IV.7 Policy Paper on Foreign Exchange Risk Management

Guidance paper on Foreign Exchange Risk Management by virtue of Section 13, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba.

1. Introduction

The purpose of this guidance paper is to provide credit institutions with guidelines to establish an adequate foreign exchange risk management policy that effectively identifies, measures, monitors and controls foreign exchange risk exposures, and that is subject to appropriate board and senior management oversight.

2. Types of prudential risks in foreign exchange business

While credit institutions are exposed to a number of different types of risk in the conduct of their foreign exchange business, most of these risks are also inherent to domestic banking business. In principle, the only risk specifically related to foreign currency business is the exchange rate risk, i.e. the risk that a credit institution 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 a certain foreign currency.

The other risks incurred by credit institutions conducting foreign exchange operations arise more as a result of the international aspects of such business than because foreign currencies are involved. One of such risks is the interest rate risk, which arises from the maturity mismatching of foreign currency positions.

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 credit institution, 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 credit institution's foreign exchange book, the credit institution 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 credit institution may be exposed for the full amount of the contract.

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.

3. The role of the management of the credit institution

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

So far as internal controls are concerned, the credit institutions should observe a clear and well-defined division of responsibility between a) foreign exchange dealing, b) accounting, and c) internal supervision. The credit institution's foreign exchange dealers should have clear and binding instructions with regards to general trading principles, as well as limits (by individual currencies and maturities) on open positions, on the size of individual contracts and on the exposure (overnight and forward) to individual counterparties.

Foreign exchange accounting should be organized in such a way that the credit institution's management is continuously in possession of a full and up-to-date picture of the credit institution's position in individual currencies and with individual counterparties. Moreover, periodic and frequent revaluations at current market rates should permit the monitoring of the development of the credit institution's profits or losses on its outstanding foreign exchange book.

4. The role of the internal auditors

It is the responsibility of the internal auditors to ensure that dealers observe the instructions and the code of behavior required from them, and that accounting procedures meet the necessary standards of accuracy, promptness and completeness. For that purpose, it is advisable that internal audits and inspections take place at regular intervals, and that from time to time spot checks are made. As a further safeguard against malpractices, the internal auditors, in co-operation with the central management, should also exchange information on outstanding foreign exchange contracts with the counterparties to these contracts.