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February 3, 2011

To,

All Authorised Dealers – Category I banks

Madam / Sir,

Internal Control Guidelines

Consequent to the rapid pace of evolution of the forex markets in India and abroad, developments in the field of Information Technology and its progressive usage in banks, the guidelines for “Internal Control over Foreign Exchange Business” have been revised. The revised guidelines are given in the enclosed document.

The document is designed to provide a scale of standards for the banks in the conduct of their foreign exchange business and is available on our website (www.rbi.org.in).

Yours faithfully,

(Salim Gangadharan)
Chief General Manager-in-Charge

Encl: as above (24 pages)

**GUIDELINES
FOR
INTERNAL CONTROL
OVER
FOREIGN EXCHANGE BUSINESS**

**RESERVE BANK OF INDIA
FOREIGN EXCHANGE DEPARTMENT
MUMBAI – 400 001**



February 2011

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FOREWORD

Guidelines for Internal Control over Foreign Exchange Business

The Internal Control Guidelines (ICG) initially framed in 1981 were revised in December, 1996 consequent to rapid pace of liberalization, structural changes in foreign exchange market and developments in the area of currency derivatives.

Due to the accelerated pace of structural changes in the global and domestic forex markets, developments in the field of Information Technology and further developments in forex derivatives and the challenges in the management of foreign exchange market, a further revision of the guidelines for 'Internal Control Over Foreign Exchange Business' was felt necessary.

Accordingly, a Group was formed to look into updation of the Internal Control Guidelines to make it a contemporary and benchmark document. The members for the Group were drawn from the Reserve Bank of India, Foreign Exchange Dealers' Association of India, Fixed Income Money Market and Derivatives Association of India, State Bank of India, ICICI Bank and Standard Chartered Bank. Feedbacks were also received from market related Departments of the Reserve Bank.

This revised edition of the ICG also takes into account the recent developments like introduction of exchange traded currency derivative contracts and the FEDAI code of conduct for service providers of electronic order matching systems. We hope that this document will provide a scale of standards for the banks in the conduct of their foreign exchange business.

Salim Gangadharan

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Foreign Exchange Department**

Mumbai,
February 3, 2011

CHAPTER 1 : ORGANISATION OF THE DEALING DEPARTMENT

1.1 General

Foreign Exchange dealing is a highly specialised function and has to be performed only by well trained personnel. Typically, a Dealing Department should consist of dealers, mid and back offices staff, who are responsible for the follow up of the deals made by the dealers. The need for effective control over the dealing operations is of great importance as possibilities exist for manipulation of exchange rates, dealing positions, mismatches, etc.

1.2 Segregation

The cardinal principle of operational procedures in the area of trading activities is the clear functional segregation of Dealing, Mid-Office, Back-Office (Processing and Control), Accounting and Reconciliation.

In respect of banks which trade actively and offer the whole range of products, dealing activities may be segregated as under:

- i) Front Office - Dealing Room
- ii) Mid - Office - Risk Management; Accounting Policies and Management Information System
- iii) Back Office - Settlement, Reconciliation, Accounting

1.3 Selection and Training of Dealers

Profound responsibility rests upon the dealers as the manner of handling the foreign exchange business of the bank can make all the difference to the bank and its customers. Adequate care therefore needs to be exercised while selecting and grooming the dealers. Management should provide opportunities to the dealing room staff to get continuously updated on global market trends in forex and derivatives trading and risk control.

While drafting personnel from other banks or organisations as dealers their antecedents should be carefully verified from the standpoint of integrity.

1.4 Electronic Data Processing (EDP)

The data processing systems used must be appropriate to the nature and volume of activities and programmed to ensure functional separation. Access rules for performing distinct functions should be defined in detail and drawn up by persons unconnected with the dealing activity. Confidentiality of the data in the systems may be ensured in the case of outsourcing of IT services to external agencies.

