned.

Merchant Banking Services



Compliances:

- SEBI (Merchant Bankers) Rules, 1992.

xi. Underwriters

Underwriters are either a company or other entity that administers the public issuance and distribution of securities from issuing body. An underwriter works closely with the issuing body to determine the offering price of the securities buys them from the issuer and sells them to investors via the underwriter's distribution network.

Underwriters generally receive underwriting fees from their issuing clients, but they also usually earn profits when selling the underwritten shares to investors. However, underwriters assume the responsibility of distributing securities issue to the public. If they cannot sell all of the securities at the specified offering price, they may be forced to sell the securities for less than they paid for them, or retain the securities themselves.

Compliances:

- The SEBI (Underwriters) Regulations, 1993.

xii. Registrars

It is an organisation, usually a bank or a trust company, that maintains a registry of the share owners and number of shares held for a mutual fund, bond or stock, and makes sure that more shares are not issued than are authorised.

Compliances:

- SEBI (Registrars to an issue and Share Transfer Agents) Rules, 1993.

xiii. Intermediation or Advisory Services Company

There are a number of investment options available for the investors but at the same time, every investor is not meant for every kind of investment option. There are a number of factors like returns from the investment, security of the investment and several other risk factors that are involved with the investments.

These companies are designed to provide advice to the investors in selecting the right investment options that suit their investment plans and also the risk tolerance capacity. At the same time, the intermediation or advisory services companies are handling the investor's money and investing it according to the client's choice.

xiv. Conglomerates

A financial services conglomerate is a financial services firm that is active in more than one sector of the financial services market e.g. life insurance, general insurance, health insurance, asset management, retail banking, wholesale banking, investment banking, etc. A key rationale for the existence of such businesses is the existence of diversification benefits that are present when different types of businesses are aggregated.

xv. Securities Market

- Allow firms to raise capital more directly from investors, in particular by issuing equities and bonds, in turn allowing investors a share in the success of the economy. Securities markets have witnessed rapid growth over recent decades and become increasingly internationalised.
- Capital markets continue to innovate. Commodity markets allow firms to fix prices for products in the future, removing risks and allowing firms greater certainty in production and investment decisions. Derivatives are securitised products that allow business risks such as movements in the price of commodities. The global derivatives market, including 'over-the-counter' (OTC) and exchange-traded derivatives, has grown rapidly.

5.6 Critical Developments

- The number of shareholders in India is estimated at 25 million. However, only an estimated 2 lakh persons actively trade in stocks. There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. Expectations are that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock markets have been constrained by some unsavory developments, which have led to retail investors deserting the stock markets.

Mutual Funds

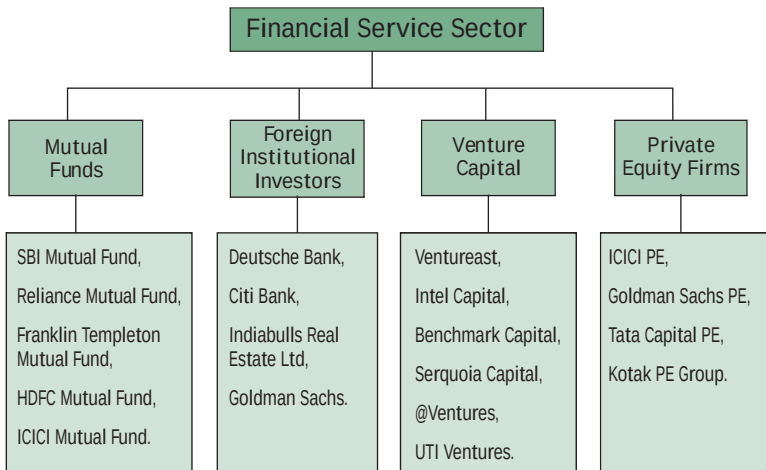
- The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With issuance of SEBI guidelines, the industry has a framework for establishment of many more players, both Indian and foreign players.
- The Unit Trust of India remains the biggest mutual fund controlling a corpus of nearly Rs. 70, 000 crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 scheme. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular.
- The foreign owned AMCs are the ones which are now setting the pace for the industry. They are introducing new products, setting new standards of customer service, improving disclosure standards and experimenting with new types of distribution.
- The insurance industry is the latest to be thrown open to competition from the private sector including foreign players. Foreign companies can only enter joint ventures with Indian companies, with participation restricted to 26% of equity. It is too early to conclude whether the erstwhile public sector monopolies will successfully be able to face up to the competition posed by the new players, but it can be expected that the customer will gain from improved service.
- The new players will need to bring in innovative products as well as fresh ideas on marketing and distribution, in order to improve the low per capita insurance coverage. Good regulation will, of course, be essential.
- The Capital Issues (Control) Act, 1947, repealed, offices of the Controller of Capital Issues were abolished and the initial share pricing were decontrolled. SEBI, the capital market regulator was established in 1992.
- Foreign institutional investors (FIIs) were allowed to invest in Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through euro issues.

