Limits on UK banks' foreign exchange positions

Introduction

The much publicised foreign exchange losses suffered by a number of leading banks in 1974 provided some salutary lessons and aroused sudden widespread interest in possible official limits on banks' foreign exchange positions. Some central banks or regulatory authorities subsequently introduced new controls on such positions. In the United Kingdom, however, exchange control has imposed limits on banks' positions since foreign exchange markets generally reopened in the autumn of 1951. The limits in their present form date from early 1959, shortly after the return to general non-resident convertibility, and apply to all banks authorised by the Treasury to deal in foreign currencies.

Limits on foreign exchange business are applied by the banks in at least three different areas – currency exposure, maturity mismatching, and credit risk. This article deals only with official limits on currency exposure, but these are supplemented by banks' own internal limits in all three areas.

The limits

Authorised banks in the United Kingdom must observe two limits at the close of business each day:

a an *open position* limit for all foreign currencies together, both spot and forward, against sterling; and

b a *spot against forward* limit, also for all foreign currencies together, against sterling, on net current assets held in cover of net forward sales.

At the outset there is a problem of definition. In foreign exchange market terminology, 'spot' relates to deals which are to be settled up to two days ahead, while 'forward' transactions refer to all deals for value beyond two working days ahead. In all statistics reported to the Bank, however, 'spot' is defined as *current* assets and liabilities, and all spot deals awaiting settlement are treated as forward deals and so included under forwards. It is the latter, statistical, definition of 'spot' which is applied to the limits under discussion; and although it differs from market terminology, the anomaly is recognised and accepted throughout the London foreign exchange market.

The *open position* limit applies to the difference between a bank's assets and liabilities in all foreign currencies including forwards; its position may be either 'long' (i.e. where the bank is holding net assets in foreign currency) or 'short' (net liabilities). The limit operates symmetrically, controlling both the extent to which a bank may have an overall net liability (which, when eliminated, would ultimately entail a drain on the official reserves, or exert a downward influence on sterling's exchange rate), and an overall net asset (which, when eliminated, would ultimately be included in the official reserves, or exert upward pressure on the rate). Table A shows a long open position of £30,000, i.e. the bank holds net assets in foreign currencies of the equivalent of £30,000 spot and forward taken together. Its current assets in foreign currencies exceed its current liabilities in foreign currencies by the equivalent of £80,000, but it has contracted to deliver £50,000 of foreign exchange forward.

Table A
£ thousands

	Spot	Forward	Total
Foreign currency assets	100	–	100
Foreign currency liabilities	20	50	70
Net	+ 80	–50	+ 30

The *spot against forward* limit controls the extent to which net current assets in foreign currencies may cover net forward liabilities. It is not symmetrical, operating only when a bank has a net spot asset and a net forward liability. In Table A, the spot against forward position is £50,000 (i.e. out of £80,000 of net spot assets, £50,000 is held in cover of net forward liabilities). The purpose of this limit is to minimise the amount of foreign currency held outside the official reserves. Where the

Table B
£ thousands

	Spot	Forward	Total
Foreign currency assets	200	20	220
Foreign currency liabilities	40	140	180
Net	+160	−120	+ 40

Table C
£ thousands

	Spot	Forward	Total
Foreign currency assets	100	20	120
Foreign currency liabilities	40	150	190
Net	+ 60	−130	− 70

banks as a whole are holding a significant amount of net spot assets against net forward sales, the country's foreign exchange assets are dispersed throughout the commercial banking system rather than held in the central reserves. A country like the United Kingdom, whose reserves are small in relation to its short-term liabilities, cannot afford such dispersion.

The two limits are treated separately. For example, it is possible for a bank to be within its open limit, but outside its spot against forward limit, or conversely. This is shown in Tables B and C, which assume an open limit of £50,000 and a spot against forward limit of £100,000. In Table B, the open position (net foreign currency assets of £40,000) is within the open limit, but the spot against forward position of £120,000 exceeds the limit by £20,000. In Table C, the open position (net foreign currency liabilities of £70,000) breaks the open limit, but the spot against forward position of £60,000 is within the limit.

The fact that the spot against forward position is controlled, and that both limits operate against sterling only, shows that the prime objective of the limits is to protect the official reserves. Prudential limits would concern themselves only with the open position, while extending that concern to each individual foreign currency. Nevertheless, prudential considerations (see page 358) were not ignored when the limits and the reporting system were devised; and this explains why the limit on the open position operates both ways, controlling short positions (net liabilities) in foreign currencies, as well as long positions (net assets). Moreover, from the point of view of market management, open positions have an equally disruptive potential either way — a large open position in favour of sterling is only too liable to be reversed at a highly inopportune moment for the authorities.

Unlike the open limit, the spot against forward limit only works one way, and does not limit the amount of net spot liabilities that may be held against net forward purchases of foreign currencies, so that UK banks can switch into sterling without restriction. The reason for this is that non-residents are normally freely permitted to acquire sterling, and inflows into sterling therefore cannot be stopped;[1] a 'negative spot' against forward limit would simply exclude UK banks from this type of business.

