Foreign currency exposure

Paper issued by the Bank on 24 April 1981.

A Introduction

1 This paper sets out the basis on which the Bank will measure, monitor and discuss with banks and licensed deposit-taking institutions (both groups hereafter referred to collectively as 'banks') their exposure to movements in exchange rates.(1) These arrangements will form part of the regular process of supervision and be included within the scope of prudential interviews.

2 The arrangements set out in this paper will apply to those banks for which the Bank of England has supervisory responsibility under the Banking Act. Banks in the Channel Islands and the Isle of Man are, therefore, not included. There are different arrangements for UK-incorporated banks and for branches of foreign banks, although both will participate in the same reporting system. These arrangements are covered in detail in Section C.

3 The primary responsibility for the control of exposures arising from foreign currency operations, as for any other aspect of a bank's business, must rest with a bank's own management. However, in the discharge of its supervisory responsibilities, the Bank needs to know the methods by which bank managements control such exposures, the extent of each bank's exposure, and its relation to other risks and to its capital.

4 Foreign currency operations give rise to risks which, although not unique, are probably more pronounced than in other markets. Satisfactory internal control procedures are essential. A number of the more important aspects of such controls were described in the Bank's circular of December 1974, an extract of which is attached as an annex to this paper. The Bank will wish to be informed about the general arrangements within each bank for controlling its foreign currency trading.

5 Exposure to movements in exchange rates is only one of the many categories of risk to which banks are subject in the conduct of their foreign currency operations. The broad range of risks is considered in the risk assets ratio, set out in the Bank's paper *The measurement of capital*,(2) in which the aggregate foreign currency position is included. However, the nature of foreign currency operations and the short time scale in which significant exposures to loss can be incurred as a result of them present particular problems and, in the Bank's view, justify special arrangements.

B Elements to be measured

Positions

6 The Bank is concerned with exposures arising out of any uncovered foreign currency position in any currency. Furthermore, each bank's exposure needs to be considered both in terms of its net position in any one currency and its overall position, i.e. the aggregate net position in all currencies.

7 Net currency positions will include the position held against sterling (more easily measured as the net position in sterling) because the risk of loss arising from a net open position in sterling is no different from that arising from a position in any other currency. The net position in sterling will, therefore, be monitored separately and included in the assessment of each bank's overall exposure.

8 Transactions in precious metals which result in positions have similar characteristics to those in currency. All references in this paper to currency should be taken to include gold; for a few specialist banks, the Bank will also take positions in silver into account.

Accruals and future flows of income and expense

9 Anticipated flows of income and expense not yet received can give rise to an exposure which, if determinable, should in principle be measured. Those which have been accrued will have been included by the bank as an asset or a liability in the measurement of its overall exposure. Those which have not been accrued (including known future flows) need not be included, unless the bank wishes to do so because it has already covered them.

Dealing and structural positions

10 Banks often find it convenient to identify and distinguish foreign currency exposures which arise from their daily or 'normal' banking operations (henceforth referred to as 'dealing' positions) from those exposures which are intended to be of a longer-term nature (henceforth referred to as 'structural' positions). The Bank believes this is a valid distinction and that structural positions may conveniently be considered separately from dealing positions. It will, therefore, be prepared to exclude structural positions from the guidelines agreed with each bank. This distinction does not mean that the Bank considers structural exposures are without risk, and the aggregate foreign currency position included in the risk assets ratio set out in the Bank's paper *The measurement of capital* encompasses dealing and structural positions.

(1) The paper reflects the outcome of consultations with the banking community on the discussion paper on the same subject issued in December 1979, following the Governor's letter to banks of 23 October 1979.

(2) Issued by the Bank in September 1980 and reproduced in the September 1980 *Bulletin*, page 324.

11 Each bank will have its own views on the categorisation of exposures as dealing or structural. The dividing line will not always be clear cut and will depend on the particular circumstances of that bank. The Bank will wish to ensure, however, that the make-up of a structural position does not undermine the application of the guidelines for the dealing position. Therefore the Bank will wish to be consulted on whether any part of a position in any currency should be treated as structural. The Bank would normally accept, as structural, exposures arising from banks' fixed and long-term assets and liabilities, including such items as loan capital, premises, and investments in subsidiaries and associates. It might also be appropriate to treat, as structural, positions which banks are obliged to maintain as a result of laws or market conditions to which their overseas affiliates are subject, and positions which arise as a result of reserves or provisions being maintained in currencies appropriate to the banking risks against which they are being held.

C Reporting and monitoring

UK-incorporated banks

12 The Bank will not set any formal limits on the size of a bank's foreign currency positions, but will agree dealing position guidelines with each institution individually. These will take account of the institution's particular circumstances and expertise.

13 The guidelines will be expressed in terms of a relationship between the dealing position and the bank's capital, because it is ultimately from this source that any loss arising from the position has to be made good. As a general rule, for banks which are experienced in foreign exchange the Bank will expect to agree the following guidelines:

(i) Net open dealing position in any one currency: not more than 10% of the adjusted capital base, as defined in the Bank's paper *The measurement of capital* for the risk assets measure.

(ii) Net short open dealing positions of all currencies taken together: not more than 15% of the adjusted capital base.

