Building on belief

Revitalizing internal control systems to better manage lending risk

Abstract

Effective internal control systems are pivotal for efficient risk management and the smooth functioning of banks. Financial institutions' broader risk and governance framework is underpinned by the three lines of defense model where initial risk accountability and ownership lie with the lines of business (LoB), which act as the first line of defense. Given lending is a complex and highly regulated LoB, both stakeholders and regulators demand greater first-line process accountability and transparency. Embedding adequate internal controls in operations, risk, and compliance processes can help banks address these needs and maintain proof of compliance. Likewise, banks must ensure that these controls are optimized and automated to maximize coverage and minimize business interruptions, which will help address process inadequacies and efficiently manage unexpected events, thereby enabling superior risk management. This white paper discusses the importance of embedding and automating internal control systems across banks' lending functions to strengthen risk management.

Managing evolving dynamics in lending

The onslaught of technological innovations, the rise of digital, and pressure on profit margins have forced banks to undertake massive digital transformation journeys and aggressively seek newer business models, increasing business complexity and risk levels. This exposes banks to unknown risks due to the higher degree of risk inherent to evolving digital models and a greater probability of risk functions not being in tandem with the pace and scale of transformation. As a result, regulators and investors demand assurance of banks' financial soundness and security.

The surge in risk exposure and vulnerability makes it critical for organizations to identify and respond to emerging business and regulatory risk events promptly and effectively. Systematic control measures built across the lending lifecycle based on the risk appetite can help banks manage evolving threats and build resilience. Internal control measures should be an effective blend of the directive, preventive, and detective activities, which must be integrated across systems, policies, procedures, and processes for safeguarding banks' assets. While directive controls lay down guidance on process adherence and acceptable norms, preventive controls enable proactive protection against non-compliance and fraudulent activities. Detective controls facilitate the quick identification of exceptions, non-compliant and fraudulent activities in the process. Apart from limiting risks, controls can help measure performance effectively, make judicious business decisions, and evaluate processes for loopholes.

Why embedding lending controls is important?

The lending function includes product development, sales, origination, disbursement, credit maintenance, and supervision, with responsibilities distributed across multiple teams. Gaps in the execution of policies and procedures and failure to incorporate them in daily operations can render the teams ineffective and may foil opportunities for process improvement. Adhering with control parameters for new product and service delivery and routine functions like loan underwriting and valuations helps banks avoid errors, deter fraud, and receive alerts on potential problems or compliance breaches. Any weaknesses here can impact process assurance levels and result in losses due to bad loans or errors. However, when embedded in the business process and executed properly, a well-designed system of internal controls can reduce the possibility of errors and irregularities and assist in their timely detection. Hence, effective internal control systems that are periodically monitored and enhanced are instrumental in detecting errors caused by process or system anomalies and human errors due to personal distraction, negligence, impulsive decisions, or deliberate non-compliance with policies.

Limiting risk through effective controls: What banks must do

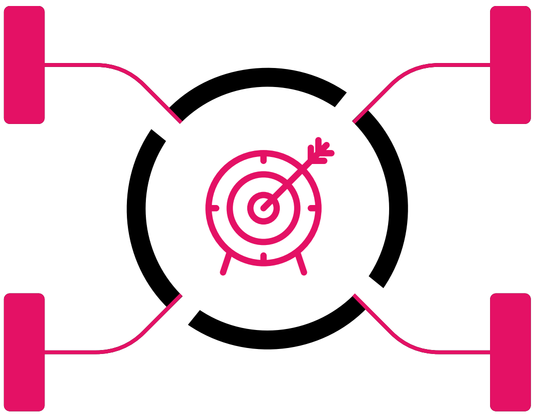
Clearly, effective internal controls are instrumental in safeguarding assets, protecting company data, minimizing errors, achieving regulatory compliance, preventing fraud, and enabling banks to securely execute fiduciary responsibilities. Proactive calculation and assessment of risks ensure stronger oversight that allows banks to survive stress tests with a lower probability of failure. Banks must therefore strengthen their first line of defense by embedding control measures across the lending lifecycle and systems and processes (see Figure 1).