- The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading.

Private mutual funds permitted

- The Depositories Act had given a legal framework for the establishment of depositories to record ownership deals in book entry form. Dematerialization of stocks encouraged paperless trading. Companies were required to disclose all material facts and specific risk factors associated with their projects while making public issues.
- To reduce the cost of issue, underwriting by the issuer were made optional, subject to conditions. The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices was stopped and fresh guidelines were issued by SEBI.
- SEBI reconstituted governing boards of the stock exchanges, introduced capital adequacy norms for brokers, and made rules for making client or broker relationship more transparent which included separation of client and broker accounts.

Key Players in the Sector – Private and Public



5.7 Key Elements And Peculiarities

i. Market reporting

- Successful financial services organisations recognise that greater transparency and clear explanation of the rationale for business strategies will be critical in boosting market confidence and securing access to limited capital in the wake of the financial crisis.
- Smart firms are therefore looking beyond basic compliance to provide real insights into the appetite for risk, the priorities and assumptions governing risk management and how risk influences key business decisions.
- Forward-looking companies are also looking closely at how to influence and respond to planned changes in market reporting to ensure they reflect the realities of their business and provide more relevant and reliable information for analysts and investors.

ii. Operations

- Many financial services organisations have found that their attempts to cut costs and improve efficiency in the wake of the financial crisis have been far less successful than hoped and is already proving difficult to sustain. There is a particular risk that knee-jerk operational shake-ups could damage customer service or jettison the talent the business needs to capitalise on.
- Further improvements could be achieved through a more aggressive approach to product rationalisation, reducing needless management layers and identifying opportunities for integration and consolidation in areas. Streamlining and simplification can not only cut costs, but also strengthen management control and oversight, as well as support and secure operationally organic and external growth, whether domestically or internationally.
- With their wide view of value chains processes cost, risk and profitability, the finance and operations functions to jointly identify opportunities for savings, operational improvements and developing strong, realistic, and executable business cases.

iii. People

- Forward-looking financial services organisations recognises that a

different set of skills, smart deployment of talent and the realignment of compensation structures will be critical to their ability to adapt to the fundamentally different competitive and regulatory environment that is emerging from the financial crisis.

- As tough market conditions diminish the opportunities for short-term trading returns, successful firms will have to look at how to attract and nurture people with the mindset and ideas to develop lasting relationships, work within tougher risk and compliance demands and create value over the long-term.
- A particular challenge is how to reward people when compensation policies are facing a tighter rein.
- Ultimately, the commitment and behavior of the people within an organisation is critical in rebuilding the trust of consumers, markets and governments, without which investment, growth and profitability will not recover.

iv. Regulation

- The financial crisis has highlighted questions about the adequacy of the regulatory regimes governing financial services, which are being met with increasing demands and changes in the regulatory environment under which organisations operate. Leading Financial organisations should be able to use the changes in regulation as an opportunity to develop a systematic approach to governance, risk and capital management and use these capabilities to provide a more informed and assured approach to decision-making. Facing greater media and political scrutiny, they will also be able to balance the need to restore profitability with the expectations of being a responsible corporate citizen.

v. Restructuring

- The ability to measure current and prospective risk-adjusted returns will be critical in identifying what businesses to develop or divest and convey the rationale for restructuring strategies to analysts and investors.
- Restructuring will open up valuable opportunities for agile and strongly capitalised firms, who can step in to take advantage of divestment or market exit by weaker competitors. Firms need to

explore alternative and innovative financing options to support their growth strategies. This could include private equity funding, either in the form of capital injections or strategic partnerships.

