

BANK AUDITS AND RISK MANAGEMENT IN TURKEY

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Abstract

Banks are of vital importance in economies, because their bankruptcy leads to losses for millions of small savers. As a result, banks are closely audited all around the world. The prerequisite for a healthy economic system is the use of internal and external auditing and risk management in banks. In this study, the developments of internal and external audits in banking have been summarised according to regulations in Turkey and significant risks have been discussed in terms of bank management decisions and risk management. Additionally, Basel regulations and capital adequacy have been analysed and the problems that affect the banking sector in Turkey have been summarised. The aim of our study is to determine the current situation and this study is based on a literature and regulation review.

Keywords: *Audit, Banking System, Internal Audit, Risk Management*

JEL Classification: M41, M42, M49

1. INTRODUCTION

Banks are of vital importance in economies, because their bankruptcy leads to losses for millions of small savers. As a result, banks are closely audited all around the world. A banking system has two essential functions: the transfer of funds and financial services. The banking system is established through confidence, such that a defect or crisis of confidence can interrupt the wealth transfer within economy, negatively affect the production and investment decisions by increasing the cost of capital and endanger savings of small savers. Therefore, the prerequisite for a healthy economic system is the use of internal and external auditing and risk management in banks. The reasons for the popularity of studies related to this sector include the importance of the banking sector in Turkey for the economy and the recent banking crisis. In this study, the developments of

internal and external audits in banking have been summarised according to regulations in Turkey, and significant risks have been discussed in terms of bank management decisions and risk management. Additionally, Basel regulations and capital adequacy have been analysed and the problems that affect the banking sector in Turkey have been summarised. The aim of our study is to determine the current situation of bank audit and this study is based on a literature and regulation review.

2. EXTERNAL AUDIT IN BANKS AND CURRENT SITUATION IN TURKEY

The Central Bank of the Republic of Turkey (CBRT), the Treasury, the Banking Regulation and Supervision Agency (BRSA), the Capital Market Board (CMB) and the Banks Association of Turkey (BAT) are authorised to audit and regulate the Turkish Financial System. The Treasury is authorised and liable to audit and regulate of leasing, factoring, forfeiting, assurance, finance companies and currency exchange offices The CMB also oversees the regulation of capital market instruments and institutions.

A defect or privative development that occurs in the banking system affects not only bank owners but also the economy and society more generally. For the banking system to remain healthy, banks need to be audited by different institutions than banks. In Turkey, the BRSA, the Saving Deposit Insurance Fund (SDIF) , the BAT, the CBRT and independent external audit firms are the institutions that perform external audits of banks.

2.1. Banking Regulation and Supervision Agency

According to the 43rd article of Banking Law 5411, the BRSA is authorised to specify, analyse, monitor, measure and evaluate the balance between assets, receivables, equities, liabilities, revenues, expenditures and all other factors affecting banks' financial structure and the risks encountered. Setting limitations and standard ratios as well. To fulfil these tasks, the BRSA creates regulations and takes necessary precautions.

The BRSA was established to protect the rights and interest of small savers, to ensure confidence and stability in the financial markets and to ensure the affectiveness of the credit system. Furthermore, the BRSA can make the decision to seize banks, take over banks and alienate them to SDIF.

2.2 Saving Deposit Insurance Fund

According to the 111th article of Banking Law 5411, the SDIF has been established to insure deposit to protect the rights and interest of depositors, as well as to ensure confidence and stability in financial markets, insure deposit and contribution funds, manage the banks with Fund and strengthen and restructure their financial standing. It also transfers, merges, sells or liquidates such banks; executes and concludes the follow-up and collection transactions for the receivables of the Fund, manages the Fund's assets and resources and performs other duties assigned by law.

According to 106th article, if the operating permission of a bank is revoked, its management and supervision shall be transferred to the Fund.

