ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

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GUIDANCE NOTE FOR DEPOSIT TAKERS (Class 1(1) and Class 1(2))

Foreign Exchange Risk Management

March 2017

STATUS OF GUIDANCE

The Isle of Man Financial Services Authority ("the Authority") issues guidance for various purposes including to illustrate best practice, to assist licenceholders to comply with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.

Version 1.1

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Part 1 – Deposit takers incorporated in the Isle of Man

This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence, jointly referred to in this document as both 'deposit takers' and 'banks'.

1. Rationale for Foreign Exchange Risk Management

1.1 The foreign exchange market is arguably the largest and most liquid of the international markets, and large and rapid movements in exchange rates are commonplace. In order to minimise the possibility of financial loss, it is therefore essential that deposit takers identify, measure and manage their foreign exchange risk effectively.

1.2 Foreign exchange risk is not confined to proprietary positions taken by a bank and client driven transactions, but can also arise from known profit flows in foreign currency, and provisions for bad debts denominated in foreign currency. It is important that these exposures are identified and, where necessary, hedged, on a timely basis.

1.3 Banks are exposed to a number of different risks in the conduct of foreign exchange and general business, and these may be categorised as follows. This list is not exhaustive and is for guidance purposes only:

a) ***Exchange rate risk (open position)***

This is the risk that the bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position in a currency. Where the value of asset/inflow exposures in one currency is not equal to the value of liability/outflow exposures in that currency this is described as an ***open position.*** Open positions may be short (liabilities exceed assets) or long (assets exceed liabilities). This is a simplistic definition, and the components of the calculation of an open position are given below. Banks with a short open position in a currency are exposed to the risk that the currency might appreciate, while those with a long open position in a currency are exposed to the risk that the currency might depreciate.

b) ***Interest rate risk***

This risk arises from unmatched forward foreign exchange transactions.

c) ***Settlement risk***

Also known as time zone risk, this is a form of credit risk that arises from transactions where the currencies settle in different time zones. For example, where a bank enters into a transaction to sell Australian Dollars and buy US Dollars, they are obliged to pay AUD to the counterparty some 15 hours before they are able to receive their USD in settlement[1].

d) ***Credit risk***

This risk arises from the failure or default of a counterparty. Technically, this is a credit risk where only one side of the transaction has settled (see settlement risk above). If a counterparty fails before any settlement of a contract occurs, the risk is limited to the difference between the contract price and the current market price (i.e. an exchange rate risk).

e) ***Country risk***

This is essentially a form of credit risk arising from either the currency of the trade or the centre in which the counterparty is situated rather than the counterparty itself. However, there are implications for foreign exchange transactions. In particular, many investment managers buy stocks in emerging markets where there may be some political risk, and will instruct the treasury department to buy or sell the currency according to the trade. In the event of sanctions being imposed by the government of that country, or an international agency such as the United Nations, banks may not be able to sell balances or deliver currency in settlement of trades already completed.

1.4 The most common risk faced by banks on the Isle of Man is exchange rate risk, which emanates from two distinct areas:

a) FX business transacted with clients and counterparties, including proprietary trading
b) Profits or losses arising from the bank's foreign currency deposit and loan books, and operational cash-flows in foreign currency.

1.5 ***The open position risk*** arising from client business is relatively easy to identify and measure. However, it is essential that all deals be processed as soon as possible after the trade has been agreed with the client and that authorised dealing personnel are advised of deals of a material size.

1.6 ***Foreign exchange risk*** positions arising from a bank's profit and loss account are more difficult to assess accurately. However those banks with material profit flows in foreign currency should carry out an assessment as to the benefits of hedging their risk. As such foreign exchange risk will normally emanate from outside the treasury area, as a matter of best practice, the decision to hedge or not should be taken at a minuted Management or ALCO meeting.

[1] A transaction is not complete until settlement has taken place in the latest applicable time zone. This is also referred to as "Herstatt Risk".

1.7 ***Interest rate risk*** arises from any unmatched forward foreign exchange positions the bank may have. The only true foreign exchange risk incurred here is the difference between the spot and forward trade in each currency. Should a bank buy spot Sterling against US Dollars and sell the identical amount of Sterling, say 3 months forward, the foreign exchange risk is the difference between the spot and forward US Dollar amounts. However, the bank will have a long GBP, short USD forward foreign exchange position. A movement of interest rates in either of these currencies over the period of the forward trade will generate a revaluation profit or loss. Although interest rate markets are not as volatile as foreign exchange, it is important that banks measure and monitor all risks.