vi. Risk

- In the face of an increasingly complex and uncertain commercial, regulatory and geopolitical environment, financial services organisations are looking to develop a more proactive, systematic and integrated approach to governance and risk management. However, governance, risk management and compliance are still primarily seen as a regulatory obligation rather than a value driver.
- Effective enterprise risk management can help to underpin sound governance and related compliance requirements by providing a comprehensive framework of internal controls and reporting procedures. The results are enhanced stakeholder confidence and sustainable value creation.

5.8 Role Of Information Technology

5.8.1 As Financial Services have become more complex, offering new products in more channels, the scrutiny and the need for data management oversight and consistency has greatly increased.

Among the key IT challenges facing the Financial Services industry today are:

- ▶ Preserving investments in old systems while leveraging new technologies to drive down transactions costs, expand and improve customer service.
- ▶ Integrating organisation-wide disparate systems to gain operational efficiencies.
- ▶ Substantially reducing time for deployment of new systems.
- ▶ Reducing IT costs and obtaining better ROIs for new investments in the long-term.

One hot issue that continues to pick up steam within the financial services industry (FSI) is that of Data Governance. Financial Institutions (FI) produce and consume extremely large volumes of data and rely on insights they gain from their data to run their business. In this point of view, one needs to understand as to why Data Governance will continue to play a significant role in the coming years across the Industry.

5.8.2 The need for assessment is required keeping the below factors as a focal point:

- ▶ Data Governance need to take a 'front seat' in the prioritisation of future projects.
- ▶ The process by which one manages the quality, consistency, usability, security, and availability of organisation's data.
- ▶ The fact that lack of transparency into risk and financial information may have substantially contributed to the sudden nature and speed with which the credit crunch impacted the world financial system.
- ▶ FI's information capabilities, including the ability to produce clear and concise reports that illustrate the financial health of an institution, are becoming ever more present and necessary.
- ▶ The current economic climate has presented the Financial Service Industry with the challenge of increased cost-cutting measures, which often cause Data Governance initiatives to be put on the back burner or eliminated altogether.
- ▶ Runaway costs and process inefficiencies caused by incorrect data. Data problems can be very expensive to fix because the root cause is often not adequately addressed.
- ▶ Missed revenue opportunities resulting from a lack of insight.
- ▶ Regulatory penalties or damaged reputations resulting from a lack of data transparency.
- ▶ A lack of user confidence and / or understanding of business data, which constrains value realization from other technology investments.
- ▶ Redundant databases and no clear system of record.
- ▶ No clear ownership or accountability for quality and consistency of data.
- ▶ No clear standards to measure quality of data resources.
- ▶ No method to measure data quality and the impact of poor data quality. Shadow finance and technology organisations often manually fix problems instead of addressing root causes.
- ▶ Clear policies, standards, and procedures that will be used across the organisation are critical.

- ▶ Data Governance is not solely a technology issue, nor should the initiative be owned by information technology. In fact, it is absolutely critical that ownership for Data Governance starts and ends, with the Business, with support from information technology.
- ▶ Requires a multidisciplinary approach, and through the exact roles and structures of the data owners may change from situation to situation, the final structure should be documented and communicated throughout the organisation.

5.9 Value-Addition Opportunities Through Internal Audit

Internal Audit in Financial Services Sector can include following areas:

Areas	Key Value-Addition Opportunities
• Risk Management	• Key risks identification and maintenance of risk registers.
• Regulatory Compliances	• Compliance to SEBI guidelines, Companies Act and Income Tax compliances.
• SOP Compliance	• Documented Systems and Processes related to Trade and Settlement, Treasury and Funds Management, Portfolio Management Services (Brokerage, Mutual funds, Asset Management Companies).
• Cost Control and Cost Reduction	• All major cost areas / functions.
• Information Technology	• IT Controls Effectiveness Review and identification of 'Gaps' in existing and desired IT controls system.
• Human Resources (HR)	• Implementation Review of the HR Policy.

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