2.3 The Banks Association of Turkey

The BAT was established in 1958 under the framework of banking law. Banks that operate in Turkey are obligated to become members of the BAT, which is a professional organisation with the status of a public legal entity.

The aim of the Association is to preserve the rights and the benefits of the banks, to carry out the studies on the growth of the banking sector, that analyse factor facilitating, robust functioning and the development of the banking profession, to strengthen competition power, to make decisions that will block unfair competition, and to implement and demand the implementation of these decisions, in line with the regulations, principles and rules of banking. (The Banks Association of Turkey)

The Association sets the ethical professional principles and standards upon receiving the approval of the BRSA, as well as monitoring the application of decisions made by the BRSA. (5411 Banking Law: art. 80) Additionally, the Association imposes administrative fines on members who do not fully comply in a timely manner with the decisions and measures made by associations. (5411 Banking Law: art. 81)

2.4 The Central Bank of the Republic of Turkey

The power of the CBRT was established Law in 1211, article 4. According to this article, the Bank is authorised to make regulations pertaining to duties and powers entrusted to it by the law and to supervise compliance with these regulations.

The CBRT is authorised to issue banknotes, to control the volume of currency issued and the volume of credit and, as the lender of the last resort, to extend credit to the banks. The CBRT must be independent to implement monetary policy. The CBRT is empowered to specify and supervise the gold and currency rates that are alienated to the CBRT by banks, as well as the amount of gold and currency that can be retained by banks. In addition it can manage the country's foreign exchange position and the factors related to export and import. It can also request necessary information from banks.

2.5 Independent Audit Firms

The working principles of independent audit firms have been set by the BRSA considering the opinion of the Union of Chambers of Certified Public Accountants of Turkey, the Turkish Accounting Standards Board, the CBRT and the associations of institutions. If during their audits, independent audit firms detect any matter that may endanger the existence of a bank or evidence demonstrating that its managers have severely violated the law or the articles of association, the independent audit firms shall notify the BRSA thereof. (5411 Banking Law: art. 33)

According to Law 1211 article 43, banks submit their balance sheets, income statements and audit reports approved by independent audit firms to the CBRT. The aim of having the reports prepared by independent audit firms is to determine whether the banks' financial reports have been prepared in accordance with generally accepted accounting principles and to ensure the reliability of these reports in internal and external financial circles. Therefore these reports have different qualifications than the reports prepared by banks auditors. (Delikanlı, 1998: 6)

During the 2001 crisis, 19 banks transferred to the SDIF due to the erosion of their equity. This situation indicated a defect in the banking sector with regard to transparency. The BRSA produced a regulation related improving the banking sector and ensuring the transparency of banks on February, 01,2002 in accordance with the law amended to improve banks' equity. With this regulation independent audit procedures were rearranged, the banks' balance sheets were cleared from window dressing, financial statements of 2001 period were audited twice by another independent auditing firm. (Özyürek,2002)

3. INTERNAL AUDIT OF BANKS AND THE SITUATION IN TURKEY

An internal audit is a kind of audit that is useful in helping companies to consider their overall financial and nonfinancial operations. It is also an important tool for controlling the management of a firm. The aim of an internal audit is to analyse whether or not the company's assets are being properly safeguarded and whether the operations are being carried out in compliance with the policies in place. An additional goal of an internal audit is to measure the effectiveness of company controls and otherwise evaluate these controls. In this regard, an internal audit is an important instrument for controlling management. An internal audit also helps a firm to attain organisational objectives by introducing systematic and disciplined approach to evaluating and improving the effectiveness of the risk management, control and governance processes. (The Institute Of Internal Auditors)

According to the definition approved by the Institute of Internal Auditors (IIA) in July 1999, an internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations.(The Institute Of Internal Auditors, 2008: p.5) The effectiveness of banks' internal audit systems must be monitored continuously. (Basle Committee on Banking Supervision,1998: p.10)

Established in 1942, the IIA has played an important role in shaping the concept of the modern internal audit. The International Internal Audit Standards were developed by the IIA and adopted by professional organisations in various countries. These standards, are a guide to internal audits both for institutions and for auditors. The standards consist of what are called attribute standards, performance standards and implementation standards. While the attributes and performance standards are applied to all internal audit services, the implementation standards are applied to specific types of engagements like assurance and consulting activities.