1.8 ***Settlement, credit, and country risks*** normally only materialise where a bank deals with customers and counterparties where physical cash payments are required to settle the trade. These risks are inherent forms of credit risk arising from foreign exchange trades, and limits would normally be proposed to the Board via the credit approval process, under advice from Treasury or ALCO.

2. Overview of the Authority's Approach to Foreign Exchange Risk Management

2.1 The Isle of Man Financial Services Authority ("the Authority") requires all banks to have a prudent foreign exchange risk policy and appropriate systems in place to measure and monitor foreign exchange risk, and to ensure that the policy is adhered to. The policy should be approved by the Board. The Authority recognises that appropriate systems and controls for foreign exchange risk will vary with the scale, nature and complexity of a bank's activities.

2.2 Whilst the Authority does not seek to impose specific limits for foreign exchange risk exposure, banks are not expected to assume risk that, in the event of an adverse movement in foreign exchange rates of 10%, would constitute a potential cost of in excess of 10% of a bank's LECB.

2.3 Foreign exchange risk will be assessed for capital adequacy purposes and a 100% weighting will apply on the net reportable open position.

2.4 Banks are expected to carry out periodic (minimum six monthly) stress testing exercises to assess the potential cost of a shock 20% movement in exchange rates, as appropriate to the business.

3. Foreign Exchange Risk Management Policy

3.1 The foreign exchange risk management policy should clearly define instruments in which the bank is authorised to trade, risk limits commensurate with the bank's activities, regularity of reports to management, and who is responsible for producing such reports.

The policy should be reviewed on a regular basis, normally at least annually, to ensure that it remains appropriate.

3.2 The main points that need to be considered when drawing up a policy are given below:

a) Open position limits commensurate with customer driven turnover, and the bank's appetite for market risk
b) Separate limits should be allocated for each currency, together with an "overall cap" limit. Banks that assume risk on a proprietary trading basis should also introduce measures to limit intraday risk (normally a maximum of five times the overnight cap limit)
c) Where a bank trades with counterparties other than members of their own group, settlement and country limits should be addressed and clearly defined
d) Forward foreign exchange mismatch limits
e) List of approved instruments
f) Use of foreign exchange derivatives
g) The expertise and experience of authorised personnel
h) Authority to trade with counterparties other than group companies (where appropriate)
i) Monitoring and reporting systems
j) Recording and follow up of limit excesses
k) Impact on P&L of an adverse 10% movement in exchange rates on maximum permitted exposure
l) Imposition of a "stop loss" limit to restrict or prevent any further trading other than client deals and hedging
m) Segregation of duties
n) Trading mandates for authorised personnel
o) Limitation on out of hours trading
p) List of authorised brokers (if applicable)
q) Code of Conduct for authorised personnel

4. Procedures and Systems

4.1 The Authority requires banks to monitor their foreign exchange risk on a frequent and timely basis. The Authority would expect banks that assume any foreign exchange risk to be in a position to measure their positions on an ongoing basis and to report to management daily. It follows from this that a bank must have adequate procedures and systems for monitoring foreign exchange risk. This requires:

a) A clear allocation of the responsibility for measuring and reporting foreign exchange risk
b) The maintenance of reliable systems that can produce accurate reports promptly

c) Active senior management involvement in, and clearly allocated responsibility for, foreign exchange risk reporting
d) Regular reporting to group or parent companies

4.2 The system that produces the foreign exchange risk reports should be linked to the bank's core systems, and be capable of being reconciled to core data.

4.3 Reports should follow the principles of good management information, for example:

a) Clarity
b) Highlight key information, in particular breaches or exceptions
c) Highlight unutilised limit capacity
d) Use of an exception based commentary

5. Calculation of the Net Open Position

5.1 Components

A bank should calculate the ***net open position*** in each currency, including gold, but excluding the base currency.

a) For the definition of an ***open position***, see the section on rationale
b) Normally, a bank's ***base currency*** is the currency in which its capital is predominately denominated and in which its statutory accounts are reported:
   (i) Occasionally, it may be appropriate for a bank to use a currency other than Sterling as a base currency for the assessment of FX risk. In such cases, the Sterling net open position would also have to be calculated. However in such cases the prior permission of the Authority should be sought.

