Box B

Foreign Currency Exposure and Hedging Practices of Australian Banks

Australian banks source a significant share of their funding for domestic lending from offshore debt markets, mainly in the United States. Much of this debt is raised through medium to longer-term bond issuance or short-term commercial paper programs. As at March 2009 around 20 per cent of banks' total liabilities were denominated in foreign currencies. Despite this apparent on-balance sheet currency mismatch, the long-standing practice of swapping the associated foreign currency risk back into local currency terms ensures that fluctuations in the Australian dollar have little effect on domestic banks' balance sheets.

According to the latest available data for 2009, banks' main foreign currency exposure was through foreign debt liabilities which, when netted against foreign currency debt assets, amounted to a net foreign currency debt position of $339 billion, up from $186 billion in 2005 (Table B1).[1] The value of derivatives held against this on-balance sheet debt position in order to hedge the foreign currency risk increased to $414 billion in 2009, leaving an open long position on foreign currency debt of $75 billion.

Banks' equity liabilities are entirely denominated in local currency terms, but they have foreign

Table B1: Foreign Currency Exposure and Hedging Practices of Australian Banks[(a)]
$ billion

	2005	2009
Debt		
Net foreign currency exposure	-186	-339
Derivatives	168	414
Open foreign currency debt position	-18	75
Equity		
Net foreign currency exposure	33	23
Derivatives	-10	-5
Open foreign currency equity position	23	18
Open foreign currency position debt & equity	5	92
Residual derivatives	-5	-54
Net foreign currency position	**1**	**38**
Per cent of assets	0.1	1.6

(a) A negative number denotes a net foreign currency liability position
Source: ABS; RBA

1 See *Foreign Currency Exposure*, ABS Cat No 5308.0, March Quarter 2009 and D'Arcy P, M Shah Idil and T Davis (2009), 'Foreign Currency Exposure and Hedging in Australia', RBA *Bulletin*, December, pp 1–10 for a broad discussion of the latest survey.

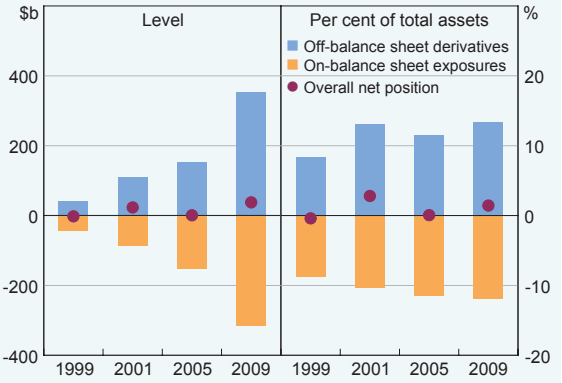
currency exposures arising from their direct equity investments in offshore banking operations, predominantly in New Zealand and the United Kingdom. The off-balance sheet derivative position held against these exposures is smaller since there is less motivation to hedge long-term commitments against relatively short-term exchange rate fluctuations.

Additionally, banks held $54 billion of derivatives not specifically allocated to positions in debt or equity. At least part of these derivative positions is likely to have been used to hedge the remaining overall net balance sheet exposure ($92 billion after accounting for open debt and equity positions) rather than specific transactions.[2] The result is that banks, in aggregate, maintained a net foreign currency position in 2009 of $38 billion (or just 1.6 per cent of total bank assets). This net position has been relatively stable over time, with derivatives hedging broadly matching the growth in gross on-balance sheet exposures (Graph B1). Furthermore, while the gross dollar value of foreign currency risk and derivatives have grown quickly at an average annualised rate of around 20 per cent over the past decade, they have maintained a relatively stable share of around 12 per cent of the asset base they support, though the recorded figure was somewhat smaller in 1999 when only the major banks were surveyed.

Around 50 per cent of banks' foreign currency liabilities had maturities of more than one year, while the remaining short-term debt was roughly evenly split between that with maturity of less than one year but greater than 90 days and that with maturity of less than 90 days. The derivative instruments used to hedge the foreign currency risk associated with these exposures varied, though banks showed a clear preference for foreign exchange swaps to hedge shorter-term liabilities, and cross-currency interest rate swaps for term debt. Since the gross banking-related flows are very large, the market segments which are most liquid tend to be the ones where the banks are most active.

While banks have little net exposure to foreign currency risk, the rising cost of hedging has made it more expensive to diversify the funding base across several offshore markets (Graph B2).[3] Cross-currency basis swap spreads – paid by Australian entities to

Graph B1
Foreign Currency Position of Australian Banks*



* Total banking sector (except 1999 which is limited to major banks)
Sources: ABS; APRA; RBA

Graph B2
Cross-currency Swap Spreads
Foreign currency to AUD

Sources: Bloomberg; RBA

2 See Becker C and D Fabbro (2006), 'Limiting Foreign Exchange Exposure through Hedging: The Australian Experience', Reserve Bank Research Discussion Paper 2006-09.

3 See Davies M, C Naughtin and A Wong (2009), 'The Impact of the Capital Market Turbulence on Banks' Funding Costs', RBA *Bulletin*, June, pp 1–14.

hedge both the principal and interest payments on foreign currency bonds – have widened from 5–10 basis points before the crisis for US dollar issuance, to around 30–40 basis points. The all-in cost of hedging other major currencies into Australian dollars has increased even further, due to the additional swap leg between those currencies and the US dollar. More recently, the elevated cross-currency basis swap has given non-residents an incentive to issue Australian dollar-denominated Kangaroo bonds, with issuance picking up significantly in recent months. These non-residents are the natural counterparties to the local banks' hedging transactions as they hedge their Australian dollar exposures back into foreign currencies, which in turn, puts downward pressure on the cross-currency basis swap.