Guideline 7

GUIDELINE 7
PRUDENTIAL GUIDELINES ON FOREIGN CURRENCY DEPOSITS
AND RELATED TRANSACTIONS

PURPOSE

The Central Bank of The Gambia, empowered under Section 68 of the Financial Institutions Act (FIA) 2003 hereby prescribes Prudential Guidelines on Foreign Currency Deposits (FCDs) and related transactions. This Guideline hereafter referred to as the Guideline on FCDs is for the monitoring and regulation of authorised financial institutions engaged in foreign currency business. It is designed to capture the level of exposure of institutions in this area at varying frequencies i.e. daily, weekly, monthly and annually.

INTERPRETATION

In this regulation, unless the context otherwise requires, **"Authorized financial Institutions"** refers to banks or other dealers authorised by the Central Bank to take FCDs. This authority shall be granted by the Central Bank upon meeting the criteria set in the Guidelines.

"Bank" means the Central Bank of The Gambia.

"bank" means any financial institution whose operations include the acceptance of deposits transferable by cheque or other means of third party transfer.

"Banking business" as defined in Section 2 of the FIA 2003.

"Corresponding bank" means a foreign bank, which has a correspondent relationship with a bank or financial institution in The Gambia and holds deposits or performs services for and on behalf of the bank in The Gambia.

"Dealer Authority" means authority granted by the Central Bank to accept foreign currency deposits and related foreign currency transactions.

"Financial institution" as defined in Section 2 of the FIA 2003.

"Foreign currency" includes any currency issued by a government other than the government of The Gambia or a document intended to enable the person to whom it is issued to obtain any currency other than the currency of The Gambia.

"Foreign currency account" means an account maintained in foreign currency.

"Foreign currency assets" refers to all assets denominated in foreign currency.

"Foreign currency liabilities" refers to all liabilities denominated in foreign currency.

"High rated institutions" refers to institutions rated by international rating agencies within the categories AAA to AA-.

"Inter-bank foreign exchange market" means the market in which spot, forward, futures or such other foreign exchange trading mechanism operate.

"International rating agencies" means internationally recognized rating firms.
"Licence" means banking licence issued under Section 3 of the FIA 2003.

"Low rated institutions" refers to institutions rated by international rating agencies within the categories A+ and below.

"Off-balance sheet items" refers to obligations that are contingent upon the bank.

"Regulation" means the regulation made by the Central Bank of The Gambia under section 68 of the FIA 2003.

"Risk weighted capital" as defined in Instruction 7 of our Manual of Instructions and Guidelines.

"Short-term" refers to a period within one year.

"Under-capitalised bank" refers to a bank, which holds risk weighted capital ratio below the prescribed ratio in Instructions 7.

STATEMENT OF POLICY

Objectives

1. The major objective of this prudential regulation is to minimize exchange risk by preventing booking of foreign currency positions

or accumulating exposure**s** that cannot readily be hedged by week's end, thus exposing the bank to foreign exchange risks and potential for losses.

2. To allow authorised banks to play an active role in the development of foreign exchange instruments in a stable and developed foreign exchange market.

3. To facilitate foreign exchange based lending by banks while at the same time minimize credit and liquidity risk inherent in foreign currency lending.

4. To provide a basis and framework for a market determined exchange rate.

5. To ensure that banks have put in place adequate foreign exchange risk management systems, appropriate operational guidelines and internal controls intended to identify and control foreign exchange risks.

6. To minimize risks arising from concentration of foreign exchange placements and/or deposits.

<u>Rationale</u>

1 Experience has shown that banks and financial institutions are exposed to substantial foreign exchange risks especially by running open positions. Consequently, the limitation of foreign exchange exposures is perceived as a necessary and significant component of banks' or financial institutions' internal controls and overall foreign exchange risk management system.

2 Authorised banks are vulnerable to liquidity and credit risks inherent in excessive lending in foreign exchange hence the need to regulate banks' lending in foreign currency.

3 Authorised banks are vulnerable to concentration risks inherent in excessive placements of foreign exchange with their correspondent banks.

4 The placement of foreign exchange with foreign financial institutions or correspondent banks require a higher capital cushion in the case of low rated institutions.