Embed and automate controls

- Reduce manual execution risk by embedding and automating controls across the process lifecycle
- Enhance process quality and efficacy

Rationalize and optimize internal controls

- Align business and risk objectives for a balanced approach
- Avert concentration of control parameters in low-risk areas and ensure adequacy in higher risk areas



Increase engagement through training

- Improve first line accountability and involvement through proper training
- Engage through effective campaigns and gamified training programs

Perform continuous evaluation, enhancement, and reporting

- Ensure proactive evaluation using data visualization tools, live dashboards, and AI-enabled insights
- Enhance protections envisioned by management

Figure 1: Effective lending control measures

Embed and automate controls

The majority of controls in lending processes tend to be manual and are subject to execution risk. Daily operations require manual tasks like filling checklists, ensuring loan approvals comply with guidelines, seeking approvals on exceptions, and more. This makes the credit function error-prone, with a high probability of a few exceptions going unnoticed or subpar execution of some tasks. However, automating controls and embedding them into the process lifecycle could help manage key business metrics and processes more efficiently while retaining the credit risk within prescribed limits. For example, advance system alerts on expiring home insurance policies can prevent insurance gaps, or automation of disclosure generation and distribution can prevent possible process or compliance mishaps.

Various controls can be set up in advance by automating manual and repetitive tasks and embedding thresholds and guidelines. Automating controls can serve as a mitigation strategy for preventing risk events and improving the process quality and efficacy. However, banks must ensure that the controls are designed accurately as automating an ineffective or incorrect control can increase the risk manifold.

Rationalize and optimize internal controls

A key objective of internal controls is to ensure the effectiveness and efficiency of business functions. Controls, when too stringent, can invite workarounds or too many overriding requests, making them less credible and wasting managers' time on approving these exceptions. Thus, it is imperative to design these controls based on the risk appetite of the LoBs and their key risk and performance metrics. It is best to follow a systematic and balanced approach where adequate controls are embedded in high-risk areas and the concentration of control parameters in low-risk areas is avoided. For example, too many controls in loan underwriting could prevent straight-through processing (STP) of applications, but very few might lead to an increased risk of default. Hence, a balance between goals and risk must be maintained, as misalignment of business and risk objectives can slow down a process.

Banks must classify their inventory of controls by defining and describing each control, stipulating what is controlled (key risk indicators), determining where and how frequently controls are applied, and evaluating their efficacy in managing risk and alignment with business goals. Insights from this exercise will help banks weigh the risk against profit goals, and re-balance and re-design the controls to eliminate deficiencies and redundancies.

Increase engagement through training

The first line of defense optimally manages risk and other key performance indicators (KPIs) such as cost, effort, and profit in a bank's business functions. However, given rising regulatory pressure to increase the first line accountability, banks must initiate measures to enhance risk forecasting and mitigation. A mature and well-trained first line of defense equips banks with the capability to maintain control data quality and ensure proper execution of the control parameters. Conducting continuous training programs on process risk and management, leveraging gamification techniques and running communication campaigns, play a critical role in driving engagement, spreading awareness about the value of controls, encouraging better first-line ownership, and ensuring robust monitoring.

Perform continuous evaluation, enhancement, and reporting

Typically, controls are perceived as a regulatory activity or an aftereffect of a risk event but seldom as a value-oriented act. Even though internal controls can help banks draw valuable insights on the functioning of their business processes, banks place limited emphasis on the maintenance and enhancement of these controls. This negligence can cost banks and financial institutions dearly.

The relevant controls and rules of the lending systems must be updated to align with changing regulatory and business needs. Banks must periodically and proactively evaluate controls (new and old) for adequacy and efficacy. And here’s where intelligent technologies come to the rescue. Banks can use artificial intelligence (AI)-backed intelligent data extraction tools to detect discrepancies across data and documents for reconciliation-based controls; for instance, to eliminate inconsistencies between billing invoice data and actual payment receipts. AI and analytics can provide early warning signals and help identify risk in a process, which, in turn, can help banks anticipate and design necessary preventive controls. Additionally, unsupervised machine learning (ML)-based root cause analysis tools can expose hidden functional issues and provide recommendations to prevent future errors. For instance, to improve lending KPIs like ’first time right applications’, banks must analyze loan applications originating from various sources like branches, loan officers, or brokers to identify the sources from where maximum applications are getting rejected. This will enable the bank to identify the root cause for rejection and route them for review rather than STP workflow.

To ensure that the internal control system continues to provide the protections envisioned by the management, the effectiveness of controls must be continuously monitored and tested. Data visualization tools and live dashboards can be used to monitor performance, deviations, and related key risks or performance indicators to discover opportunities for enhancements.

Take charge of lending risk and performance

Given the magnitude and velocity of change that disruptive technologies and digital business models bring, banks must continue to innovate to remain competitive. This will necessitate aggressively seeking opportunities for innovation within the increasingly changing risk landscape and require financial institutions to proactively identify emerging risk events and respond to them quickly and effectively. To accomplish this, establishing robust internal controls for each LOB is key, and banks that act swiftly will successfully create an environment equipped to achieve risk and business goals, stealing a march over their peers.

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