Audit of Treasury Operations of a Bank in the Times of Change

Treasury business of the bank is very vital but at the same time vibrant in nature. The money getting churned on daily basis is huge. There is a direct relationship between risk and rewards. In modern era, treasury includes funds management in domestic and/or international markets based on the financial exposure and management objectives of the bank. The auditors' job is to verify these activities, and give the required assurance as per the nature of the assignment. Hence, in depth understanding of the treasury business is a crux. He needs to change his auditing techniques in sync with the changes in the treasury business, and regulatory framework. He should be updated. The staff working on the audit should be tech-savvy and try to maximise the benefits of spreadsheets. This will help to minimise the majority of the audit risks for the auditor. Read on to know more…

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Introduction

Bank is a financial institution that accepts deposits from the public and creates credit activities. To manage the funding part pertaining to these two preliminary activities, the function or department of "Treasury" is created. The term "treasury" was first used in classical times to describe the votive

buildings erected to house gifts to the gods. In Greek and Roman era, physical treasuries were incorporated within religious buildings to make the funds sacrosanct for the religious purpose.

In modern era, treasury includes funds management in domestic and/or international markets based on the financial exposure and management objectives of the bank. In current times, the functions and modes of treasury and its operations are changed drastically. This change is in line with the change in the form of ways of saving money, ways of investments, avenues for investment, and avenues for earning profits by taking advantage of the moves in the capital and currency markets. In present days the drastic evolution of currency is being seen in the form of Bitcoins. Hence, it is expected that the treasury operations need to be understood in greater detail while conducting the audit of this very important function of any bank.

Types of Treasury Audit

The following audits are normally required to be conducted, pertaining to treasury.

Statutory Audit
Internal Audit
Concurrent Audit
Special Audit
Dealing Room Audit under RBI guidelines

The objective and the deliverables are different pertaining to each type of audit to be conducted.

Statutory audit of treasury involves verification of treasury activities from accounting and revenue recognition point of view. Statutory audit involves various kind of certifications pertaining to investments, provisions on investments, compliances with Cash reserve ratio (CRR) and Statutory liquidity ratio (SLR), etc.

Internal audit is an independent, objective oriented, assurance and consultative activity designed to add value to the internal control framework and treasury business. Internal Audit is largely a "management function" and aim to find out the effectiveness and the efficiency of internal processes, procedures and the internal controls set around the same.

Concurrent audit is an audit mandated and regulated through various guidelines and scope prescribed by the Reserve Bank of India (RBI). In the current scenario, the RBI issues frequent guidelines on concurrent audit, its scope, various certifications needed from concurrent auditors.

Special audit is the audit as desired by the management of the bank. Hence, this audit does not have boundaries. The objective of the assignment determines and guides the execution methodology. In depth knowledge of treasury functions including operational aspects is a key to execute any special audit.

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Treasury operations

Treasury/Dealing Room activity is usually carried out as a centralised function. It may be carried out at Corporate Office or separate dealing room premises. In general, vicinity to RBI was an aspect to be considered in earlier days for selecting the location of treasuries. In current days also, it is the prime reason which helps to facilitate manual submission of the documents at ease. Most of the banks in India have integrated treasuries which involves both Rupee and foreign exchange transactions. The core function of any Treasury involves:

- Trading
- Asset Liability Management
- Primary Dealers' function
- Customer transactions
- Management of foreign branches / subsidiaries

Every treasury is headed by a "treasurer", who has the responsibility to manage treasury operations in the most efficient manner.

Functional Segregation

Good governance demands segregation of duties. This principle is highly applicable to treasury activities as the volume of money involved is humungous. Any minor overrule of "4 eyes principle" may lead to collapse of the entire organisation. So also, controlling the greed of a dealer/trader is another crucial reason, as to why this segregation is

of utmost importance. Barings Bank in Britain was the example quoted very frequently in this respect. Any treasury personnel while undergoing his initial training is taught "Nick Leeson" lesson, which guides them as to what they should not be doing. There needs to be a documented segregation of duties, roles and responsibilities. This is one of the RBI mandatory controls to implement. This segregation includes:

- Front Office
- Mid-Office / Middle Office / Risk Management
- Back Office & Accounting

Front office mainly consists of dealer/traders. The dealers/traders who offer "two way" quotes i.e. "Buy/ Sell" are known as "market makers". The other dealers perform the asset liability function, merchant cover trades, etc. Front Office calculates and intimates the daily card rates pertaining to core foreign currencies against INR for the Bank as a whole. Executing a deal is the primary job of the Front office.