The importance of the internal audit terms has increased notably since 2000, after some institutional and financial scandals took place. Since then, in large, developed markets like the

United States, the importance of internal audits and auditors has increased. SOX¹, has improved the internal auditors perceived authority according to American public opinion. These scandals and SOX have affected other western countries and Turkey as well. However, the term internal audit is not a new term in our country. The Inspection Board has a history of almost fifty years. (<http://www.denetimevreni.gen.tr>)

The internal auditing of banks is carried out by the internal control unit, the audit (inspection) unit and the risk management group. The organisation and regulation of the internal control and audit units need to be independent of each other, because they are responsible to the bank's board of directors and top management, respectively.

3.1. Internal Control Unit

Internal control is the financial control of plans related to the protection of assets and effective management of current operations. According to a more extensive definition, internal control include controls related to management and accounting. The term "internal control" is parallel to control terms that have to do with evaluating and revising companies' operations and denoting the systematic structure of the controls necessary for the company. (Çatıkkaş, 2005: p.7) In recent years, there has been a great deal of significant problems in the banking sector caused by the deficiencies of effective internal control systems. The deficiencies of internal control systems have led to both financial losses and a loss of positive public image for some world-famous banks. While the internal control system was once intended to prevent error and fraud, in the present day it seeks to decrease all risks that banks encounter. The internal control system plays an important role in helping banks to attain their objectives and keep their financial structure healthy.

According to Banking Law 5411, which became affective on November, 01, 2005, banks have an obligation to establish and operate effective internal control and risk management, as well as an appropriate internal audit system. According to the 29th article of this law, the banks are obliged to establish and operate adequate and efficient internal control, risk management and internal audit systems that are in harmony with the scope and structure of their activities, that can respond to changing conditions and that cover all of their branches and undertakings subject to consolidation to monitor and control the risks that they encounter. Additionally according to the 30th article, internal control activities shall be carried out by the internal control department and the internal control personnel under the board of directors. The internal control unit and the duties and the powers of these unit's personnel are regulated based on the Regulations on Internal Systems of Banks issued by BRSA on November 01, 2006. According to these regulations, internal control systems, internal control operations and methods for carrying out these operations shall be presented by the internal control unit and top managements of related units.

¹ SOX: The Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law issued to protect investors.

3.2. Audit Unit

Inspection units control whether the activities of the bank are effectively planned and whether these activities are conducted in accordance with the law, regulations and bank strategies, policies, principles and goals: they evaluate and ensure the efficiency and effectiveness of internal control and risk management systems and, periodically audit all domestic and foreign units, branches and affiliates.

3.3. Risk Management Unit

Risk is an event or situation that will affect an organisation's ability to attain its objectives. Risk management is a systematic management style that consists of the specification and analysis of risks that an organisation encounter, the assessment of the potential impacts of risks to the organisation and decisions regarding what action can be taken to eliminate and reduce risk with internal control technicals. (Fikirkoca, 2003: p.25)

According to the Regulation on Internal System of Banks, the purpose of the risk management system is the identification, measurement, monitoring and control of risks through policies, implementation procedures and limits that are formed to maintain control and, if necessary, to change the risk/return structure of the bank's future cash flow and accordingly, the quality and the extent of its activities. (Regulation on Banks' Internal Systems, 2006: art.35)

Based on this regulation, banks are obliged to determine limits to fundamental risk results associated with their operations and these limits have to be approved by the board of directors. Risk limits are set by managers of related operational units, senior individuals in the risk management unit and the bank's general manager.

