

# The Impact of the Internal Audit in Reducing Credit Risk in Commercial Banks in Kosovo

*Shqipdona Hashani Siqani*

PhdC at University of Prishtina,  
Assistant Professor at Colleg “Globus”, Prishtina, Kosovo

*Edona Sekiraca*

PhdC at University of Prishtina, Head of Balance of Payment Statistics  
Division, Statistics Department, Central Bank, Kosovo

doi: 10.19044/esj.2016.v12n4p268 [URL:http://dx.doi.org/10.19044/esj.2016.v12n4p268](http://dx.doi.org/10.19044/esj.2016.v12n4p268)

---

## Abstract

Credit risk represents the vast majority of the risk in the context of estimating the capacity of the transfer of risk from commercial banks. Any commercial bank operating, in Kosovo, must have a system for managing credit risk. An important and essential process, such as the management of the credit risk, cannot be carried out without the aid of internal audit. From the survey results, it was concluded that the process of auditing the banks recommended the implementation of policies for managing credit risk of the respective commercial bank's policy. This also include the policy of credit risk management of the Central Bank of the Republic of Kosovo, implementation of procedures, regulations and rules for credit exposure, loan portfolio diversification, training of staff of the credit risk involved in completing the loan files, etc.

---

**Keywords:** Audit, Credit risk, Commercial banks, loan, Kosovo, loan

## Introduction

The main activity of commercial banks in Kosovo is lending to private clients and small and medium enterprises. Based on this activity, the most evident risk that commercial banks in Kosovo face is that the borrower might not be able to fulfill the obligations of the contractual agreement fully or partly. Considering this issue, the credit risk constitutes the most significant risk. However, this is in the context of calculating the capacity of the transfer of risk from commercial banks. Due to the nature of the bank, bank loans are the largest source of credit risk. Therefore, management and credit risk reduction has gained special importance in the framework of achieving a successful performance in a commercial bank.

Risk management has evolved to become a risk governance system. This is due to the dynamic environment of the financial system. Furthermore, this process today has integrated directors, managers, internal auditors, and other employees that operate under policies and procedures which were adopted by this governance. Internal audit of the banks is very important for a safe and sound functioning, particularly for credit risk management. Therefore, the aim of this research is to reveal the role of internal audit in managing the credit risk in commercial banks in Kosovo.

Any commercial bank operating, in Kosovo, must have a system for managing credit risk. Therefore, this must include policies, procedures, rules and structure which are convenient to the nature, scope, and complexity of their activities. In order to have an effective policies of credit risk management, it must be communicated in the proper time, be reviewed regularly, and should be applied at all levels of the bank with the appropriate procedures.

An important process is the fact that credit risk management cannot be carried out without the aid of internal auditors. In such cases, internal audit is indispensable. This is because it provides alternatives which contribute in solving problems. Moreover, it aids the institution in achieving its objectives. Additionally, the planned audit recommendations foster improvement as well as further development.

The challenge of internal audit is to ensure that banks have a full practice in the risk management model, where is included the governance of the institution, policies, procedures, and documentation. This is because the environment must be even more cautious about credit risk management. The focus of internal audit should not only be restricted in scrutinizing and controlling their work, but also in providing efficacy and safety in the framework of managing the credit risk.

### **Literature Review**

Banks are exposed to credit risk from loan activities or in cases where bank acts as an intermediary on behalf of customers or third parties or when the bank issues guarantees. Credit risk represents the risk when a borrower is not able to pay all amounts of debt on time based on contractual agreement. Subsequently, bank structures the level of risk. It undertakes by setting limits on the values of the risk it takes toward a borrower, industry, or a geographical area. These types of risk are monitored on a permanent basis and reviewed every month or more frequently. The limits of credit risk for borrowers were approved by the management of the relevant bank.

Credit risk is the risk of financial loss of a bank if a customer or counterpart of a financial instrument fails to fulfill its contractual obligations. This appears mainly on loans and the advances of the bank to its customers

and other banks, as well as to investments in securities. With the purpose of reporting credit risk, the bank deals with all the elements of credit risk exposure (such as the risk of impairment to be liable, the risk at the state level or at the sector level).

Credit risk exposure is managed through regular analysis of the ability of borrowers and potential borrowers to perform the obligations in terms of payment of interest and principal, and by changing these limits when needed. Credit risk exposure is also managed by taking mortgages and corporate and personal guarantees.