Mid office also known as Middle office or Risk management department takes care of controlling all critical business risks. These risks primarily include market risk, liquidity risk, regulatory risk and operational risk. Other risks like credit risk, asset-liability management risk, maturity risk, etc. are monitored at bank's level. Risk monitoring and supervising the positions taken by the front office is the primary job of Mid office.

Back office is the unit which takes care of all operational aspects pertaining to the activities done by Front office. This unit verifies and authorises the deals struck by the Front office. The deal needs to be confirmed with the counterparty. In case of foreign exchange, derivative deals, additional activities like receipt of term sheet, tracking of underlying, tracking of past performance exposure, reconciliation is required to be performed by the Back office. Further, the accounting is expected to be performed by the application software and the reconciliations of foreign exchange and rupee cash positions is performed by the Back office. Further, reconciliation of positions as per Front office records with the bank's accounting records is another activity to be performed by this unit.

Banks may have foreign branches locally offering various types of products in foreign currencies. These product offerings are based on the "Treasury Policy" /"Investment & Fx dealing policy" of the bank. Based on the Reserve Bank of India (RBI) directives, the Bank may have International Banking Unit (IBU), which takes care of foreign currency exposures as per the Business model of the Bank. This IBU can be considered as extended arm of Indian banks which could not set up foreign branches/subsidiaries.

In the current times, the treasury applications are evolved to compute the more complex risk management tools like computation of value-at-risk (VAR), numbers of PV 01, duration, modified duration, credit risk, credit concentration risk etc. These are the risk monitoring tools largely used by the banks. So in the audit procedures, the auditor can periodically validate the workings of these risk management tools.

Product Offerings

In the current era, treasury of ultra large banks offer the following products:

Domestic / Rupee Treasury

- Money Market Products – Call Borrowing, Lending, Repo, Commercial Paper etc.
- Dated Securities – Government Bonds, Corporate Bonds & Debentures, etc.
- Structured Products – Pass Through Certificates (PTC) , Security Receipts (SRs), Venture Funds, inflation indexed bonds etc.

International / Forex Treasury

Foreign Exchange Transaction – Spot, Forward and Swap transactions with Interbank as well as non-bank counterparties in foreign currencies.

Derivative Treasury

- Rupee Derivative Products – Interest Rate Swap, Currency Swap, etc.
- Forex Derivative Products- Interest Rate Swap, Options, Forwards, Currency Swap, various types of structured options.
- Commodity Derivative Products.

Transaction in Bullion which includes outright sale/purchase with counterparties in bullion including coins and bars, bullion on consignment and forward exchange contracts in bullion. As of now, it is not heard about handling of positions in Bitcoin (crypto-currency) by treasury of Indian banks. But the Indian Corporate community has started accepting Bitcoin to settle its international business transactions. As per the European Banking Association (EBA) the risks associated with Bitcoin, being virtual currency, is manifold.

All the above products can be traded in the open market or at "Over the Counter (OTC)". There is more transparency in case of market based / platform based products rather than in case of OTC trades. The fair value in active/liquid market is always available for any analysis pertaining to unrealised profit/losses. The empanelled brokers may get involved while executing these kinds of deals.

Audit Approach

The audit approach of auditor changes, based on the execution of different types of audit as enumerated above. The important aspect is the auditor should understand each product feature *vis-a-vis* the operational guidelines of the Bank. He needs to be well versed with various rules/regulations/guidelines issued by RBI, Fixed Income Money Market & Derivatives Association of India (FIMMDA) and Foreign Exchange Dealers' Association of India (FEDAI), Securities and Exchange Board of India (SEBI), at the minimum.

In the days prior to 1990, the treasury used to keep the records largely in manual or semi manual form. The treasury application software were limited to manually capture the transaction and send to Back office for authorising and further processing. During that time, the audit was paper-based. The transactions to be covered under audit were comparatively simple and easy to understand.

For statutory auditor, giving a certification on Capital Adequacy Framework under Basel III as well as computation of Capital to Risk- weighted Assets Ratio (CRAR) is a huge challenge. These two aspects are truly speaking applicable for the entire balance sheet of the bank. But since, on a standalone basis, balance sheet is any treasury is top-heavy, the treasury auditor is expected to have full knowledge of these RBI Regulations while calculating CRAR.