A risk management system must be independent within the organisational structure. The duty of monitoring and assessing of risks is carried out by the risk management group which operates under the risk management unit. In the process of the identification, monitoring and evaluation of risks the internal control and risk management groups must work together according to the principle and procedures indicated by the board of directors. If necessary, inspectors will evaluate speciality risks, i.e. legal and operational risks.

4. RISKS IN BANKING SECTOR

In banks, funds obtained from various sources are allocated between investment alternatives. The criteria of risk allocation are the risk ratings and return amounts of every alternative. Existing risks within the banking sector can be grouped as internal and external risks. While internal risks result from the structure of the banking sector, external risks result from the events that occur outside of the sector. The existing risks of the banking sector can be listed as operational risk, country risk, management risk, credit risk, interest risk, market risk, currency risk, liquidity risk and undercapitalisation risk. (Dilawar: <http://www.scribd.com/doc/11760698/Risk-Management-for-Banking-Sector>)

In asset management, banks must specify existing risk precisely, and assets must be allocated according to these specifications. Operational risk arises from a lack of effective internal controls and auditing procedures. Operational risk is the risk of failure of bank procedures whether from external causes or as a result of error or fraud within the institution.

As is known, there is a close relationship between risk and return. When risk increases, returns increase as well. Banks keep cash and quick assets in their portfolios to reduce liquidity risk. Consequently, banks' profitability is affected negatively. Moreover, if an interest rate is high, opportunity cost will be high as well, because of the cash kept in banks' portfolios to reduce liquidity risk. If a bank does not monitor or estimate the market developments appropriately, it encounters liquidity risk. Then, it can be compelled to take on a loan that entails high costs or to loss-sell its assets to fulfil its obligation. If other precautions are not taken, a formal authority can close the bank or can merge the bank with another institution.

5. BASEL REGULATIONS AND RISK MANAGEMENT IN BANKS

The Basel Committee was established in 1974 by 10 developed countries' central bank governors. The Committee meets regularly four times a year. In 1998, the Committee issued the Basel I Capital Standards. According to these standards, operations criteria for banks and capital adequacy rates that make the ratio between bank capital and the sum of risk-weighted bank assets equal to or greater than 8% have been determined. The Basel I Standards made a concession to OECD countries regarding capital adequacy and concentrated on credit risk only. In 1996, the Basel I Standards were amended and market risk were included. The amended standards came into effect in 1998. However, due to deficiencies related to credit risk measurement, rapid change and the development of financial markets and the sophistication of transactions, the Basel I Standards' effectiveness was reduced in that interval of time. (Beşinci, 2006: p.2) Consequently the Committee started to work on setting up new standards. The Basel II Standards were issued in June 2004.

5.1. Capital Adequacy

Capital adequacy has to do with the minimum capital ratio of a bank according to the risks that the bank has encountered. When a bank is suffering losses because of the credit and market risk due to its assets, the bank's capital provides security indicating the bank's ability to pay its depositors. The bank's capital must be parallel to its encountered risks. Thus the financial structure of a bank can become strong and the bank can provide the required security to its depositors. According to capital adequacy requirements, core capital consists of paid-up capital, legal reserves, optional reserves, reserves against probable losses, net profit for the period and previous years' profit. Any losses for those periods are deducted from the capital base. The sum of general provisions for loans: the bank's fixed assets revaluation fund: provisions for the revaluation of the fixed assets of investments in subsidiaries, affiliates and others: subordinated debt and provisions held for probable losses and securities value increases is defined as supplementary capital. (Thompson, 2002: p.2) Capital adequacy regulations determine the capital adequacy ratio and the shares of core and supplementary capital that make up total capital. When the share of core capital in the capital adequacy ratio increases, bank owners' potential losses in the event of bankruptcy increase. This

limits the tendency of bank management to take risk the purpose of achieving high returns. Basel I concentrated on credit risk only, but Basel II includes operational risk as well. According to Basel I, banks must consider credit and market risk when they determine adequate capital. However, according to Basel II, banks must consider operational risk as well. Basel II defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people or systems based on external events. The Basel II regulations include standardised methods that are predicated on similar arithmetic and statistical/arithmetical methods related to credit, market and operational risk.