Where data is recorded direct in an EDP system, it must be ensured that dealers are enabled to enter transactions solely through identification. The trading date, time and transaction serial number must be entered automatically by the system, which must be made impossible for the dealer to alter without proper authorisation. If the dealer deviates from the specified norms while entering transaction data, this must be approved in each case by an official not connected with the dealing office. Deals concluded after the Back Office has closed recording for the day (late deals) are to be marked as such and included in that day's position. A late deal slip must be passed immediately to an official unconnected with the dealer.

1.5 Duties of Dealers

The dealer has to operate according to the guidelines laid down by the management. Ideally dealers may confer before work starts on the trend in the overnight markets in the light of the newsbag and the bank's own business and arrive at a tentative view of the market. It is essential that efficient communication channels be provided for dealers to facilitate consultations with designated authorities.

1.6 Dealing Procedure

The dealers should not be entrusted with accounting work. Deals struck should be recorded on printed deal slips. The deal slips should indicate the name of the broker (if any), and the counterparty bank, currencies, amounts, time, deal rate due dates and other necessary particulars depending on the type of product traded, under authentication of the dealer. The deal slips should be passed on without delay to the Back Office for further processing. Banks are free to devise the format of the slips. In an automated system, hard copies of deal slips may not be required.

1.7 Voice Recording

Experience has shown that recourse to taped conversation proves invaluable to the speedy resolution of differences. It is, therefore, desirable to introduce voice recorders in the dealing rooms. The tapes may be preserved for at least two months and where a dispute has been raised, until the issue is resolved. Access to the equipment and tapes should be subject to strict control.

1.8 Rotation of Dealers

The tenure and rotation of duties of dealers may be decided by the individual bank management which may, however, be documented in the bank's internal control policies. Further, a system of an annual compulsory two-week (or longer) continuous break should be maintained so that no dealer remains at the job continuously.

1.9 Code of Conduct

Authorized Dealers should conduct their activities with utmost prudence and integrity. Authorised Dealers must ensure that the staff concerned in the dealing room understand and abide by the Code of Conduct prescribed by FEDAI and FIMMDA. Dealers should be required to acknowledge in writing that they have read, understood and would observe the Code. It must be made clear to them that disciplinary actions could be taken against those who breach the Code. All dealers should furnish an undertaking to conform to the Codes of Conduct.

1.10 Code of conduct for Electronic Order Matching System (EOMS)

In the Indian forex broking service space, voice brokers are accredited by the FEDAI. With the advent and wide spread usage of technology, electronic forex broking and order matching systems have arrived in the forex market. As service providers were not subject to any regulation, FEDAI in 2009, evolved a Code of Conduct and Rules for self-regulation by EOMS. This has been communicated to the service providers to whom the Code is applicable with effect from January 1, 2010.

1.11 Back Office

The Back Office should ensure the following:

- (a) Independent confirmation of contracts is obtained for deals other than those put through the Clearing Corporation of India Ltd (CCIL), which are matched by CCIL from the counterparty banks and subject to exchange of one time bilateral agreement between them and duly verified for correctness and in no case the dealers sign the confirmation. In regard to Cash/Tom/Spot contracts, confirmations may not be followed-up, if the amounts thereof have already been received in the Nostro accounts.
- (b) Discrepancies noticed are rectified on the same day.
- (c) It should be ensured that there is no backlog of confirmation of deals.
- (d) In respect of computer generated deal confirmation slips, which are not signed, banks issuing such confirmation execute a stamped agreement in favour of the counterparty banks assuming responsibilities for errors/ omissions.
- (e) The evaluation of foreign exchange profits and losses are undertaken as directed in Chapter 4.
- (f) As most of the deals at present are put through online, pipeline transactions may be 'nil' or very few. The need for submitting a statement of true currency position is left to the discretion of the bank management.
- (g) The Position and Funds Registers are continuously updated on the basis of deal slips and the reports of business flowing in from the branches, to assist the efficient transmission of information to the dealing room and the management.
- (h) In such of those banks where the system does not provide the facility, Rate-Scan reports are prepared at least thrice a day (viz. at opening hours, afternoon and closing hours) and deals at wide variance with the ongoing market rates are enquired into.