Internal audit identifies, analyzes, assesses, and documents the different types of information, which enable the achievement of the bank's objectives. The audit makes this by using analytical methods, which enable him to examine and compare the relationship between financial and operational data. Therefore, the information to be evaluated must be adequate, relevant, and useful in order to provide a solid foundation for the findings and recommendations. During the execution, the working documents serve to support the findings and recommendations.

An audit report prepared by the auditors is a summary of descriptions of the audit work performed, relevant and reliable collection of evidence, problems identified, and the corrective actions that management should perform in making people and systems to work correctly, effective, and in legal ways. This demonstrates the client's authority to audit or an audit that occurred as a result of the need for the investigation to functionally independent auditor. However, the management of the organization may need to make changes to improve the way work is done. So, the main purpose of the audit is to prepare a good and professional report with findings from the audit process and the implementation of the contents of this report by the management and the other people involved<sup>67</sup>.

### **The System of Credit Risk Management**

The risk is already present in almost all the decisions that a business makes. Identification and risk assessment helps us to understand if we can cope with it. Thus, this shows the difference between the reward and the failure. Credit risk represents the possibility that a debtor is not willing to pay the interest and principal in time or not pay at all, under conditions specified in the loan agreement.

In a commercial bank, credit risk manifests in negative equity, income, problems in cash flows, no liquidity, no stability, economic loss limitations in the fulfillment of objectives, restrictions in doing business, and the possibility of expanding to that bank. For most banks, loans are the

---

<sup>67</sup>Reserve Bank of Malawi “*Risk Management Guidelines For Banking and Institution*”

largest source of risk. Hence, they are still considered as the main cause of the bank failure.

Consequently, credit risk management is the core of every bank. Therefore, we should give considerable importance to improve skills in terms of Risk identification, Risk measurement,

Risk monitoring, and Risk controlling.<sup>68</sup>

So, credit risk is considered low when it is understandable, measurable, controlled, and when the bank has the capacity to cover the negative results. However, its nature cannot be predicted with absolute certainty. Managed credit risk will bring benefits not only to banks but also to the bank's clients.

Common sources of risk in banks occur due to competition, technology, customers, economic factors, regulations, work processes, procedures, and adequacy of information in decision making. Banks must have a system for managing credit risk, which must include policies, procedures, rules and structure, and appropriateness to the nature, scope, and complexity of their activities.

Banks should develop strategies and policies to manage credit risk continuously. On a timely basis, they should make an assessment of the quality of loans and other assets, including determining the adequacy of the reserve for losses related to this risk. Banks should create an appropriate organizational structure for managing credit risk. Thus, they should clearly define the powers and responsibilities of governing bodies.

The staff of the department of credit risk management must have knowledge about the types of risk to which the bank is exposed. Once the risk is identified properly, policies consistent with the objectives and core mission of the bank and its procedures should provide detailed guidance on the implementation of extensive strategies of business. This generally includes restrictions designed to protect the institution that are reckless or have excess risks. Management is responsible for implementing these policies and the necessary control to limit the relevant risks<sup>69</sup>.

Banks should conduct stress test which will evaluate, in an appropriate way and in ongoing basis, their exposure to credit risk. Thus, this can be achieved by taking into account possible changes in the future, risk factors that affect the quality of the loan portfolio, and the financial situation of the bank, as it affects the net profit and capital adequacy ratios.

Directors and management must be qualified for the formulation of strategic and operational plans, high quality personnel with appropriate

---

<sup>68</sup>Reserve Bank of Malawi "Risk Management Guidelines For Banking and Institution"

<sup>69</sup>Banka Qendrore e Kosovës, "RregullorjapërMenaxhimin e RrezikutKreditor"

training and skills and personal character, a comprehensive system of risk management, and an adequate access to information.

In setting credit limits, they must have clear financial strength, economic conditions, and the willingness of the bank. Therefore, credit limits were imposed to avoid concentration risk for products, activities, specific industries, economic sectors, and geographic regions.

Credit limits should be reviewed regularly taking sufficient information to enable a full assessment of the risk profile of borrowers. These assessment include credit purpose and the source of repayment, integrity and reputation of the borrower or counterparty, the history of repayment borrowers, the capacity to repay current loan given, legal capacity of the borrower or counterparty to assume responsibility, the terms and conditions of the loan, and the relevance and applicability of collateral or guarantees<sup>70</sup>. Once we have reviewed all these deals, the bank makes an internal assessment based on the information sufficiency.