The main benefits expected from Basel II can be listed as follows (10 Soruda Yeni Basel Sermaye Uzlaşısı, 2005):

- An increase in the banks' risk management effectiveness,
- An increase in the effectiveness of banks' intermediation functions
- The banks' capital level will become parallel to encountered risk
- Market discipline will increase through the information divulged to the public
- The corporate governance structure of banks' customer companies will improve

Even though the Basel II regulations have not been applied to the Turkish banking sector yet, the Turkish banking sector has made significant progress towards their application. Additionally, studies on the application of Basel II have been carried out by the BRSA with the collaboration of banks and other interested parties. The BRSA does not consider the Basel II as just an ordinary regulation or calculation instrument indeed, it is seen as a core element of risk management strategy. (10 Soruda Yeni Basel Sermaye Uzlaşısı, 2005)

5.2. Internal Audit System for Risk Management

Risk management is the process by which managers satisfy these needs by identifying key risks: obtaining consistent, understandable, operational risk measures: choosing which risk to reduce and which to increase and by what means: and establishing procedures to monitor the resulting risk position. (Pyle, 1997: p.2) When the risks are assessed, all risks that exist for banks must be taken into consideration. To carry out the risk assessment function effectively, banks' top managers must assess risk regularly and execute regulatory measures according to varying conditions. When the problems that lead banks to suffer losses are analysed, the cause of these problems is determined to be a deficiency of the internal audit system. The internal audit system ensures the detection of problems that might cause losses.

In 1998, Risk Management and Modelling Group, one of seven working groups of the Policy Development Group, the subcommittee of the Basel Committee on Banking Supervision, formed principles regarding effective supervision and audits in banking. According to these principles,

banks' boards of directors are the last authority for the establishment and operation of an effective internal audit system. (Banking Regulation and Supervision Agency) The bank personnel at any level that are responsible for internal audits produce information that contributes directly or indirectly to internal audits. An effective internal audit system necessitates the identification and evaluation of material risks that can prevent the attainment of the bank's objectives. When the risks are assessed, all risks that exist for banks must be taken into consideration. In order for the risk assessment function to be carried out effectively, banks' top managers must assess risks regularly and take regulatory measures according to varying conditions.

Independent and qualified inspector must actively and comprehensively control the internal audit system. These controls are an important part of the internal audit system and must be directly reported on to the board of directors, inspection board and top management.

6. THE PROBLEMS OF BANKING SECTOR IN TURKEY

Today, the quality of the Turkish banking sector has risen a good deal in terms of both financial and institutional structure. However, it is a well known fact that there are some problems that are negatively affecting the development of the Turkish banking sector. Banks are institutions that have to operate with high risk because of the nature of banking. These risks can exist in any country and any period because risks are the part and parcel of financial markets. What is most important is the accurate identification and management of risks. Banks' top managers must attain adequate and accurate knowledge and must establish systems required for risk management. If this occurs, the affect of risk and crisis remain at a minimum. (Yıldırım: <http://www.econturk.org/Turkiyeekonomisi/oguzbanka.doc>)

The main problems of the banking sector can be listed as; high cost of financial resources, problems related to inflation and stabilisation programs, problems of equity, problems related to rapid technological progress, low resource cycle of commercial banks, problems associated with banks' short position, inadequate audit and oversight procedures and the problems resulting from group banking. Because of these problems, an effective risk management system is critical for banks.

