SUPERVISION OF BANKS' FOREIGN EXCHANGE POSITIONS
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I. General remarks

There are many activities of banks which involve risk-taking, but there are few in which a bank may so quickly incur large losses as in foreign exchange transactions. The risks inherent in foreign exchange business, particularly in running open foreign exchange positions, have been heightened in recent years by the increased instability of exchange rates. Consequently, the monitoring of these risks has become a matter of increased interest to supervisory authorities.

The purpose of this note is to consider the prudential aspects of banks' foreign exchange activities. It is not directly concerned with the restrictions that countries may place on their banks' foreign exchange business for exchange control, monetary or other macro-economic reasons. In exercising prudential control over this area of banks' activities, however, supervisory authorities need to take into account the role of the banks as "market-makers" in foreign exchange. This role has two aspects. Firstly, banks have to quote rates to their customers (including other banks) at which they stand ready to buy and sell currencies. Secondly, by themselves taking open positions in currencies, banks (as well as non-banks) help to ensure that the foreign exchange markets are balanced at any point of time without excessive and erratic exchange rate fluctuations. In other words, supervisors have to weigh prudential considerations against the need to enable the banks to play their part in the smooth and efficient functioning of the exchange markets. Whatever may be the exact balance struck between these considerations, supervisory authorities must seek to ensure that the risks assumed by banks in their foreign exchange operations are never so large as to constitute a significant threat either to the solvency and liquidity of individual banks, or to the health and stability of the banking system as a whole.

II. Types of prudential risks

While banks are exposed to a number of different types of risk in the conduct of their foreign exchange business, most of these risks also feature in domestic banking business. In principle, the only risk peculiar to foreign currency business is the *exchange rate risk*, i.e. the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position, either spot or forward, or a combination of the two, in an individual foreign currency.

The other risks incurred by banks conducting foreign exchange operations arise more as a result of the international aspects of such business than because foreign currencies are involved. One such risk is the *interest rate risk*, which arises from the maturity mismatching of foreign currency positions. Even when the spot-plus-forward positions in individual currencies are balanced, the pattern of forward contracts may produce a forward/forward mismatch. In such situations, a bank may suffer losses as a result of changes in interest rate differentials and concomitant changes in the forward exchange premiums, or discounts, of the two currencies concerned.

Another type of risk is the credit *risk*, i.e. that of a defaulting counterparty to a foreign exchange contract, or a loan contract involving foreign exchange. In that case the bank, provided it originally had a balanced book, would find itself inadvertently left with an uncovered exchange position. Although this kind of credit risk potentially encompasses the total of a bank's foreign exchange book, the bank would suffer an exchange loss only to the extent that the exchange rate had in the meantime moved in such a way that a cost would be involved in covering the position opened up by an unfulfilled foreign exchange contract. However, in the case of a loan contract a bank may be exposed for the full amount of the contract.

A further risk is the *time-zone risk*, which arises because of the twenty-four hour nature of foreign currency markets. With time-lags frequently occurring between settlement in one currency in one centre and settlement in a different currency in another time-zone, banks may be exposed for the full amount of the contract if the counterparty or the payment agent defaults in the interim.

Finally, most foreign exchange contracts involve counterparties who are resident in other countries, with the result that *sovereign (or country) risk*, e.g. the risk of a ban on the transfer of currency by the nationals of a particular country, will also be present.

III. The role of bank management

Primary responsibility for the safety of banks in their foreign exchange operations rests with the managements of banks. In particular, it is management's responsibility to set appropriate limits to the risks taken by a bank in its foreign exchange business and to ensure that there are proper internal control procedures covering this area of a bank's activities.

So far as internal controls are concerned, the banks should observe a clear-cut and well-defined division of responsibility between a) foreign exchange dealing, b) accounting, and c) internal supervision. A bank's foreign exchange dealers should have clear and binding instructions both as regards general trading principles and as regards limits (by individual currencies and maturities) on open positions, on the size of individual contracts and on exposure (overnight and forward) with individual counterparties. Dealers should be strictly required to record each transaction on a dated and sequentially-numbered form and to pass it promptly to the accounting department. The instructions to the dealers should, moreover, prohibit the conduct of business (including business within the same banking group) at exchange rates which are unrepresentative of the prevailing level in the market and should include a general code of conduct for their relations with exchange brokers. As a matter of general principle, profit targets should not be imposed by a bank's management on its dealing department, even though there may well be some presumption that income will be forthcoming from this source.

The accounting department should receive without delay all the information from the dealers that is necessary to ensure that no deal goes unrecorded. All foreign exchange contracts, whether spot or forward, should be promptly confirmed in writing. Furthermore, dealers should never write their own outgoing confirmations; this should be the responsibility of the accounting department alone, which should also be the first to receive the corresponding incoming confirmations. If confirmations are not forthcoming, the counterparties should be contacted promptly and in the absence of satisfactory explanation the bank should inform its supervisory authority.

In addition, foreign exchange accounting should be organised in such a way that the bank's management is continuously in possession of a full and up-to-date picture of the bank's position in individual currencies and with individual counterparties. This information should not only include the head office but also the positions of affiliates at home or abroad. Moreover, periodic and frequent revaluations at current market rates should permit the monitoring of the development of the bank's profits or losses on its outstanding foreign exchange book.