Credit analysts and part of the administration which issue loans must have efficiency and effectiveness in the administration of the loan. However, this include monitoring documents, contractual requirements, legal agreements, collateral, and accuracy. All these terms must function properly with management policies prescribed procedures, and laws and regulations.

Another consideration should be paid to the cases of loans, which should be reviewed and ranked on the list of risk by the borrower's financial situation. Loans assessed with high risk should have additional observation and monitoring through more frequent visits by credit analysts, negotiations and proactive efforts, frequent contacts, and restructuring of credit expansion in credit limits or decrease in interest rates to help improve lenders repayment capacity. All the progress made on bad loans should be reported to the management.

According to CBK regulations for credit risk management, credit by credit exposure are classified into standard, watch, substandard, doubtful, and loss credit<sup>71</sup>. Banks should allocate provisions for loans, which is always at higher levels of provision than the minimum required by policy. Provisions should be made to the net exposure after deducting the eligible collateral. In addition to specific provisions required against exposures classified, banks will share the general provisions of the remaining portfolio, and not the classified or segments of the portfolio.

The general provision should be allocated on the basis of documented historical experience, adjusted for current conditions and future market.

---

<sup>70</sup>Reserve Bank of Malawi “ Risk Management Guidelines For Banking and Institution

<sup>71</sup>Banka Qendrore e Kosoves, “Rregullorja per Menaxhimin e RrezikutKreditor”

However, minimal provisions for loans are classified as substandard 20%, doubtful 50%, and loans with losses 100%<sup>72</sup>.

### **Internal Audit**

Today, financial institutions` are surrounded by a dynamic environment with a lot of unexpected events. To cope with this environment, they must meet the requirements of regulators in order to strengthen the governance of institutions and the expansion of more and more products and services. The Internal Audit, in such a situation, is very necessary. This is because it offers the solution to problems and provides assistance to the institution in achieving its objectives as planned, as well as its recommendations offer for the purpose of improvement and development<sup>73</sup>.

Internal audit's inception has been focused on preventing frauds. Then, a number of internal audit organizations have changed their focus to contributing to institutions in terms of observation, operational improvements, and strategic processes under regulatory consents.

The challenge of internal audit is to ensure that banks have a full practice risk management model involving the institution's governance, policies and procedures, and documentation. This is because the environment should be even more devoted to risk management.

The challenge of internal audit is to ensure that banks have a full practice risk management model involving the institution's governance, policies and procedures, and documentation. This is because the environment should be even more devoted to risk management. According to the latest standards for risk management, internal audit should:

- Have an important role in risk management;
- Support the risk management by providing security on critical controls;
- Develop new techniques for monitoring, reviewing, and communication to improve the effectiveness of risk management;
- Collaborate with other auditors to get training and practices in order to gain knowledge in every situation<sup>74</sup>.

However, the internal audit of the banking institution is critical for bank's safe and sound function particularly for risk management system. The scope of the audit process in the bank includes:

- Organization of credit files, whether they are in order and complete;

---

<sup>72</sup>Banka Qendrore e Kosoves, "Rregullorja per Menaxhimin e RrezikutKreditor"

<sup>73</sup>Prioritviti Risk & Business Consulting , Internal Audit "Top Priorities for Internal Audit in Financial Services Organization"

<sup>74</sup>John Short reed, John Fraser, Grant Purdy, Arnold Shenfield, "The Future of Internal Audit Role In (Enterprise) Risk Management"

- Presence and completion of main credit exposure documents, such as: at the application stage, the preparation of reports of credit worthiness, collateral valuation, legal opinion, disbursement, and monitoring of credit exposures;
- Compliance with relevant external regulators;
- Monitoring and observation of the prior audit report.

Internal audit to achieve the objectives set for the loan portfolio exposure disbursed, selects a certain number of files of credit exposures over a certain period (per one year). During sampling, it was intended to be as a representative as possible. So, the criteria used for selecting these clients mainly includes; all regions, different amounts of exposure, outstanding loan, different rates of debt, loans with "grace "period, and the composition of the collateral. In addition, the auditors may conduct interviews with credit analyst associated with the process of organizing and storing of loans.

The procedures and findings of internal audit should be documented. Also, attention should be paid to it, and the findings should be identified in order to minimize them.