1.12 Dealings in Exchange Traded Currency Products

The Currency Futures in the USD/INR pair were introduced in India in August 2008 through recognized exchanges, regulated by the SEBI. Subsequently, Currency futures in the Euro/INR, JPY/INR and GBP/INR pairs and Currency Options in the USD/INR pair have also been introduced.

Exchanges would normally require margin amounts to be deposited with them for trading in their products. The margin amount would vary, depending upon currency, volatility and other factors. At the end of business each day, exchanges based on closing prices, publish a daily settlement price, on the basis of which individual client's MTM may be computed.

Banks dealing in exchange traded products on behalf of their customers must ensure that the margin amounts required by the exchanges are recovered from their customers, as also the negative MTM, based on the daily settlement price. For proprietary trading portfolios in exchange traded products, banks must ensure revaluation of their portfolios on a daily basis, and apply stop loss norms as deemed fit, to these positions. All guidelines of the RBI, SEBI as well as extant regulatory guidelines, must be adhered to.

CHAPTER 2 : DEALINGS THROUGH EXCHANGE BROKERS

2.1 Exchange Brokers – Prohibitions

Exchange brokers, being intermediaries, are prohibited from acting as principals and maintaining positions in foreign currencies. Banks should therefore refrain from doing anything which may result in the brokers taking over the function of dealers/intermediaries.

2.2 Deals through Brokers – Confirmation

Brokers' notes should be received promptly before the close of business on the day on which the deals are concluded and exceptionally before the opening hours of the succeeding day. These should be checked and reconciled the same day.

2.3 Nomination of Brokers

Nomination of brokers for deals not put through their medium is not permitted.

2.4 Brokers' Panels

As a general rule, Authorised Dealer banks should not discriminate between recognised brokers for business offered at competitive terms. Ideally, at least 5/6 brokers should be empanelled and the panel should be reviewed annually, taking into account the nature and volume of the business done through the brokers, their market reputation, credit worthiness, etc.

2.5 Complaints

Any complaint from any source against the dealers must be promptly investigated.

Serious complaints alleging acceptance of gifts and other favours (or any other gratification) by the dealers should be put up to the appropriate authorities for necessary action. All such cases should be reported to the Central Offices of the Department of Banking Supervision and Customer Service Department of the Reserve Bank of India, indicating the nature of actions taken.

2.6 Payment of Brokerage Claims

The accounting department should maintain a broker-wise record showing details of the forex dealings made by the dealers. The staff of the dealing department should not have anything to do with the scrutiny and passing or payment of brokerage claims.

2.7 Brokerage Statements

A monthly statement showing broker-wise payments together with a statement for the preceding twelve months should be put up to the management. Changes in the panel of brokers may also be indicated in the report.

2.8 Malpractices by Brokers

Complaints relating to malpractices by brokers should be promptly brought to the notice of the Foreign Exchange Dealers Association of India, Mumbai.

CHAPTER 3: RISK CONTROL AND RISK MANAGEMENT

3.1 Introduction

In the wake of the major relaxation in foreign exchange management and the freedom given to Authorised Dealer banks to offer new forex products, focus on risks seems appropriate. Greater emphasis therefore will have to be laid on assessing, and managing risk. Authorised Dealers should offer products (structured or otherwise) to the customers strictly as per the extant Reserve Bank's Guidelines.

3.2 Requirements of the system

The risk control and risk management systems must be designed in accordance with the scale, complexity and risk content of the trading activities being conducted or envisaged.

3.3 Responsibilities of the Senior Management

Transactions in different hedging products (forwards and derivatives) have to be closely overseen by the senior management. Dealing in any new product or any change in the existing product design should have prior approval from the competent authority. Banks should have policies approved by the Board or a Committee so authorised in this regard by the Board, encompassing control processes guiding the activities.