5.2 The ***net open position*** is the sum of the following elements:

a) The ***net spot position***, as calculated in accordance with chapter 11 of the Authority's guidance note on quarterly prudential returns; and

b) The ***net forward position***, as calculated in accordance with chapter 11 of the Authority's guidance note on quarterly prudential returns

6. Valuation

When calculating the local currency value of instruments or positions, the following practices should be adopted, as appropriate to the business:

a) A bank's net position should normally be calculated on a weekly basis as a minimum

b) Banks should account for revaluation profit and loss on their residual positions on a monthly basis as a minimum

c) Closing mid-market rates should be used. Ideally, these rates should be obtained, or, as a minimum, independently verified by staff other than authorised dealing personnel. Local currency amounts should be translated into base currency using prevailing closing mid-market spot rates

d) Forward transactions should be revalued at prevailing outright mid-market rate for the outstanding period to settlement

e) Other appropriate FX related contracts should be revalued on a mark to market basis.

Part 2 – Deposit takers operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)

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1.5 ***The open position risk*** arising from client business is relatively easy to identify and measure. However, it is essential that all deals be processed as soon as possible after the trade has been agreed with the client and that authorised dealing personnel are advised of deals of a material size.

1.6 ***Foreign exchange risk*** positions arising from a bank's profit and loss account are more difficult to assess accurately. However those banks with material profit flows in foreign currency should carry out an assessment as to the benefits of hedging their risk. As such foreign exchange risk will normally emanate from outside the treasury area and, as a matter of best practice, the decision to hedge or not should be taken at a minuted Management or ALCO meeting.

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1.8 ***Settlement, credit, and country risks*** normally only materialise where a bank deals with customers and counterparties where physical cash payments are required to settle the trade. These risks are inherently forms of credit risk arising from foreign exchange trades, and limits would normally be proposed to the Board via the credit approval process, under advice from Treasury or ALCO.

2. Overview of the Authority's Approach to Foreign Exchange Risk Management

The Authority requires all branches to be subject to a prudent foreign exchange risk policy and have appropriate systems in place to measure and monitor foreign exchange risk. The policy should be reviewed annually by senior management. The Authority recognises that appropriate systems and controls for foreign exchange risk will vary with the scale, nature and complexity of a branch's activities, and that the branch is likely to be part of the wider policies and procedures of the bank.

3. Foreign Exchange Risk Management Policy

3.1 Senior management of the branch should be aware of the foreign exchange risk policy of the bank and any reporting and monitoring requirements with which it must comply.

The policy should be reviewed on a regular basis by senior management, normally at least annually, to ensure that it remains appropriate.

3.2 The foreign exchange risk management policy should take into account the nature of the branch's business and the various types of foreign exchange risk that arise from it.

4. Procedures and Systems

4.1 The Authority requires branches to monitor their foreign exchange risk on a frequent and timely basis. The Authority would expect branches that assume any foreign exchange risk to be in a position to measure their positions on an ongoing basis and to report to management daily. Such reporting and monitoring may be performed at the bank rather than the branch itself. It follows from this that a bank must have adequate procedures and systems for monitoring foreign exchange risk. This requires:

a) A clear allocation of the responsibility for measuring and reporting foreign exchange risk within the group
b) The maintenance of reliable systems that can produce accurate reports promptly
c) Active senior management involvement in, and clearly allocated responsibility for, foreign exchange risk reporting
d) Regular reporting to/from the branch.

4.2 The system that produces the foreign exchange risk reports should be linked to the bank's core systems, and be capable of being reconciled to core data.

4.3 Reports should follow the principles of good management information, for example:

a) Clarity
b) Highlight key information, in particular breaches or exceptions
c) Highlight unutilised limit capacity
d) Use of an exception based commentary

Appendix 1 – Glossary

"ALCO" means an Asset and Liability Committee.

"bank" is the Isle of Man incorporated deposit taker (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

"branch" means a branch in the Isle of Man of a deposit taker incorporated outside the Isle of Man.

"large exposures capital base" **("LECB")** is interpreted in accordance with the Financial Services Rule Book.