Treasury Audit Approach – Change with the Tide!

A bank's treasury is the nerve centre of its operations and manages its clients' and own money. The range of operations in a bank's treasury function is wide and transcends beyond just managing asset liability mismatches and determining internal fund transfer pricing for various businesses. In the recent past, we have read about some very well publicised frauds in banking institutions, particularly the likes of UBS, JP Morgan and Societe General where the quantum of losses due to treasury frauds ran into millions of dollars. Another interesting trend one could notice is the extent of sophistication in which these frauds were done and how the perpetrator was able to hide the losses over a prolonged period of time. Scale, diversity, complexity of products and quantum of funds all add up to making a treasury function of a bank vulnerable to all operations and accordingly warrants special audit focus.


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Treasury Operations of a Bank

The treasury function of a bank is primarily engaged in managing the proprietary desk (bank's own investment and derivative book) and a sales desk (which manages client facing deals and transactions). Over the years, the range of products and risk management solutions offered by banks to its clients have increased manifold. Though quite ring fenced from an Indian context, the challenges of ensuring compliance with regulatory requirements on "dos and don'ts" on products that a bank can transact with are very onerous. Combined with challenges of valuing treasury products, particularly derivatives, makes the operations very complex and specialised.

Learning From Recent Treasury Frauds and Losses

It is evident that some institutions which experienced instances of frauds or operational losses in their treasury businesses, failed to institute and implement basic control environment principles. There was complete

breakdown in the review process and absolute lack of responsibility hand-off. The current common practice of outsourcing and off-shoring also leads to challenges of assigning adequate in-house responsibility of work undertaken by outsourced (captive and external) agencies. Following are some of the instances of lapses which came to the forefront:

- Trades done intra-desk were subjected to less stringent control processes and accordingly fictitious trades were recorded for showing trading P&L;
- Late booking of trades, to avoid those getting captured in the bank's risk reporting system;
- Inappropriate checks and balances to monitor cancellation and amendments of trades;
- Lack of review of desk P&L's at a gross position level. Net P&L's camouflage losses at individual trade level;
- Inadequate MIS to monitor open positions. P&L attributes not available at a sufficient granular level;
- No clear hands-off on processes undertaken at offshore/outsourced locations;
- Failure of controls essential to ensure smooth transitioning of employees from one role to another, without diluting any review responsibilities;
- Lack of strict adherence to bank's policies. Some transactions undertaken were clearly outside the remit and permissibility of the trading desk;
- Lapses in follow up of confirmations and reconciliation breaks.

Key Determinants for Tailoring an Audit Approach

A comprehensive treasury audit plan requires that the audit team has a thorough understanding of the treasury operations. It is imperative that a health check and assessment is done by the auditor of the bank's monitoring framework governing treasury operations. This will aid in selecting key controls and activities that should be audited, to gather an appropriate level of audit evidence. The following are some of the constituents that one should look at during the course of the audit work.

- Control culture in a bank dictates the work ethics in which the treasury operations are conducted. A strong governance structure lays boundaries within which the operations are done. Tone at the top is critical. How frequently and rigorously senior management review and direct the scope of treasury operations is key to a well governed operational setup.
- Fraud risk is pervasive to treasury business and auditors need to reflect on the possibilities and likelihood of occurrence of such frauds. In doing so, it is essential to understand the levers of the business and operations – what incentivises the trader and how can he circumvent controls for personal profiteering.
- Regulatory environment in which a bank operates influences the scale and complexities of treasury operations. A large section of the banking community in India believe, that RBI's consent on permissibility of treasury activities for a bank operating in India is very restricted in comparison to some of the more matured financial markets. In retrospect, this stance by the regulator has been an effective shield for Indian banks from the direct impact of the credit crisis. Further, there have been no known significant treasury frauds reported in India. Compliance culture of a bank vis a vis RBI regulations will provide a heads up on the level of audit risk in the treasury function.
- Given the nature and complexities of product offerings and services by a bank's treasury, these are inherently more sensitive and prone to customer grievances. This demands an assessment of processes the bank has implemented to ensure compliance with customer suitability and appropriateness guidelines. A review of the customer complaints process along with the litigation cases being dealt with by the bank, will provide a fair view of existence of any concerns or issue in this context. Further, it will also provide a flavour of the management's philosophy in dealing and addressing such matters.

Need of the Hour

Auditors need to take a step back and introspect whether traditional audit procedures which hitherto were being performed, are adequate to mitigate some of the audit risks inherent to a bank's treasury, given the evolution of treasury operations over the years. Though it is pertinent to note that, recent experiences indicate lack of adherence to basic control principles

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as the primary reason for prolonged undetected frauds, the nature and structure of treasury frauds have undergone changes. These are multilayered, cuts across various IT applications, goes beyond a single person's remit and are very difficult to detect in the first instance.

One can argue that audit procedures are not necessarily geared to detect all instances of fraud; however, one cannot turn a blind eye towards a 'ticking bomb' which could lead to a material misstatement in the financial statement and cause significant reputational damage and financial loss to a banking institution.

What Could One Do?

Given the scope of audit engagements, the work performed by an auditor is done under a certain framework and it is bound to have dependencies on the assessment and conclusions reached on the quality of control environment in the treasury function. Accordingly, it is essential for auditors to evaluate the effectiveness of some of the tools used by senior management, to monitor operations and risk in a bank's treasury. The following are some of the documents/ processes which one could review and verify, to gauge the control culture and the robustness with which these are followed in spirit.