The policies should detail the type and nature of the activity authorised, articulate the risk tolerance of the bank through comprehensive risk limits and require regular risk position and performance reporting within the following broad parameters which should be subject to periodical review. The policy of the banks to be approved as above to, inter-alia, include the following:

- a. the business strategies on which trading in the individual product groups is based,
- b. the markets in which trading is allowed,
- c. the nature, scope, legal framework and documentation of trading activities,
- d. the list of counterparties with whom trade may be conducted,
- e. the procedures for measuring, analyzing, monitoring and managing the risks,
- f. ceilings for risk positions according to the type of business or risk organizational unit or portfolio,

- g. the procedure for reacting to (i) any overshooting of the limits and (ii) to extreme market developments,
- h. the functions and responsibilities of individual members of staff and work units,
- i. internal accounting and external/internal reporting,
- j. staffing and technical equipment,
- k. the internal control and monitoring system,
- l. the maintenance of confidentiality in respect of trades,
- m. 'Suitability and Appropriateness' guidelines,
- n. electronic trading platforms,
- o. access control to dealing room, with audit trails,
- p. access control management and review.

It is essential that there must be a written acknowledgement of these guidelines from the members of the staff confirming that they have noted the relevant instructions applicable to them.

The bank should have an effective process of evaluation and review of the risks involved in various trading activities undertaken by the dealers, in respect of all hedging products. Some of these risks are mentioned below.

3.3.1 Credit Risk

Credit risk (Pre Settlement and Settlement) is the risk of loss due to inability or unwillingness of the counterparty to meet its obligation. This risk can be effectively managed through fixing of counterparty limits, appropriate measurement of exposures, ongoing credit evaluation and monitoring, and following sound operating procedures.

a) Pre-settlement Risk

Pre settlement risk is the risk of loss due to counterparty defaulting on a contract during the life of the transaction. The exposure is also referred to as the replacement cost. The level of this exposure varies throughout the life of the hedging product and is known with certainty only at the time of default. A key tool for the effective management of this risk is the fixation of exposure limits on counterparties.

b) Settlement Risk

Settlement risk is the risk of loss arising when a bank performs on its obligation under a contract prior to the counterparty doing so. The risk frequently arises in international transactions because of time zone differences. The failure to perform may be due to operational breakdown, counterparty default or legal impediments. Banks should, therefore, monitor and control settlement risk very effectively.

3.3.2 Liquidity Risk

Liquidity risk is the risk that the bank will be unable to meet its funding requirements or execute a transaction at a reasonable price.

Market liquidity risk is the risk of a bank not being able to exit or offset positions quickly at a reasonable price.

3.3.3 Gap Risk/Interest Rate Risk

These are risks owing to adverse movements in implied interest rates or actual interest rates differentials that arise through transactions involving foreign currency deposits, forward contracts, currency swaps, forward rate agreements, forward delta equivalent of currency options trades, and through numerous other currency and interest rate derivatives.

3.3.4 Legal Risk

In addition to the foregoing risks, there is legal risk, which exists in all kinds of financial markets. It is probably more so in foreign exchange and interest rates given their inherent volatility. It is, therefore, extremely important that banks as also the corporates dealing in these products take such steps as would sufficiently protect them from the legal standpoint.

The surest way to do so is to insist on exchange of internationally accepted Master Agreements such as ISDA, IFEMA, and ICOM between the parties to be supported by other relevant documentation.

3.3.5 Operational Risk

The data processing system used must be appropriate to the nature and volume of trading activities. A written contingency plan has to ensure, among other things, that in the event of a break down of the equipment back up facilities can be deployed at a short notice. (Please also refer DBOD Circular on 'Comprehensive Guidelines on Derivatives' dated April 20, 2007)

3.4 The risk management process

Banks should have a comprehensive and adequate risk management procedure covering both trading and non trading activities. This procedure should enable the management to assess exposures on a consolidated basis. It should be easily understood by the dealers, back office, mid office staff, senior management and the Board of Directors. Such a procedure will assist in limiting and monitoring risk taking activities at all levels.

3.5 Limiting risks

Global limits should be set up for the bank's local interbank business as well as its transactions in the overseas markets. The 'limits' system should be consistent with the banks overall risk management process, expertise and the adequacy of its capital to undertake such activities. At present the net open exchange position limit and the Gap limits for maturity mismatches fixed by each bank require approval of the Reserve Bank.