The regulations were minimal. But post-scam in government securities of 1992, the entire picture of treasury and its audits had drastically changed. Nowadays, audit is paper-less. Majority of the audit evidence is given in soft/digital form. The data is stored on the bank's network and print is avoided due to data secrecy and confidentiality.

Post 1992, RBI had taken massive initiatives and efforts to make transactions in dated government securities to be reported on the electronic trading platform. Subsequently, the platform was put in use for automatic matching of the orders placed through Negotiated Dealing Platform (NDS). This platform has been placed for money market activities as well. Through Clearing Corporation of India (CCIL), RBI has started monitoring the behaviour of trading in government securities. This has helped to create a direct interface for capturing the trade into the treasury application software. This has substantially reduced the risk of manipulating the capturing of the deals into the books of accounts of the bank.

So, the audit procedures need to be changed to understand how the NDS system works, its various cut-offs, and various reports generated through CCIL website. Auditor can use this upgradation in the information technology to track short-sale in dated government securities, delayed reporting of the deals on NDS platform, spreads maintained in offering two-way quotes, matching the prices with the prices offered by brokers, speculation in any securities, etc. Since the reports from CCIL can be downloaded in spreadsheets, data messaging is simple and quick. Through these procedures, auditor can bring value addition for the bank. Similar techniques can be used across all product offerings by the Bank. So, non receipt of underlying within 15 days, non receipt of the confirmations within stipulated time etc. can be very well monitored by the auditor as well. Instead of only relying on the data given by the bank, auditor can validate the correctness of the data. But at the same time, it needs to be remembered that a basic audit principle of giving the complete as well as correct data is the prime responsibility of the auditee, so in this case, of the bank. Auditor, performing any kind of audit, can validate / revalidate the data.

Parallel to this, CCIL had developed Fx – Clear and FX – Swap platforms. These platforms provide neutral, transparent, order driven dealing mechanism for market participants.

As a result of the introduction of above order driven, anonymous dealing infrastructure, the

risk of settlement has been substantially reduced. CCIL guarantees the settlement being the central counterparty.

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Further, today, audit tools are available which you can install with bank's permission on bank's network or on the data given by the bank. These tools need to be customised to get the analytics results. Before implementing the tool, the auditor needs to finalise the areas/aspects he wishes to verify.

Any analytics pertaining to structured products require judging the underlying cash flow of the product offerings. This was one of the root cause diagnosed in Lehman Brothers crisis. The derivative products offered to the hedge funds was one of the reasons for this financial crisis. In India also, banks had offered high-end derivative products without understanding the actual need of the corporate to hedge its financial risk. Corporates also conveniently relied on the banks' advice without doing its own analysis as to whether the underlying risk is limited to any threshold or its open if the market moves against the expected price movements. During this period, it was very crucial for the auditor to study the product, discuss the same with the treasury personnel and verify whether it was resulting in any way with non-compliance to the RBI guidelines.

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Based on the RBI guidelines, a lot of certifications are needed from statutory, internal and concurrent auditors of the treasury. Being a statutory auditor,

RBI also expects a detailed Long Form Audit Report (LFAR) which covers all aspects of treasury starting from money market activities, RBI reconciliations, SGL reconciliations, etc. It also expects the auditor to comment upon the adequacy and effectiveness of the information systems in treasury. Recently, RBI has also started sending data forms under Risk Based Supervision (RBS) in tranches. These RBS data forms require the observations from the concurrent as well as internal auditors of the bank.

Impact of Accounting Standards

As the product offerings are getting complex day-by-day, so also the accounting of the same. In recent periods, application of new set of standards namely Indian Accounting Standards (Ind AS) is a huge challenge for the banks as well as auditors. It starts with the basic aspects as how to calculate the effective interest rate (EIR) on the dated securities. It is more complex when applying the principles of hedge accounting. Further, accounting the "transaction cost" for specific class of financial assets dealt by the treasury is another new challenge for the banks as well as auditors. The concepts of hedging are very complex and are expected to move in tandem with the movement in the market. Hence, the auditor is expected to get well versed with the changes in the accounting standards, which is more principle based. At the same time, these changes in the accounting standards bring subjectivity while applying. So, the documentation of audit procedures, reasons for relying on management estimation, hedge documentation verification, etc. will be of utmost important in the coming days.

To summarise, auditor needs to change his auditing techniques in sync with the changes in the treasury business, and regulatory framework. He should be updated. The staff working on the audit should be tech-savvy and try to maximise the benefits of spreadsheets. This will help to minimise the majority of the audit risks for the auditor.■