

CAFRAL
Program on Treasury Management

Internal Controls and Regulatory
Issues

11 August 2012

Integrated Treasuries – Normal Functions

- Statutory Reserve Requirements
- Liquidity Management
- Money Market Operations
- Fixed Income Securities – Investment and trading (including Gilts and other securities)
- Rupee Derivatives – IRS, FRAs
- Foreign Exchange operations (including derivatives)

Integrated Treasuries – Normal Functions

- Foreign currency borrowing
- Other securities such as equities, preference shares, pass through certificates, etc
- Treasury related services such as Constituent SGL facility
- Securitisation etc.
- Correspondent Banking
- Gold business, if allowed to import
- Hedging the balance sheet and trading
- Transfer Pricing
- Treasury as a profit centre

Regulatory Prescriptions

- Rakesh Saxena – his fraud accelerated introduction of internal controls in Indian treasuries – forex business
- There are regulatory prescriptions on almost all aspects of treasury management e.g., CRR to be maintained, SLR to be maintained, securities eligible for SLR, classification of investment in three classes, caps on call borrowing and lending, FCY borrowing, interbank liability limits, investment in non SLR securities, investments in unlisted securities, investment ceiling in subsidiaries and financial service companies,

Regulatory Prescriptions

Investments by banks in liquid/short term debt schemes of mutual funds, investments in CPs, CDs, debentures, net open position in foreign transactions and AGL limits, securitisation, requirements for hedging, accounting, etc

Issues in Treasuries

- JP Morgan, Society General, UBS, MF Global, Libor scandal, Rajat Gupta all point to one common thing i.e. “yeh dil mange more”.
- And “yeh dil mange more” keeps on getting endless
- Amir Khan’s programme on alcoholism. Over time it becomes a disease. Similarly super normal gains become not only intoxicants but disease
- Further over time, mis-selling creeps in to maintain those level of gains.
- Amir Khan’s programme on malpractices in medical profession. Generic drugs and branded drugs. Also prescribed more than required. Similar practices prevalent in treasury too

Issues in Treasuries

- Also one starts resorting to creative processes and accounting.
- All this develops over a period of time.
- Amir Khan Programme on Water Resources – Research on frog – put in boiling water, would jump and come out immediately. Put in normal water and start warming up slowly. Will start getting used to warm water and will remain in water even when it starts boiling. It will even get burnt.
- Hence rotation of personnel working in treasury within, if feasible and out of treasury is must.
- Practically very difficult but must be implemented.

Issues in Treasuries

- “yeh dil mange more” is equally relevant for senior managements too.
- Why more and large frauds in treasury and treasury related areas. Incentive to employees to take risk and conceal any loss – difficult to pass on high cost to customers by way of plain credit and deposit products. Hence think of complex products in treasury. Either mis-sell, if not fudge books and accounts. Recent examples JP Morgan and LIBOR setting
- Profit centre.
- SPVs/SIVs during crisis
- Hence self-discipline by senior managements and treasury personnel is very important.

Some general issues

- GDP – relationship between financial sector GDP and real sector GDP
- Where money went banks in India as well as corporates lost huge amounts in complex derivatives.
- Frequent cancellation and rebooking of contracts by customers.
- IRS are mostly inter bank.
- When in inter bank deals, both the sides make money – what could be the reason.

Some Facts

- Lack of investors confidence. US treasuries attracting huge funds, although they are offering yields at rock bottom level. 10 years yield at around 1.5 per cent.
- USD 980 billion are parked with ECB by the European banks.
- Shares Price to book value of some of the banks is Credit Agricole (20 per cent), Bank of America, Citi, Barclays(all 40 percent), BNP (50 per cent), Santander (Spain) (60 per cent), Mizuho (70 per cent), JP Morgan (80 per cent) and HSBC (90 per cent)

Some facts

- Citi shareholders lost 94 per cent of their investments from 2003 to 2012
- Bank of America study showed that their losses from treasury products during crisis were higher than their trading gains in the last 40 years.
- JP Morgan loss likely to go up to USD7.5 Billion
- Libor is used for USD 550 trillion swaps, other assets apart like mortgages and education loans.
- Credit swaps for some European sovereigns are higher than those for Indian corporates.

Important Controls

- Nostro and vostro reconciliation cash as well as securities – very important being payment for posting margins in cash or by securities wherever required
- Revaluation of assets (including those for HTM assets, if not for accounting for MIS at least) and liabilities, not by front office but by mid office – sources of rates. Assets and liabilities should give true and fair view on ongoing basis.
- Complex products – if revaluation not possible by mid office, better not to have business in those products.
- Hence need for a Product Approval Committee which may consist heads from Compliance, Risk, Treasury and Corporate Lending. This Committee may set suitability and appropriateness standards too.

Important Controls

- Even if controls are robust for the above processes, fake deals may be put through to conceal losses, hence counterparty confirmation process should be very strong.
- Strong concurrent audit, rate scans, mid office and back office operations.
- Concentration of deals through some brokers.
- Synchronized or circular trades as dealers develop strong contacts with their counterparts in other banks and sometimes dealers move from one bank to another to avoid rotation of duties. At times they accommodate each other – genuinely sometimes.

Important Controls

- Regulatory compliances – strong compliance function
- RBI has asked for certificate to Board by head of compliance function certifying compliance in the area of derivatives.
- Regulatory penalties on banks - abroad on functionaries too responsible for compliance
- SEBI has imposed penalty on compliance head of Satyam Computers in his duty to avoid insider trading in the Company's shares in December 2008, a few days before the big accounting scandal came to light in the company.
- Other regulators may follow suit.

Important controls

- Most important is that we should have people manning control functions, equally or more qualified than those in front office, who understand the various nuances of products being offered by the banks and they should be emboldened enough to implement controls and disciplines.
- Any other issues or experiences from your side to be shared with others.
- Thanks