Use of limits

It is only possible here to indicate briefly why banks need to hold foreign currencies:

a they must have some slight flexibility to absorb temporary market fluctuations and the mismatching between broken, and sometimes very small, amounts for customers and minimum marketable amounts;

b they need to maintain working balances abroad in foreign currencies, which for the main UK deposit banks are large both in number and in aggregate amount;

c the major UK deposit banks in particular also need to hold large amounts of foreign currency notes in tills to meet customers' travel requirements;

d the banks need to have some cushion against deliveries by customers under option contracts late in the day.[2]

It might also be supposed that the spot against forward limit is designed to give banks some latitude in meeting forward sales of foreign exchange to customers by an initial spot purchase, rather than expecting every forward sale to be immediately matched by a forward

[1] For temporary measures designed to discourage inflows into sterling between August and December 1971 see the September and December issues of the 1971 *Bulletin*, pages 296 and 436.

[2] Foreign exchange options relate only to the date of take-up, and do not constitute an option as to take-up itself.

purchase. In theory this is so, but the limits are in practice hardly large enough for the uses already listed. Moreover, the latitude for covering forward sales to customers comes mainly from the fact that, as mentioned earlier, a spot purchase in cover of such a forward sale counts as a forward transaction for the two days which normally elapse before the deal is settled: the bank thus has two days in which to match the forward sale to its customer with a forward purchase elsewhere.

How the limits are set

Exchange Control Notice EC 54, which regulates dealings in foreign currencies, establishes basic limits of £50,000 for the open position and £100,000 for the spot against forward, unless other limits are agreed with the Bank of England. For the purpose of setting limits UK banks may be divided into three categories:

a UK-owned banks;

b UK banks which are wholly or largely foreign owned (including consortium banks);

c branches of foreign banks.

Limits for UK-owned banks have developed largely pragmatically, with particular regard to the size of a bank's branch network in the United Kingdom and its need for overseas correspondents.

UK subsidiaries of foreign banks, and consortium banks with a significant foreign ownership, are allowed by exchange control to regard a certain proportion of their capital resources in foreign currency as constituting their limits.

In recent years newly-arrived branches of foreign banks have been confined to the limits set out in Exchange Control Notice EC 54. This has meant that, while such branches are offered the full facilities of the London market, they have been required to provide any further working balances (over and above their basic limits) from foreign exchange resources, rather than add to the demand on the United Kingdom's reserves by creating working balances out of borrowed sterling resources.

The Bank of England obtain weekly reports of spot and forward assets and liabilities from the banks, and may also carry out snap checks. A bank is free to approach the Bank for an overnight dispensation from its limits if they seem likely to be broken by special circumstances.

Valuation problems

Any system of foreign exchange limits where several currencies have to be expressed in terms of a single denominator, in this case sterling, is bound to create valuation problems. These are compounded when there are two limits, each ideally requiring a different method of valuation – current rates for open positions and historic rates for the spot against forward. Such a dual system would, however, be excessively burdensome. In choosing a single system of valuation, the Bank naturally preferred the one which would be more useful to individual bank managements; and because management is mainly concerned with prudential considerations, which are best served by current rates, the Bank and the British Bankers' Association agreed to use only current rate valuations for all reporting purposes.

However, the sharp changes in rates during most of the last decade have given rise to some difficulties, particularly for the spot against forward limit. For example, it was a popular feature of the late sixties for UK banks to take dollar deposits, swap them on a covered basis into deutschemarks and Swiss francs, and extend loans in these currencies: the subsequent appreciation of the deutschemark and Swiss franc severely distorted the banks' reported figures valued at current rates, with the result that many spot against forward limits were broken. The

Bank are well aware of these and other problems associated with limits, and are always ready to discuss the difficulties they create with any particular bank. Moreover, in their recent reform of banking statistics, the Bank have suggested a method of dealing with limits which would not involve an additional valuation, and they are ready at any time to give individual banks further details of this method.

Prudential aspects

Although the control of banks' positions in foreign currency is mainly designed to protect the official reserves, it has undoubtedly helped to create a climate in which limits, albeit against only one currency, have to be examined regularly. Moreover, even though the limits are against sterling only, the monthly returns enable the Bank to examine and, where necessary, to query the banks' individual positions, both spot and forward, in all the leading currencies, and in any other currency in which a bank has significant assets and liabilities. The Bank's regular prudential examinations of banks also include discussions of their maturity matching and any other unusual aspect of their foreign exchange position revealed by the returns.

Conclusion

The events of the past two years in both domestic and foreign banking, and particularly in the field of foreign exchange, have created an entirely new acceptance of regulatory initiatives. These have not been necessary in the United Kingdom in the case of limits on foreign exchange exposure, since such controls have existed for over two decades. Nevertheless, some old home truths appeared to have been neglected in a number of areas recently, and the Bank took the opportunity of reminding the banking community of them in a letter from the Governor last December. This initiative, rather than being resented, appears to have been widely welcomed, and has been followed by similar initiatives in other countries. Meanwhile, the Group of Ten Committee in Basle, chaired by Mr. Blunden of the Bank, is engaged in a number of other exercises which are designed to maintain or improve the health of international foreign exchange and deposit markets.