CRITERIA FOR TAKING FOREIGN CURRENCY DEPOSITS

(a) Prescribed Required Capital Adequacy Ratio must be met

(b) A strategy and policy for this business

(c) Organisation for the business

(d) Accounting system

(e) A process of risk identification

(f) Methods of risk measurement, monitoring and control

(g) Setting of limits to risk exposure

(h) Reports on positions versus limits, compliance with internal and legal requirements, profit and loss etc

(i) Internal audit function

(j) IT function

(k) Human resources

(l) All policies, limits, authorizations etc must be documented and reviewed and approved by the board of directors

<u>CRITERIA FOR COMPUTING FOREIGN EXCHANGE EXPOSURE LIMITS</u>

<u>Determining weekly Foreign Exchange Exposure Limits</u>

1. The computation of weekly foreign exchange exposure limits will be based on a capital ratio necessary to absorb risks inherent in foreign exchange business. The ratio will be 25% of the bank's adjusted capital. The computation will include the following items:

    - Weekly total assets denominated in foreign currency less total liabilities denominated in foreign currency.

    - Weekly total undelivered spot contracts to buy and/or sell foreign currency.

    - Weekly total uncovered forward contracts to buy and/or to sell foreign currency.

<u>CRITERIA FOR LENDING IN FOREIGN CURRENCY</u>

Lending In Foreign Currency

1. Banks are authorised to lend in foreign currency against foreign currency deposits held by them.

2. When lending from the foreign exchange deposit base the following conditions shall apply:-

   - Lending in foreign currency will be on a short-term basis.

   - Lending in foreign currency shall not exceed 82% of the bank's total foreign currency deposits at all times. i.e. the remaining 18% shall be reserve requirement, of which 80% shall be kept with the Central Bank in local currency and 20% with the bank in Foreign Currency. In the event of default, such reserves shall be subject to the same sanctions as in local currency. (See Instructions 5).

   - Lending to a single borrower shall be limited to 25% of the adjusted capital of the bank and must be in accordance with prudential guidelines on concentration of credit and other exposure limits. Insider credits shall be limited to 5% of the bank's adjusted capital.

   - An authorised bank shall not extend new foreign exchange loans or conduct any new foreign exchange business if it is under capitalised.

FOREIGN EXCHANGE RISK MANAGEMENT SYSTEMS

Managing Foreign Exchange Risks

Foreign Exchange Policy

Every authorised bank must put in place a written foreign exchange policy that is duly considered and approved by its board of directors. The policy should reflect the tolerance of the board and senior management for the various risks arising from foreign exchange activities. It should include a formal ratification of internal prudential limits governing foreign exchange operations.

The limits must be clearly defined and communicated to the Foreign Exchange Department of the Central Bank and must be periodically reviewed and updated to properly match the bank's risk profile and the quality of its risk management systems including staff skills. They should include the following:

Currency Position Limits

Authorised financial institutions must maintain a set of specific internal limits on the risk exposure to the various currencies they are trading in. The overnight open position limit of each currency should not exceed 15% of the bank's adjusted capital.

Overnight Position Limits

The overall overnight net open position for authorized banks should not exceed 25% of adjusted capital.

Counter-party / Country Limits

Authorised banks must establish internal country and counter party risk limits especially for counter parties in countries whose currencies lack convertibility or where possibility exist for the development of a shortage of foreign exchange.

Risk Management Systems and Internal Controls

Authorised banks are required to put in place adequate risk management systems and other appropriate internal control mechanisms and procedures to identify, measure, monitor and control foreign exchange exposure both on and off-balance sheet. Additionally, a well-documented and detailed set of operational guidelines and procedures must be put in place by all authorised banks to guide dealers in their foreign exchange operations.

CRITERIA FOR PLACEMENTS OF FOREIGN CURRENCY DEPOSITS

1. Authorised banks may place or deposit at any time foreign exchange balances with a parent or related group bank or main correspondent bank which has a minimum long term rating, by internationally recognized rating agencies of AAA to AA-. These placements and/or deposits will be subject to a risk weighting of 20%. Any balance and/or deposit that are placed with a parent or related group bank or main correspondent bank that is rated A+ and below will attract a risk weight of 40%.

2. Deposits placed with non-rated institutions will be subject to a risk weight of 100%. Such placements will be subject to a concentration limit of 25% of the bank's adjusted capital.

3. Authorised financial institutions shall provide the Central Bank with details of new accounts opened with correspondent banks or new relationship with financial institutions abroad.

