

Box C: Foreign Currency Exposure and Hedging Practices of Australian Banks

Australian banks have sourced an increasing share of their borrowings from offshore over recent years, with around 85 per cent of this funding raised in currencies other than the Australian dollar. As at March 2005, when the latest ABS survey of the foreign currency exposure of Australian enterprises was conducted, net foreign currency debt on the balance sheets of Australian banks

Table C1: Foreign Currency Hedging by Banks^(a)

As at March 2005

	A\$b
Net FX position on debt	-186
Derivative positions to hedge debt	168
Net FX position on debt (after derivatives)	-18
Foreign equity assets	33
Derivative positions to hedge equity	-10
Net FX position on equity (after derivatives)	23
Foreign currency position (after derivatives)	5

(a) Negative values indicate a net foreign currency liability position.
Source: ABS

stood at \$186 billion, compared with \$117 billion nearly four years earlier (Table C1). Most of this debt was raised either through short-term commercial paper programs or medium-term bond facilities.

While much of the Australian banks' offshore funding is in foreign currencies, the currency risk is typically hedged back into Australian dollars through derivatives markets.¹ Information from the ABS survey shows that banks used derivatives to hedge \$168 billion of the total

foreign currency amount raised in offshore markets, leaving a net foreign currency exposure on debt of \$18 billion. Once banks' foreign currency equity positions are taken into account, banks had a small net foreign currency asset position.

The derivative instruments used to hedge foreign currency exposures are quite varied and include forward foreign exchange contracts, cross-currency interest rate swaps, futures and options (Table C2). As at March 2005, there were large long (i.e. bought) foreign currency positions and large short (i.e. sold) foreign currency positions, which is not surprising given that banks not only hedge their own exposures, but also undertake normal day-to-day foreign currency transactions for customers (for example, exporters who have contracts that deliver US dollars in the future often sell the foreign exchange forward to a bank to avoid adverse exchange rate fluctuations in the interim).

The largest net long derivatives position, at around \$86 billion, was in cross-currency interest rate swaps. These swaps are particularly useful for banks as, in addition to hedging foreign exchange risk, they can be structured in a way that eliminates some, or all, of the duration risk attached to the issue of fixed-income securities.

¹ For previous discussions of this issue, see the August 2000, August 2002, and December 2005 Reserve Bank Bulletin articles.

Table C2: Foreign Currency Derivatives Used by Banks^(a)

Notional values outstanding in A\$ billion, as at March 2005

	Long foreign currency/short A\$ positions	Short foreign currency/long A\$ positions	Net position
Forward foreign exchange	483	-420	64
Cross-currency interest rate swaps	266	-179	86
Futures	87	-86	1
Currency options	51	-48	3
Other derivatives	1	0	0

(a) Negative values indicate a short foreign currency position. Amounts may not add to net position due to rounding.

Source: ABS

The decision to borrow offshore reflects both cost and diversification considerations. At certain times, strong demand by non-resident investors means that banks can raise funds abroad marginally more cheaply than they can do so domestically. Even where the cost difference has been minimal, banks have tapped offshore markets as a way of diversifying their funding sources. Their sound reputations and high credit quality have ensured a ready demand for their securities.

Australian banks manage the liquidity risk associated with offshore borrowings by holding portfolios of high-quality liquid assets and by diversifying their funding base. Contingency arrangements, such as lines of credit, have also been established to cover the possibility that access to wholesale funding is restricted, or large increases in withdrawals occur. Funding books are also stress tested to determine potential vulnerabilities.

Foreign currency exposures of banks are closely monitored by the Australian Prudential Regulation Authority as part of its prudential supervision framework. Under the current market risk guidelines, authorised deposit-taking institutions are required to calculate their foreign currency exposure continuously and comply with capital adequacy requirements on both their traded and non-traded currency positions.² Regulatory authorities in some countries in which Australian banks operate also impose their own requirements to ensure that liquidity is managed prudently. ✎

² See Australian Prudential Regulation Authority (2000), 'Capital Adequacy: Market Risk', APS 113.