Internal and external audit are integral to the implementation of a risk management process and to control the risk associated with the business strategy of a banking institution. To perform their function effectively, internal auditors must have the proper independence and status within the banking institution to ensure that senior management reacts to and acts with their recommendations.

### **Analysis of the Questionnaire: Impact of Internal Audit in Reducing Credit Risk in Commercial Banks in Kosovo**

The research of the impact of internal audit in reducing credit risk in commercial banks in Kosovo was conducted by the survey, which was completed by directors of the audit department of each commercial bank operating in Kosovo. From the total of nine banks operating in the financial market currently, seven of them have responded to the survey. This means that the coverage of the financial market has been about 80 percent, which is a representative sample. Hence, based on the topic of the research paper, the main purpose of the questionnaire was to provide practical information about the opinion of specialists in the field of auditing regarding their perception of the impact of the processes of previous audits. This is for the purpose of reducing credit risk in commercial banks. In realization of the paper, not all banks operating in Kosovo have responded to the survey, but the sample represents about 80 percent of banks included in the survey.

As mentioned in the above literature, many studies have been conducted to examine the impact of internal audit in reducing credit risk by using different methods to argue this. Therefore, the main purpose of this

survey was to collect experiences of respondents on the impact of internal audit in reducing the credit risk. The questionnaire was constructed based on the alternative answers and contains a total of 27 questions. These questions were divided into three (3) parts: the group of general information, the group questions about the institution, and the group questions related to the audit process and credit risk.

Gathering the data from the survey was realized via email. Questionnaires were sent to the directors of audit department of each bank, who sent back the completed survey.

### Results of the Survey

As mentioned above, respondents to the questionnaire have been directors of audit departments of each commercial bank. Seven respondents had master's level education. In terms of the level of professional qualification, 71 percent or five of them have been licensed auditor. One of them has been certified as an accountant and another 1 as an accountant. Also, 71 percent have declared that they have 5-10 years' work experience; one has declared less than five years work experience; and one has declared that he has work experience for more than 15 years. Furthermore, the results of this part of questions are presented below.

Table 1. First group of questions

Level of Education					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Master	7	100.0	100.0	100.0
Level of Qualification					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Accounting Technical	1	14.3	14.3	14.3
	Certified Accounting	1	14.3	14.3	28.6
	Licensed Auditor	5	71.4	71.4	100.0
	Total	7	100.0	100.0	
Work Experience in Auditing					
		Frequency	Percent	Valid Percent	Cumulative Percent
	Under 5	1	14.3	14.3	14.3
	5 - 10 years	5	71.4	71.4	85.7
	Over 15 years	1	14.3	14.3	100.0
Valid	Total	7	100.0	100.0	

Unlike the first group of questions that includes general information, the second group of questions deal with policy of auditing and risk management in the institution or the relevant bank.

One of the main criteria that audit must meet to realize the duties in an efficient way is its independence. The audit must be independent. Otherwise, it may not be functional. Internal audit which is independent is an essential criteria for the safe and sound bank, in particular for credit risk management in terms of improvement and further development. Out of seven banks that responded to our survey regarding the question of whether internal audit is independent, only one of the banks has responded with "partially correct". Others said that the internal audit in their bank is fully independent.

Within a credit exposure, credit application is analyzed by the banking advisor. After the completion of analysis, each case is presented to the committee for review. This committee consists of at least two members of staff with appropriate authorization rights, which decides for the client whether the loan request should be allowed or not. The Commission sets out the conditions for the loan request, including the requirements for issuing collateral. Before issuing the loan, the official of administration controls relevant agreements and other relevant documents to see if they meet all the conditions laid down by the Commission Decision.

In most commercial banks in Kosovo, the Risk Management Department has the overall responsibility for managing credit risk process. On the other hand, the department of credit risk management is responsible for ensuring a healthy process of issuing loans, creating an appropriate environment of credit, management and monitoring of the overall quality of the loan portfolio, evaluating the process of credit risk management, and the management of credit risk exposure by assessing the ability of the customer to repay the loan, etc. Credit analysis worthiness of potential customers is carried out by credit analysts, while further evaluation of the credit file, the review of credit analysis, the completion of documents and loan approval or rejection is done by the officials of the risk management department.