REMEDIAL MEASURES, ADMINISTRATIVE SANCTIONS AND PENALTIES

Administrative Sanctions and Penalties on over exposure

1. The Central Bank may impose on an authorised bank whose net open position in foreign currency exceeds the limit prescribed in Guideline 7, a civil penalty of one percent of the excess net open position per day on which the contravention continues.

2. The Central Bank may impose on an authorised bank that fails to submit the returns prescribed as per this regulation in a timely and accurate manner, a civil penalty as prescribed under Guideline 1 of this manual.

Manner of Correcting Foreign Exchange Positions

Authorised banks not in compliance with exposure limits will be given one working week within which to correct their positions before the penalties are applied. Such banks are expected to immediately explain to the Central bank reasons that led to their failure to observe the prescribed limits.

Remedial Measures

1. When the Central Bank determines through an inspection that a bank is not in compliance with this regulation, it may impose any of its enforcement powers.

2. In addition to the remedial measures given above, the Central Bank may impose any or all of the administrative sanctions with regards to an authorised bank that is not in compliance with this regulation. Such administrative sanctions may include but not limited to:

    (i) Suspension from participation in the inter-bank foreign exchange operations.

    (ii) Suspension from accepting foreign exchange deposits.

    (iii) Suspension of the privilege to issue letters of credit.

(iv) Suspension of authority to grant credit facilities in foreign exchange.

(v) Revocation of the authority to operate as an authorised dealer.

Suspension of Foreign Exchange Business by an Authorised bank undergoing criminal investigation

The Central Bank may suspend any authorised bank from conducting foreign exchange business if the bank is under any criminal investigation concerning its dealings in foreign exchange.

Instruction 15

<u>INSTRUCTION 15</u>
<u>FOREIGN CURRENCY RETURNS</u>

The Central Bank of The Gambia (CBG) under Section 68 of the Financial Institution Act (FIA) 2003 is empowered to prescribe Guidelines and Instructions for the monitoring of financial institutions. Guideline 7- "Prudential Guidelines on Foreign Currency Deposits and Related Transactions" explains the following returns:

ANNEX A: DAILY FOREIGN EXCHANGE EXPOSURE MONITORING RETURN.

ANNEX B: QUARTERLY RETURN ONFOREIGN CURRENCY DEPOSITS BY CURRENCY, NUMBER AND VALUE

ANNEX D: MONTHLY RETURN ON CURRENCY DISTRIBUTIONS OF FOREIGN EXCHANGE POSITION

ANNEX E: QUARTERLY RETURN ON FOREIGN CURRENCY POSITION

The returns must be submitted in duplicate to the Banking and Financial Institutions Supervision Department (BFISD) on or before the specified due date. However, Annex F and G are for statistical and policy purposes only and may only be submitted to the Central Bank on request.

<u>ANNEX A: DAILY FOREIGN EXCHANGE EXPOSURE MONITORING RETURN</u>

Every authorised bank shall submit to the Central Bank a Daily report, a copy of which is attached as **Annex A,** not later than 10:00 am the next day. The return is intended to determine and monitor banks' overall foreign exchange exposures on a weekly basis. It will be a requirement that the return is submitted in an accurate and timely manner.

The return is a list of all the assets and liabilities in foreign currency, converted into Dalasi equivalent. This is followed by a computation of the overall exposure.

The return monitors possible violations of open position limits of 25% of the bank's Adjusted Capital. Excess exposure is punishable by a civil penalty payable to the Central Bank.

ANNEX B: QUARTERLY RETURN ON FOREIGN CURRENCY DEPOSITS BY CURRENCY, NUMBER AND VALUE

It was proposed to introduce this new return which intends to provide more insight into FCD accounts. It will provide information on the type, currency, number and value. It will enable the Bank to analyze the characteristics of FCDs and how they compare to LCDs.

The first column shows the foreign currency distribution of the accounts. Columns two, three and four shows the type of account either corporate, Gambians abroad and other personal. Each of these headings are sub-divided into number of accounts and their values expressed in local currency. The last column and row are totals. The column shows total accounts and their values by currency whiles the row shows total accounts and their values by type or class of account.

The frequency for this return shall be quarterly. Quarter end is adequate timeframe for this return as it may form part of banks' quarterly off-site analysis. Besides, the information would not be needed more frequently than quarterly.

ANNEX D: WEEKLY RETURN ON CURRENCY DISTRIBUTIONS OF FOREIGN EXCHANGE POSITION

Every authorised financial institution shall submit to the Central Bank a monthly return, a copy of which is attached as **Annex D** not later than one week after end of month in reference. The report is intended to determine the level of foreign exchange exposure according to currency distributions.