- **Risk MIS** – Review the nature, content, frequency and granularity of MIS prepared for management review. It is important to remember that timing is of essence, a dated risk MIS has little role to play in acting as a detective control. Hence, the more evolved risk engines are capable of generating real time, accurate and scenario based data, which aids quick corrective actions. Another important aspect to assess is the quality of MIS. Many risk MIS lose the relevance and utility due to overcrowding of numbers and data. Hence, effectiveness of any risk MIS needs to be assessed on its ability to provide the 'bigger picture' impact.
- **Architecture of the treasury function** – Role overlaps/'double hatting' essentially do not follow the ideologies of 'segregation of duties'. Unfortunately, it is not uncommon to notice the existence of this. Consequently it is important to evaluate how each role and function has been defined and carved in the treasury set up at the bank. Do one or more personnel influence the sanctity of how controls are implemented and operations monitored? Is there a scope for collusion? These are some red flags and provide direction to our assessment of the control environment.

  A related point to evaluate is to assess any excessive concentration of powers and privilege rights in one individual or a close group of individuals. This is a recipe for overriding and diluting the effectiveness of any control. Such a structure demands that there is periodic review and oversight by senior management, including Board committees.
- **Position monitoring** – Numbers are meant to depict facts. Consequently, it is essential to understand how numbers representing trades, volumes, P&L's are generated and recorded. A good understanding of who does this; are these independently verified; how these are challenged and reconciled to the general ledger, is essential. It is important, that each function involved in monitoring the treasury operations are seeing the same set of numbers and more importantly, these reconcile to the numbers recorded in the general ledger.
- **Remuneration policy and structure** – Bonuses have been the infamous terms lately for bankers, particularly in Europe and USA. However, this has been the USP of a treasury front office job, i.e. large monetary compensations. Things are changing, though banks are moving towards a more balanced risk and reward compensation structure, where the risks are tangibly measured, unlike previously. Hence, it is important for an auditor to be aware of the bank's philosophy for employee remuneration in a treasury function. Matters like, weightage given for operating within the risk appetite boundaries set by the Board of the bank, linkage of trader's remuneration to ensuring and maintaining Value at Risk (VaR) within an acceptable range, are some of the indicators which provide a fair understanding, whether or not remuneration policies are one directional towards achieving business targets and profitability.
- **Account ownership** – As discussed earlier, numbers reflect the underlying substance of the transaction. Consequently, a bank which ensures that there is adequate monitoring and review of balances in each account in the general ledger associated with the treasury business, would do well in identifying any fictitious or unauthorised trades. The effectiveness of this control is dependent on the level (seniority), granularity and frequency at which these are performed.
- **Pricing of trades** – This is a wider subject and has universal and wide ranging impact on business and profitability. In context to treasury operations, the significance of this is associated with how client

facing trades are priced and how traders decide on taking proprietary positions for making trading gains.

Again, though not a very big issue for Indian banks, many international banks operating in Europe and America do face challenges on opacity of observable inputs for pricing of trades. This has two immediate impacts – (1) Day 1 P&L and (2) Incorrect pricing and resultant losses.

In our current theme of discussion, the second point is of relevance, since most frauds are committed to hide trading losses. Hence, the effectiveness of pricing policies and existence of sophisticated pricing tools play an important role in aiding traders discharge their day to day primary job with ease. As an auditor, a good understanding of the pricing mechanism provides an insight into how various price components are considered, in building up a trade price at the time of the transaction. A comprehensive internal fund transfer policy along with a trade pricing framework, avoids and discourages any discretionary pricing practices.

- **Strength of back office –** Inadequate infrastructure has been the bane of many instances of treasury frauds and operational losses. Common examples being, IT applications not geared to handle a particular type of product and hence, dependencies on excel worksheet and surrogates. Lack of adequate infrastructure has led to instances of errors, dilution in review process, inadequate and delay in information and many other constraints.

  A bank which first sets up adequate back room infrastructure and has a good measure of the volumes it can manage, provides a good report card of the level of consciousness they have on the pit falls of new business they undertake. It is therefore essential for auditors to have a good view of the adequacy of infrastructure within a bank's treasury.

Concluding Comments

Intentionally, the above commentary does not discuss much about the more common basic audit procedures which are performed as part of treasury audits. Though those procedures are a must do, the idea was to emphasise the need for audit teams to sum up the more important aspects of treasury operations, which play a critical role in facilitating assessment of the extent of risk in the treasury business of the bank.

These areas generally tend to be overlooked or are not evaluated with the same degree of rigour. Many a time, audit teams often perform exhaustive amount of transaction verification work and testing of controls. However, invariably, this effort appears to be disjointed, *i.e.* the work is not guided by an assessment and conclusion of the various points discussed above. Further, many times, audit teams seldom put all their findings and understandings together, to build a script of their understanding of the entire treasury operations and hence, fail to identify the gaps in the control design. The auditors should be vigilant about these requirements.

Hence, an effective treasury audit warrants a complete front to back view of the operations and it goes without saying, that an auditor's work should start from reviewing and assessing the policies approved in the Board rooms of banks, rather than starting transaction testing work at treasury back offices. ■