Management has to set an upper limit for losses, bearing in mind the bank's capital and earnings performance. Based on the risk control analysis and the upper limit for losses, a system of risk containing limits is to be set up which should be related both to credit risks and to market price risks. Overall limits are to be set and approved by the management for each category of risks.

Appropriate Value-at-Risk (VaR) models need to be used for quantifying the extent of market risk for a given level of confidence. Periodic review of existing models (such as VaR) including assumptions used should be done to test the robustness. Further, banks should maintain appropriate internal control systems, for managing pre - settlement credit risk. For settlement risk, whenever there is a central counterparty recognized as

such, the risk weight would be subject to the Reserve Bank norms and in all other cases, the nominal exposure may be equal to actual credit risk.

The banks must adhere to the following risk-containment measures:

- The bank should ensure that every dealer is advised promptly of the limit allocated to him.
- All deals done should be accounted for against the corresponding limits. All the individual positions are to be aggregated into overall risk position at the close of business each day with a view of ensuring that the same does not exceed the overnight limit authorised by the management and NOPL and AGL approved by the Reserve Bank.
- The limits when exceeded should be promptly reported to appropriate senior management and got approved. Banks should therefore have an adequate control system in this regard.
- Any breach of regulatory limits should be promptly reported to Reserve Bank of India, Foreign Exchange Department, C.O., Mumbai.

3.6 Reporting System - Management Information System (MIS)

An accurate, and timely MIS, is *sine qua non* to a bank's risk management process. An effective MIS should facilitate a bank's monitoring of compliance with internal controls and regulating requirements and provide reasonable comfort that these are being complied with.

The bank's risk exposures should be reported to senior management/Board. In adverse market conditions, more frequent reports should be placed before Board/Committee. The monitoring and reporting should be undertaken by officials who are not directly concerned with the trading activities. Exposure and profit and loss statement should be submitted to the senior management. In times of volatile market conditions, such reports should be submitted more frequently so that the senior management is fully apprised of the levels of activities and the risk involved.

3.7 Documentation and Record Keeping

As regards documentation with counterparty banks and with clients, banks are to be guided by the following:

(a) Forward exchange contracts with tenor not exceeding 13 months

i) Contracts between banks and customers-

Banks should obtain specific individual contract note (duly stamped), for each transaction containing the detailed terms of the contract such as amount, rate, value /delivery date, etc.

ii) Inter- bank deals-

With regard to forward exchange contracts between banks, unsigned computer generated confirmations be exchanged backed by 'one time' stamped letter of indemnity executed in favour of the counterparty banks as per FEDAI guidelines.

(b) Forward exchange contracts where the tenor exceeds 13 months

i) Contracts between banks and retail/individual customers-

As given at (a) (i) above.

ii) Inter -bank deals and contracts with other customers-

Banks should enter into International Swaps and Derivative Association (ISDA) Master Agreement.

(c) All other derivative transactions

i) Contracts between banks and retail / individual customers-

As given at (a) (i) above.

ii) Inter- bank deals and contracts with other customers-

Banks should enter into International Swaps and Derivative Association (ISDA) Master Agreement.

Note:

1. If member banks have entered into International Currency Options Market Agreement (ICOM), they may continue with it for all option transactions.

2. In regard to spot interbank deals, confirmation may not be insisted upon if the amounts thereof have been received in the Nostro account [Refer para 1.10(a) ICG].

3. In respect of item numbers (a) (I), (II) and (b) (I), member banks who have obtained International Foreign Exchange Master Agreement (IFEMA) or International Swaps and Derivative Association (ISDA) Master Agreement may continue with the same, if so desired.

4. In respect of (b) and (c), ISDA Master Agreement would be in force till altered by mutual consent. Banks should however obtain specific signed confirmation for each transaction which should detail the terms of the contract such as amount, rate, value date, etc. duly signed by the authorised signatories.