This return is a detailed statement of foreign assets and liabilities by currency. The currencies listed in this return are the approved currencies under Instructions 4 (Statement of Liquid Assets). The "Other" category is to cater for the grouping of all other foreign currencies not listed above. As per Page 8 of Guideline 7, individual currency positions are subject to a limit of 15% of the bank's adjusted capital.

ANNEX E QUARTERLY RETURN ON FOREIGN CURRENCY POSITION

Every authorised financial institution shall submit to the Central Bank a monthly report, a copy of which is attached as **Annex E** by one month following the quarter under reference. The report is intended to capture the flows of foreign exchange and determine foreign exchange holding of banks.

The return is in three main parts. The first part details the overall purchases of foreign currency made during the month as well as the deposits collected from customers. It captures the entire inflow of foreign currency from all sources, including foreign direct investment.

The second part deals with the outflow of foreign currency from the bank i.e. sales of foreign currency to the Central Bank, other domestic banks, exchange bureaux and the rest of the public. It also captures the withdrawal of foreign currency by customers from FCD accounts.

The opening balance is added together with the purchases/deposits, which is then netted off against the sales/withdrawals to arrive at the closing balance. This gives the overall foreign currency position of the bank as at the reporting date.

The last part of the return is a list of account balances as at the reporting date. This must reconcile with the closing balance at the end of the second part.[1]

STREAMLINING & INSERTION OF RETURNS

After a careful review of the FCD returns in consultation with the Foreign Department and the Economic Research Department, a number of changes have been proposed theses include incorporation of the provisions of FIA 2003, inclusion of a new return, deletion of some returns, textual amendments and change of reporting frequencies as follows –

Annex A: Daily Foreign Exchange Exposure monitoring return

The Annex remains unchanged.

Annex B: Daily report on banks' Forex Operations

It is proposed to drop this report as the information is supplied in other returns ie, Annex A & D both show the net open position which is the resultant figure of this [2]return. Annex E also shows details of purchases and sales of currencies by nature of transaction, which would be duplicated by Annex B.

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[1] *NOTE*

In addition to the above periodic returns, the Central Bank may carry out on-site inspection of foreign exchange businesses of authorised financial institutions to monitor compliance with these guidelines.

<u>Annex C</u>: Weekly return of banks Forex Commitment

It is proposed to drop this return. A similar information is being supplied to Foreign Department by banks. Submission in this will be a duplication of returns.

<u>New Annex C</u>: Monthly Return of Foreign Currency Deposits

This return will show FCDs by class and in total. It will enable differentiating FCDs from Local Currency Deposits (LCDs) in total deposits reported in the monthly balance sheet. The report will be in four main parts:

- Demand Deposits
- Savings Deposits
- Time Deposits
- Total Deposits

It will provide better understanding and an in-depth analysis of total deposits in the balance sheet. It will also enable the Economic Research Department to arrive at a new monetary aggregate, which will consist of FCDs among other things. The return will be submitted as an annex to the monthly balance sheet.

<u>Annex D</u>: Weekly return on Currency Distribution of Foreign Positions

It was proposed to change this to a monthly return and also amend the list of currencies. The change to monthly is due to two reasons namely –

- the report shows assets and liabilities by currency, it is therefore necessary to align it with balance sheet returns which are monthly.

- The other reason being that the exposures are measured against capital adequacy ratio which is measured on a quarterly basis.

The currency list change was due to some countries dropping their national currencies as a result of joining the Euro zone while others change the currency abbreviations.

<u>Annex E</u>: Monthly Return on Foreign Currency Position

The paper proposed changing the return to a quarterly return. The data provided is mainly for balance of payment purposes. The Economic Research Department said that BOP is prepared on a quarterly basis. Few headings have been detailed and new ones added to align the report more closely with the fifth edition of the balance of payments statistical manual.

Annex F & G: Foreign Exchange Outflows and Inflows respectively

It is proposed to drop both returns. They are for internal use by the banks to enable them identify purpose and source of foreign exchange. They are of no use to the Central Bank.

New Annex 'B': Return of FCD by type, number and value

It was proposed to introduce this return so as to provide more insight into FCD accounts. It will provide information on the type of currency, number of accounts and their value. It will enable the Bank to analyze the characteristics of FCDs and how they compare to LCDs.