Treasury alert 1/2011

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

How could it impact you?

Overview of the significant changes

On 2 August 2011 the Reserve Bank of India (RBI) enhanced the guidelines with regard to *'suitability and appropriateness'* policy for offering derivative products to the users, largely corporates. In its Comprehensive Guidelines on derivatives, RBI had urged the market-makers to undertake derivative transactions with users with a sense of responsibility and circumspection that would avoid, among other things, mis-selling. RBI has stated that it is imperative for market-makers to offer derivative products, general and structured products in particular, only to those users who understand the nature of the risks inherent in these transactions and further, the products being offered are consistent with users' business, financial operations, skill and sophistication, internal policies as well as risk appetite.

RBI also indicated that the responsibility of customer appropriateness and suitability review is on the market-maker.

Expectation of RBI from users/customers

While the above modification may not necessarily change how financial instruments are accounted for in the financial statements, it however focuses on needs to have enhanced internal control framework for corporates and could even impact their ability to transact in these instruments.

Through the market-maker, the RBI has mandated for specific information to be sought from corporates to demonstrate that they have laid down clear guidelines for conducting derivative transactions and institutionalised the arrangements for a periodical review of the operations and annual audit of transactions to verify compliance with the regulations.

Specific expectations from corporates

1. Before undertaking a derivative transaction or structured product a corporate will now be required to provide Board Resolution that states the following:

- The corporate has in place a Risk Management Policy approved by its 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;
  - Names and designation of officials authorized to undertake transactions and limits assigned to them;
  - A requirement that the assignment of limits to an official would be specific;
  - Accounting policy and disclosure norms to be followed in respect of derivative transactions;
  - A requirement to disclose the MTM valuations appropriately;
  - Mechanism regarding reporting of data to the Board including financial position of transaction etc.

2. A Corporate would not be able to undertake any derivative transaction which market maker cannot price independently and foreign banks cannot value the products in India.
3. A Corporate who wish to undertake structured product is required to follow prudent accounting and disclosure norms. Also the bank needs to make available a calculator that will enable the Corporate to mark-to-market the structured product on an ongoing basis.

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?
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 derivative transactions?
5. Is there a well defined reporting framework for reporting of the derivative positions and the effect on the financial reporting?
6. Do you have access to the market-makers calculator and are you able to evaluate the fair values at each reporting date?
7. How do you ensure the control over the accounting for the derivative financial instruments?
8. Have you evaluated adopting hedge accounting guidance which would help mirror the risk management objective and the financial statements accounting?
9. Are the internal audit procedures appropriately tailored to identify the key controls and ensure compliance with the ongoing increased regulatory guidance?

How can we help?

PwC would like to take the opportunity to share insights and experiences around this 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 reporting framework for various;
- 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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