The Bank would expect banks inexperienced in foreign exchange to operate within more conservative guidelines. Since exposure to a movement in any exchange rate is represented by both a long position in one currency and an equal but opposite short position in another currency (or several currencies combined), a bank's aggregate exposure can be measured as the sum of either its long or short positions. For purposes of calculating (ii) above, each bank's overall exposure will be measured as the sum of its net short open positions, spot and forward taken together.

Overseas branches of UK banks

14 For banks incorporated in the United Kingdom, the arrangements described above will apply to the operations of all their branches, both in the United Kingdom and overseas. The Bank appreciates that some banks are still developing their internal reporting systems for overseas branches and will be prepared to discuss with individual banks any problems arising from this proposal.

Subsidiaries of UK banks

15 The Bank will wish eventually to include in its consolidated assessment of capital adequacy foreign currency exposures of UK banks' subsidiaries, both domestic and overseas. This will be the subject of further consultation with the banking community in due course.

UK branches of foreign banks

16 The Bank of England has supervisory responsibility under the Banking Act for UK branches of foreign banks, although, in fulfilling such responsibility, it is enabled, under the Act, to place substantial reliance on the supervisory authorities in the country of origin. In order to carry out its responsibility under the Act and to see that foreign exchange markets in the United Kingdom are conducted in an orderly manner, the Bank will require returns to be made by UK branches of foreign banks.

17 The Bank appreciates that the operations of UK branches of foreign banks are frequently closely integrated with those of their parents and that it would be inappropriate to supervise such branches in isolation. Furthermore, these branches do not have a separate capital base against which positions can be measured. In monitoring the foreign currency operations of foreign branches, the Bank will take account of a branch's own internal controls, those exercised by its head office, and the monitoring arrangements of its own supervisory authority. Where it considers these are satisfactory the Bank will not apply separate guidelines. Where they are not satisfactory, the Bank will agree appropriate absolute levels of exposure to serve as guidelines.

Frequency and method of reporting

18 In order to monitor banks' positions, the Bank will require returns to be made on a monthly basis. The returns will give, in contracted currency amounts, the net spot long or short position and the net forward long or short position in each currency at the close of business on the reporting day. The sum of these positions will give the overall net position in each currency, in currency terms.

19 Where it has been agreed that part of a bank's position in a particular currency should be regarded as structural, this part will be deducted from the overall net position in that currency to give the dealing position.

20 The Bank will expect apparent positions arising from covered transactions, such as swaps, to be excluded from dealing positions. In a swap, one exchange transaction is linked to another at a later date and exchange differences create an apparent open position in one of the currencies comprising the swap. In most cases such positions would be eliminated by including in dealing positions appropriate amounts drawn from the internal accounts or records associated with swap transactions.

21 Dealing positions once established should be translated into sterling at current spot exchange rates. The use of forward exchange rates within the structure of the reporting arrangements described above would be inappropriate, as it would draw into the exercise exposure to movements in interest rates. The valuation of positions arising from spot and forward transactions in each currency at a single rate will also be simpler.

22 The overall net position in sterling need not be independently calculated. It should be reported as that balancing amount which ensures that the sum of all the overall net long positions equals the sum of all the overall net short positions.

23 The return made at the end of each period should also contain a report of each occasion on which the net open dealing position in each currency or the aggregate net short open position has exceeded the guidelines agreed between the Bank and the reporting institution.

Other arrangements

24 These reporting requirements will not change the existing informal arrangements whereby the Gold and Foreign Exchange Office of the Bank may from time to time discuss dealing positions directly with dealers.

Annex
Control of foreign exchange dealing(1)

Reports of the losses suffered this year by banks in a number of countries, as a result of operations in foreign exchange markets, will undoubtedly have caused many banks to undertake a rigorous review of their internal regulations governing procedures for foreign exchange dealings by, and dealing and overnight and forward credit limits imposed on, individual branches and wholly-owned subsidiaries at home and abroad. Any banks which have not yet done so are urged to undertake such a review as soon as possible and to ensure in particular that authorities to deal are specific and are confined to strictly selected staff and branches.

The list that follows is not intended as an exhaustive check for conducting such a review; it merely covers points which have arisen from the Bank's discussions in a number of centres about the losses:

1 Some general managements seem to have placed their dealers in an exposed position by looking well beyond the service element of the dealing function and imposing ambitious profit targets upon them.

2 In some overseas offices, managements do not appear to have paid sufficient attention to the relations between dealers and brokers; in London, the Foreign Exchange and Currency Deposit Brokers' Association has exercised a beneficial influence in this area.

3 Dealers should never write their own outgoing confirmations or receive incoming confirmations.

4 Forward deals should always be confirmed at once; in particular, confirmations should not be delayed until instructions are passed just prior to maturity.

5 There should be snap checks of dealing activities between regular internal audits or inspections.

6 Central management should from time to time, on a random basis, seek from correspondent banks independent second confirmations of outstanding forward contracts.

7 A bank should check with its correspondent's head or main dealing office if it notices that a branch of that bank has suddenly or appreciably expanded its operations in the forward market.

(1) Extract from the Bank of England circular of December 1974.