When customer applies for a loan request, the customer whether private or business must present his documents. However, these documents must include: personal information (individual), general information (business), work relationship, economic activity of the customer, client's history with all commercial banks in Kosovo, the status of bank accounts, collateral, etc. In the case of business customers, more details is required. Also, specific documents such as financial statements, the turnover of the business, business plan, etc are also required. In the case of medium and large loans, because of the great risk bearing, the legal opinion by the respective officer in the legal department is required. Legal assessment of such loans includes two aspects: first, whether the company is in compliance with the legislation of the business registered and operates as a legal entity; and secondly, the analysis of the collateral, if it is in accordance with policy

requirements collateral. For more about these features, we analyze the relationships between them in the table below.

Table 2. Correlation

Description		Completing the files	Visit form credit analyst	Commission review	Loan purpose
Completing the files	Pearson Correlation	1.0	0.3	(0.2)	(0.2)
	Sig. (2-tailed)		0.6	0.7	0.7
	N	7.0	7.0	7.0	7.0
Visit form credit analyst	Pearson Correlation	0.3	1.0	0.3	0.3
	Sig. (2-tailed)	0.6		0.6	0.6
	N	7.0	7.0	7.0	7.0
Commission review	Pearson Correlation	(0.2)	0.3	1.0	1.000**
	Sig. (2-tailed)	0.7	0.6		-
	N	7.0	7.0	7.0	7.0
Loan purpose	Pearson Correlation	(0.2)	0.3	1.000**	1.0
	Sig. (2-tailed)	0.7	0.6	-	
	N	7.0	7.0	7.0	7.0

Consequently, the table explains:

- There is a linear positive correlation between completion of files and visit of the credit analysts and credit review committee. This shows that when one of these segments increases, the other segment is increased as well.
- There is an inverse linear correlation between completion of files and loan review committee and the purpose of the loan. This indicates that when credit control is increased by the committee, the problem filling the files will be lower.

The third group of questions related to the process of auditing and risk management is focused on measuring the extent to which the audit process has affected credit risk management in each bank. The function of internal audit in a banking institution would perform regular control if the strategic system of risk management is properly implemented, or if imposed policies and control procedures related to risk management are in compliance.

The process of risk management and internal controls should be examined and tested periodically. The audit frequency may vary. However, it should be increased if there is significant weakness or if a major changes or new products are introduced to the market by bank.

The audit process should recommend that banking institutions should adopt and implement strategic measures for reducing the risk and the use of techniques to achieve the strategic objectives of the institution. Directors and management must be qualified for the formulation of strategic and operational plans, high quality personnel with appropriate training, and should be able to respond to changes and keep up with the trends and recent developments in the relevant field. Also, the audit process should be

recommended as the banks should be prudent in terms of the degree of concentration of credit risk in order not to significantly increase the sensitivity to exposure to certain potential failure of which could have a considerable effect on the stability of the sector as a whole. In addition, banks should conduct stress analysis test, which is an additional tool through which the sustainability of the sector is estimated to potential shocks in the loan portfolio as well as in liquid assets.

From the answers given by the respondents, we have realized that all banks conducted the audit process on a regular basis and in exceptional cases when is need for enhanced control. The technique used is the sample audit process, which in most cases is representative. So, in the audit process, a certain number of files of credit exposures disbursed during a period of time were selected. All banks reported that the results and recommendations arising from the audit process have helped in minimizing intentional and unintentional mistakes of staff involved in credit risk of the commercial bank. Also, all banks reported that the audit recommendations have generally reduced the credit risk of the relevant bank.

Therefore, the findings of the audit are the same, and the recommendations were not applied.

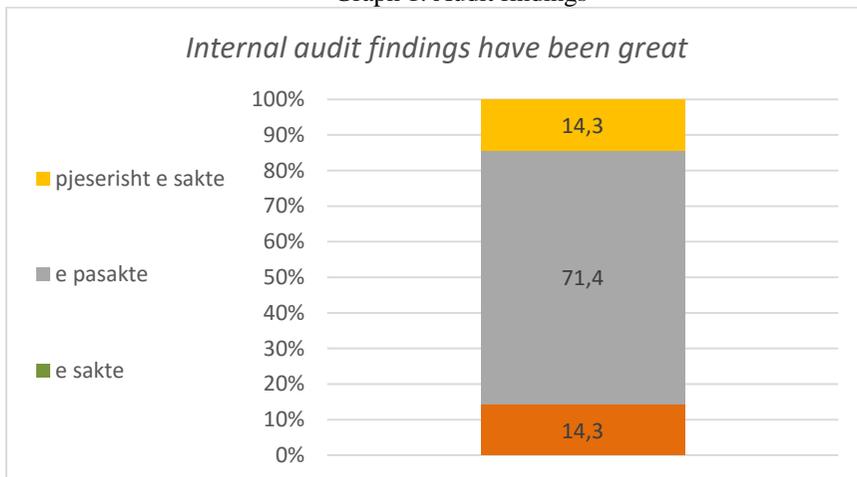
Table 3. Audit findings

Description		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	Audit findings – Implementing the recommendations	(2.5)	6.9	1.3	-.7810	(0.4)	(2.3)	19.0	0.0