Banks should obtain Board Resolution from their corporate clients specifically authorising their officials to deal and execute contracts (including derivatives).

Banks should also establish processes (checklists, tickler files, etc.) to ensure proper documentation to support these transactions and to monitor and control receipt of the documents.

3.8 Preservation of Records

All business, control and monitoring records should be preserved up to the existing statutory retention periods. Wherever statutory retention periods are not stipulated they are to be preserved as per the internal guidelines of the bank management. Back up of crucial information and data should be done and preserved according to the IT policy of the bank.

CHAPTER 4: EVALUATION OF FOREIGN EXCHANGE PROFITS AND LOSSES

Methods of Evaluation

The uniform standard Accounting Procedure for evaluation of profit / loss of foreign exchange transactions drawn up by the FEDAI and approved by the RBI should be strictly adhered to and valuation undertaken at least at the end of each month and on the balance sheet date.

The evaluation should disclose the actual profit / loss under different heads such as exchange trading, interest income, commission, etc.

CHAPTER 5: RECONCILIATION OF 'NOSTRO' BALANCES

5.1 Importance of Reconciliation

Reconciliation of 'Nostro' Account balances is an essential control function and is intended to ensure that every transaction undertaken by the bank in its Nostro account has been correctly executed.

The basic records for reconciliation are bank statements which should be received at least weekly and, the mirror account. Reconciliation must be done choosing the same date for Mirror accounts and foreign bank statements. Action on unreconciled items must be taken on an on-going basis and any delay in this regard will render reconciliation more difficult, particularly, because the correspondent banks/ branches abroad employ computerised accounting systems and micro filming procedure. Bank references quite often also involve additional costs apart from further avoidable delay.

To minimise the number of unreconciled items it is the practice of the banks to put through transactions in suspense account such as Export bills purchased, Export bills discounted, Drafts / Travellers cheques issued, Advance bills received, Inward bills/ drafts etc. As a further measure for simplification, some banks have permitted more branches to maintain independent Nostro accounts with different correspondent banks. While it is advisable for banks with a large network to adopt both measures, the management at each office maintaining Nostro accounts should be required to exercise the requisite control over reconciliation and the suspense accounts. The records of reconciliation must be held under safe custody and preserved for a sufficiently long period for reference.

It should be ensured that no set-off of debit or credit items has been made/any unreconciled item written off or appropriated to profit & loss except as permitted under the Reserve Bank guidelines.

5.2 Management Control

A monthly report should be submitted by Reconciliation Department indicating the progress made in reconciliation of Nostro account balances highlighting special features such as large unreconciled items, age-wise grouping of items, etc.

CHAPTER 6: MANAGEMENT OF RISK ARISING IN RUPEE (VOSTRO) ACCOUNTS

6.1 Control over vostro accounts too covers various aspects, viz. funds flow into the accounts, observance of discipline in credit lines extended to the correspondent bank, concealed overdrafts (and recovery of interest thereagainst), apart from periodical evaluation of credit risks.

6.2 Banks should assess their credit risks periodically say, at least once in twelve months vis-à-vis their correspondent banks whether or not they maintain Rupee accounts.

6.3 The credit risks arising from drawings on branches can be significant unless proper control is exercised over the flow of the paid drafts, etc. to the account maintaining office from the drawee branches. Such risks can be minimised by adoption of one or more of the following measures.

- i. Reduction in the number of branches on whom drafts, etc. can be drawn.
- ii. Imposition of suitable limits for drawing or for aggregate drawings during a day.
- iii. Securing draft, etc. issued advices from the correspondent.
- iv. Decentralisation of Vostro accounts by opening subsidiary or independent accounts at other important offices.
- v. Arrangements for advice over expeditious mode of communication of large payments by paying branches.
- vi. Prompt value-dating.
- vii. As far as possible, bringing all the drawee branches under Core Banking Solution.
- viii. Where on-line monitoring of funds position is ensured to avoid concealed overdrafts in vostro accounts.