It will be the responsibility of the internal audit function to make sure that dealers observe their instructions and the code of behaviour required from them, and that accounting procedures meet the necessary standards of accuracy, promptness and completeness. For that purpose it will be advisable not only that internal audits and inspections take place at regular intervals, but that occasional spot checks are made. As a further safeguard against malpractices, the auditors, in co-operation with the central management, should from time to time seek an exchange of information on outstanding foreign exchange contracts with the counterparties to these contracts. Banks should inform their supervisory authority if there appears to be a lack of control or cooperation on the part of the counterparty.

It should, moreover, be clear that the internal control procedures should cover not only the parent bank, but its total branch network and, as far as possible, also its subsidiaries. In order to facilitate internal supervision and monitoring of open exchange positions, branches should daily report their dealing positions to head office. While the extent to which individual branches are permitted to run open positions is a matter for a bank's management to decide on the basis of geographical factors and the dealing expertise of the branch concerned, head office should strictly enforce the limits it sets in order to keep control of its worldwide exposure.

IV. The role of supervisors

The role of supervisory authorities in monitoring and controlling banks' foreign exchange activity may involve one or more of the following activities:

- the surveillance of banks' internal control procedures;
- the setting of more or less formal guidelines for, or limits on, banks' foreign currency exposure;
- the monitoring of banks' foreign exchange positions.

As regards the first of these, the supervisor's job is to make sure that the banks have internal control systems as discussed in section III above, that these systems function effectively and that both internal and external reporting is as far as possible safeguarded against falsification.

As regards guidelines for, or limits on, banks' foreign exchange exposure, it is desirable to distinguish between a bank's dealing position in foreign exchange and its infrastructure position in foreign exchange (participations, investment in property, etc.). Moreover, supervisors should distinguish between a bank's total uncovered position in foreign currencies and its open positions in individual foreign currencies. Thus, it will make quite a difference whether a bank's uncovered position results primarily from exposure in just one currency, or whether it is the sum of smaller exposures in several currencies. To take account of these qualitative differences, the authorities might apply a system of dual limits, one on a bank's exposure in individual foreign currencies, and one on its overall foreign exchange exposure, i.e. the gross aggregate of its long and short positions in individual foreign currencies. It might also be desirable to restrict a bank's net position in domestic currency, but this is more likely to be for monetary or exchange control purposes than for prudential reasons.

A further point which the supervisory authorities have to consider in this context is whether it is desirable to monitor and/or to set limits on banks' dealings in gold and precious metals. While in many countries banks' dealings for their own account are either negligible or statutorily prohibited, higher prices and greater activity in precious metals markets have increased the possibility that banks may become over-exposed in their operations in these markets. To reduce this risk, banks could be required to include positions taken in gold or precious metals within any limits imposed on their foreign exchange positions, or alternatively separate limits might be imposed on these activities.

In supervising banks' foreign exchange business, the authorities will have to base themselves in large measure on bank managements' own standards of prudence. They must, therefore, satisfy themselves that management adhere to some rational policies with respect to foreign exchange exposure, such as limiting open exchange positions to a certain proportion of the bank's own funds. To avoid the risk of over-trading, it might also be desirable for a bank to keep its total foreign exchange turnover approximately in line with the size of its balance sheet. Those authorities which go further and set guidelines or limits equally need to find some standard by which to judge what degree of flexibility banks should be given. In several major countries, the standard used is the size of the bank's capital base.

For the purpose of monitoring the banks' foreign exchange business, the authorities need to make use of two types of information flows: statistical reports from the banks about their foreign exchange operations; and information about events and developments in the foreign exchange market.

As regards statistical reports, it will be neither practicable nor necessary for the supervisory authorities to obtain the full range of information about the banks' exchange-market activities and exposure that should be available to the banks' own management. The periodic reports to the authorities should, however, show, as a minimum and rather frequently, the banks' open spot-plus-forward position in individual currencies and preferably also their gross positions. Limits on foreign exchange exposure will shield a bank from risk only when they are adhered to on a permanent basis. Therefore, the authorities will have to make sure, perhaps by means of unannounced on-the-spot examinations, that these periodic reports also provide a realistic picture of a bank's foreign exchange activities between reporting dates. Where formal limits on exposure are applied, the periodic reports supplied by the banks might be required to include statements of each occasion on which the limits were exceeded. The authorities also need to guard against banks "parking" foreign exchange positions with their affiliates in other countries. Although this practice is difficult to detect where multinational groups are involved, supervisors should have access to banks' dealing slips and should ensure that these are properly dated and sequentially numbered.

General information about developments in the exchange market is available to the authorities through the contacts which central banks maintain with market participants. In that connection the authorities should encourage banks to keep them informed, for example, about requests by other banks to deal (or to carry over exchange contracts) at rates which are unrepresentative of the level prevailing in the market, confirmations not being forthcoming, an excessive volume of foreign exchange business transacted by another bank, or more generally about market rumours and anomalies. Where the central bank is not responsible for banking supervision, it should pass on information it obtains from its market contacts to the supervisory authorities. Similarly, on an international level the authorities should exchange on a confidential basis any market rumours concerning banks under their respective supervision.