The purpose of this comparison is to see whether the findings of audit and the impact of internal audit in credit risk management was a major contribution or not. The results of T test show that p-value is less than the conventional significances level 5% or 1%, respectively. The value is .029%, which indicates that the audit findings and implementation of recommendations by banks have contributed in reducing the credit risk.

In the last three survey questions of whether the findings from the audit process have been minor, important or large, the respondents' answers are given in the figure below.

Graph 1. Audit findings



## Conclusion

Credit risk is the dominant risk in which the banking system in Kosovo is exposed. Therefore, any commercial bank operating in Kosovo, must have a system for managing credit risk. This system must include policies, procedures, rules and structure, which should be appropriate to the nature, scope, and complexity of their activities. For the policies of the credit risk management to be effective, it must be communicated on the right time, be reviewed regularly, and should be applied at all levels of the bank with the appropriate procedures. Thus, the control of these policies and procedures is monitored by the internal audit department of each bank.

Internal audit provides alternatives for solving the problems and in helping the institution in achieving its objectives as planned, as well as recommendations for improvement and further development. The challenge of internal audit is to ensure that banks have a full practice risk management model, including governance institutions, policies and procedures, and documentation. Banking institutions must possess strong systems of internal control to ensure that they are not unduly exposed to strategic risks.

The main activity of commercial banks in Kosovo is lending to private clients and small and medium enterprises. Based on this, the credit risk or the risk that the borrower may not be able to meet the obligations of the contractual agreement fully or partly, is the most important risk facing commercial banks in Kosovo. Consequently, the credit risk constitutes the main risk in the context of calculating the capacity of the transfer of risk from commercial banks. Due to the nature of the bank, any bank loans are the largest source of credit risk. Therefore, management and credit risk reduction has a special importance for a successful performance of a commercial bank.

Results of the survey that was conducted with commercial banks, in Kosovo, show that each commercial bank operating in Kosovo had the relevant departments of internal audit. This regularly and unregularly undertake process of controlling in order to reduce credit risk. From the survey results, the following has been recommended in the process of auditing of each bank: the implementation of policies for managing credit risk of the respective commercial bank and the policy for credit risk management of the Central Bank of the Republic of Kosovo; the implementation of procedures, regulations and rules for credit exposure; diversification of portfolio; training of staff involved in completing issuing the loans, etc. According to respondents, all these and other recommendations from the audit have been implemented and have contributed in reducing credit risk.

### **References:**

- Theofanis Karagiorgos, George Drogalas, Iordanis Eleftheriadis<sup>3</sup>, Petros Christodoulou, "Efficient Risk Management and Internal Audit"  
Banka Qendrore e Republikës së Kosovës, "Rregullorja për Menaxhimin e Rrezikut Kreditor"  
Prioritiviti. Risk & Business Consulting , Internal Audit "Top Priorities for Internal Audit in Financial Services Organization"  
Catherine Soke Fun Ho, Nurullizza Yusoff, "Preliminary Study on Credit Risk Management Strategies of Selected Financial Institution in Malaysia"  
Basel Committee on Banking Supervision "Principles for the Management of Credit Risk"  
John Shortreed, John Fraser, Grant Purdy, Arnold Schanfield, "The Future of Internal Audit Role In (Enterprise) Risk Management  
Kosmas Njanike "The impact of Effective Credit Risk Management on Bank Survival"  
Reserve Bank of Malawi "Risk Management Guidelines For Banking and Institution"  
The IIAF White Paper "Internal Auditing Role in Risk Management", 2011  
Angus Dickinson, Principal, Head of Risk Management Services, Sydney, RSM Bird Cameron "Interfacing risk management and internal audit - conflicting or complementary"  
Clifton Larson Allen "The role of Internal Audit in Risk Governance"