6.4 Special Aspects for Vostro Account Monitoring

Close monitoring of funds flow in Vostro account is required with a view to averting hot money flows on the one hand and speculative dealing in the Rupee on the other. Apart from this, the accounts should be monitored for quickly identifying sudden changes in volume of operations, changes in nature of operations, etc. so that discreet enquiries can

be made about the cause for the changes. Any unusually large operations (whether credits or debits) in inactive or the less active Vostro accounts should be promptly looked into to ensure that they are genuine operations.

6.5 Confirmation of balances

It is an essential feature of customer service to the overseas banks maintaining Vostro accounts to send out certificates of balance and obtain conformation thereof periodically. It should be ensured that the confirmations duly signed by the authorised signatory of the bank are received in time and are kept on record. Authenticated SWIFT confirmation may also be acceptable.

CHAPTER 7 : CONTROL OVER MISCELLANEOUS ASPECTS OF DEALING OPERATIONS

7.1 Dealing Hours

The dealing hours for USD/INR transactions should be as per FEDAI guidelines in force. In respect of cross- currency transactions, if dealers are required to work longer hours it is essential that the managements lay down the extended working hours.

7.2 Off-premises and After Office Hours Trading

The bank should embed in its policy document whether deals done off-premises and after office hours are permissible. If such transactions are permitted, adequate controls should be put in place to ensure that transactions are executed by authorised personnel and within the approved limits. Particulars of these transactions must be entered into the bank's account at the earliest.

The bank should also lay down clear guidelines regarding use of other communication equipments, if permitted, such as mobiles, chat facility on internet, etc., for dealing after office hours, and regarding primary record of the transaction. (Regarding preservation of records refer to Para 3.8)

7.3 Substitution of names of banks in inter-bank contracts

Substitution of one bank by another in inter-bank contracts by broker is not a recognised practice as brokers operate on the specific instruction of the dealers and not vice versa. Substitution is, therefore, prohibited.

CHAPTER 8: AUDITING

8.1 Internal Audit

The nature and scope of internal audit varies widely between banks. However, its work will generally be designed to ensure that established procedures are adhered to and are operating effectively. Thus, an important part of its work will be to review the adequacy and timeliness of key management reports, such as those relating to limit excesses and maturity periods, and to ensure that appropriate action is initiated in response to this information. Other tasks of the internal audit department will include statutory and regulatory compliance reviews, data processing control reviews, and back-office efficiency reviews. For the internal audit function to be beneficial it is essential that its reports are submitted promptly to senior management.

The officers drafted for audit should have the requisite expertise, knowledge and experience.

8.2 System Audit

Special audit of the Dealing Room and the system in operation should be conducted at least once in a year. Typically, the areas tested during this audit should include the following:

- i. Dealing-room procedures to ensure that all deals executed are promptly captured by the accounting system.
- ii. Reconciliation of foreign exchange positions between the dealers' records and the accounting system.
- iii. Review of incoming deal confirmations.
- iv. Full scrutiny of sample deals.

Compliance with the minimum requirements is to be checked at irregular, appropriate intervals by the auditors. The main audit areas listed below should be subjected to a risk-based audit once a year.

- ❖ limit system
- ❖ determination and reconciliation of positions and results
- ❖ changes in the EDP systems
- ❖ completeness, correctness and timeliness of the internal reporting system

- ❖ functional separation
- ❖ degree to which transactions are in line with market conditions
- ❖ confirmations and counter-confirmations

8.3 Concurrent Audit

As advised by the Reserve Bank from time to time, concurrent audit is to be regarded as a part of AD's early-warning signal system to ensure timely detection of irregularities and lapses aimed at prevention of fraudulent transactions at branches undertaking foreign exchange transactions. Bank's management shall bestow serious attention to the implementation of the same. While minor irregularities pointed out by the concurrent auditors are to be rectified on the spot, serious irregularities should be reported to the Controlling Authority for immediate action. The bank shall ensure that concurrent auditors of the branches undertaking foreign exchange transactions are also fully conversant with the provisions of FEMA and the Rules/ Regulations/ Notifications/ Directives issued under it.