

Treasury alert 2/2011

RBI's Comprehensive
Guidelines on
Derivatives – modification
dated 02 November 2011

How could it impact you?



pwc

Our previous 'Treasury alert 1/2011' shared with you, summarises the impact of modification on 'Comprehensive Guidelines on Derivatives', April 2007 issued by Reserve Bank of India (RBI) with regard to 'Suitability and Appropriateness Policy' for offering derivative products to user.

To enhance the guidelines issued in August 2011 and provide clarity on 'Broad principles for undertaking derivative transactions by market makers' and 'Suitability and Appropriateness Policy', RBI has issued further modification guidelines on November 02, 2011.

These changes are in response to the suggestions made by Foreign Exchange Dealer Association of India (FEDAI) and other market participants.

Overview of significant changes

Prior to the issuance of this guideline, there were ambiguities with regards to:

- Which derivative product can be treated as a structured derivative product?
- Whether 'Suitability and Appropriateness Policy' will apply to forex forward contract or not?
- Whether a derivative can be treated as an underlying for a structured derivative product?
- What will be the effective date for the modifications issued?
- What should the Corporate include in their approved Risk Management Policy for undertaking structure derivative product or any other derivative?

Following are the significant changes stated in modification guidelines issued on November 02, 2011:

Broad principles for undertaking derivative transactions by market makers

Generic derivative products may include the following instruments used to hedge an existing interest rate and forex exposure, on a standalone basis:

- Forex Forward Contracts
- Forward Rate Agreements
- Interest rate caps and floors (plain vanilla only)
- Plain Vanilla Options (call option and put option)
- Interest Rate Swaps
- Currency Swaps including Cross-Currency Swaps

Structured derivative products are either combination of 'cash instrument and one or more generic derivative products' or 'two or more generic derivative products' but it should not contain derivative instruments as underlying.

Examples of structured derivatives are:

- Interest rate swaps with put or call option,
- Cross currency interest rate swaps with interest rate cap or floor.

Cash instruments are a financial instruments which are available in the money market like certificates of deposits; repurchase agreements i.e. the Repos, bills of exchange, interbank loans; commercial papers etc.

Applicability for forex forward contract

Notification clarifies that the said Policy will not be applicable for forex forward contracts. Forex forward contract transaction can be undertaken if permitted under Foreign Exchange Management Act, 1999 (FEMA) or in terms of the rules or directions issued by RBI.

Effective date

The above modified guideline will be effective for transactions from January 1, 2012.

Specific expectations from the corporates

To undertake any derivative product other than a structured derivative product, a corporate will now be required to provide a copy of their Board Resolution, which contains the following:

- the limit assigned by the corporate to each bank.
- name and designation of the officials authorised to undertake derivative transactions on behalf of the company, list of officials to whom transactions will be reported by the Bank and person(s) authorised to sign ISDA and related agreements. These officials will be distinct from those authorized to undertake the transactions.
- specific products that can be transacted by the designated officials named therein.

In order to undertake a structured derivative product, the corporate is required to have a Risk Management Policy approved by the board which contains the following:

- Guidelines on risk identification, measurement and control;
- Guidelines and procedures to be followed with respect to revaluation and monitoring of positions;
- Designation of officials authorized to undertake transactions and limits assigned per transaction;
- Assigned limits on a per transaction basis to the officials authorised to transact derivatives.
- Accounting policy and disclosure norms to be followed in respect of derivative transactions;
- A requirement to disclose MTM valuations appropriately;
- Segregation of duties between front, middle and back office;
- Mechanism regarding reporting of data to the Board which will include financial position of transaction etc.

Questions that you may wish to consider?

1. Have you initiated efforts to develop and/or update the financial risk management framework in your organisation?
2. Have you implemented a process for identifying appropriate controls relating to the treasury operations? Further, how do you ensure control over accounting for derivative financial instruments?
3. Does your risk management policy define proper authorisation matrix for undertaking a derivative transaction?
4. Is there an appropriate segregation of duties within the organisation with respect to the structured derivative transactions?
5. Do you have access to market makers calculator and are you able to arrive at fair values at each reporting date for structure derivative products?
6. Have you evaluated adopting hedge accounting guidance which will help mirror the risk management objective and the financial statements accounting?
7. Are the internal audit procedures appropriately tailored to identify the key controls and ensure compliance with the ongoing increased regulatory guidance?
8. Do you trade or intend to trade in structured derivative products?

How can we help?

PwC would like to take the opportunity to share insights and experiences for the change in compliance for derivative financial instruments.

The areas where we can provide service:

- Help in formulating a Treasury Policy;
- Advise on policies, procedures and controls to be built in the organisation around the derivative transactions;
- Assist in defining a treasury framework;
- Assist in evaluation and implementation of hedge accounting solutions for derivative financial instruments;
- Evaluate the internal control framework and suggest tailoring the internal audit steps.

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