In an inflationist period, the banking sector encounters a lot of problems. During such a period, banks' earnings appear to increase nominally. However, they decrease in real terms, and the real amount of equity decreases as well. In an inflationist period, the cost of banks' financial resources and their operating costs increase, while investment alternatives that incur low risk decrease as a result of the increased rate of credit interest. Furthermore, during an inflationist period, problematic credit issues increase, and this situation endangers banks' receivables. The most important fund source of commercial banks is its deposits. Despite other funding developments that may arise, deposits remain important, and there continues to be a strong relationship between deposit rates and inflation rates. In Turkey, entrance into the banking sector was simplified in the 1980s; however, in recent years, it has become complicated by the public authority. Attempts to overcome this constraint have made the number of investment bank increase in recent years. Leaving the sector is not accepted as normal because of the negative affect of such a move on publicity. The difficulty of entrance into and exit from the sector is an important factor that

disturbs the principles of perfect competition market. This situation reduces the sensitivity to risk factors and leads to unfair competition. Another significant problem in the Turkish banking sector is insufficient equity. Considering 1980s, the number of banks increased, but some domestic and foreign banks' equity is insufficient. The fund sources of these banks are the interbank or international financial markets. Therefore, these banks do not have the power to compete in either national or international markets. If a bank's equity is strong, the bank's ability to resist market risk will be strong as well. The Turkish banking sector is in the midst of harmonising with rapid technological progress and the world financial markets as they start provide financial services such as leasing, factoring, forfeiting and risk management tools such as swap, forward, futures, options and internet banking services. However, when these financial techniques are applied, some problems arise in terms of internal audits and risk management because of the deficiency of basic legislative facilities and economic instability at play. In our country, commercial banks cannot even lend out half of their deposits as credits, and if they do so, the costs of these credits become too high. Top managements determines aggressive targets for branch employees and these employees who are concerned about achieving specified targets, make loans to customers with low credit worthiness. Except for during the 1994 depression, banks made significant profits in the 1990s, because of low foreign exchange rates and high interest rates. During this period, a significant portion of foreign exchange deposits were given as a loans against local currency. Between 2000 and 2002, a currency peg was applied in Turkey in accordance with the program to fight against inflation. As a result, getting into debt from foreign markets became attractive. Banks that did this lent their resources as loans in domestic markets and through domestic government bonds. Consequently, the short position and exchange rate risk of the banks increased. Many banks that were in the short position became immersed in high interest rate debt in the 2000 crisis, and banks had to buy foreign exchange with high exchange rates because of the application of a floating exchange rate during February 2001 crisis. Consequently, the banks were exposed to high costs.

One of the main problems in the Turkish banking sector is a lack of effective audit procedures and oversight in the sector. The lack of an affective system to audit and regulate the sector uncovering deficiencies of the banks' internal audit systems, has caused serious problems. To provide effective audits in the banking sector, the number of auditors must be sufficient and they must have required technical knowledge, the necessary database must also be available, political barriers that can make auditing ineffective must be broken down and penalties to deter fraud must be employed.

7. CONCLUSION

If in a country, politics becomes about violence, deterrence, impatience, and ideological discrimination and if the politics affects judicial bodies, the army, employment and the university the situation becomes extremely negative. At some points, this has been Turkey's situation. In our country, in spite of capital market liberalisation, foreign capital inflow has been oriented at direct investment and has been limited in any case. In addition, the limited capital that has flowed into our country has been oriented toward short-term portfolio investment. Moreover, nearly all of the private banks in Turkey are under the control of particular individuals, groups or holdings. Some groups have two or more banks. As a result, banks have departed from real banking operations and begun to make loans only to the associated companies and affiliates.

Parallel to international regulations, Banking Law No. 5411, which went into effect in 2005 and the “Regulation on Internal Systems of Banks” which became affective in 2006 obliges banks to have an internal auditing system and necessitates continuous audits of companies together with periodic inspection. Using professional audits, the deficiencies of banks can be determined and appropriately addressed. In this way, banks can achieve pecuniary savings and generate earnings. The most important adequacy criterion for banks is banking risk measurement and the effective management of this risk within the context of risk-oriented audits.

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