

## Box 2

# New Regulatory Framework for Foreign Exchange Market Operations<sup>1</sup>

In an effort to comprehensively renew the regulatory framework and adjust it to the multiple events and innovations that have taken place in the Colombian scenario over the last eighteen years, *Banco de la República* recently began working on a revision of all pertinent regulations. The idea was to start using the logic of a foreign exchange market with a floating exchange rate with agents that have many years of experience participating in it. Not only these agents but also the markets in general became more sophisticated during these years, and the country was able to consolidate significant achievements in terms of institutional solidity and development.

In conjunction with all this development, the risks also became more sophisticated. Now, not only do the Colombian financial intermediaries use other currencies for their treasury transactions, but part of their balance sheets is also in other economies, especially those in Central America. The risks associated with exposure in the currencies of those countries, and not just the US dollar, began to be increasingly more pertinent. As a result, a task was started based on the following question: what should the goal of the regulatory framework of the market be? The answer included several criteria, as explained below.

### 1. Macro-economic and External Sector Information

First, this framework must guarantee the information necessary to calculate the country's balance with the rest of the world (i.e., the balance of payments) and, in particular, the amount and types of capital flows. Likewise, the information will probably be required to monitor the changes in the foreign exchange risk faced by the professional managers of these flows and transactions. This information is

mainly compiled through the foreign exchange reports that accompany the so-called “channeling” of the transactions. Considering the above, the opportunity was used to simplify the reports and eliminate details that were required but were not relevant when the information was analyzed.

Since other sources of information are available, this was why the Colombians' obligation to report the financial investments that they make abroad was eliminated. In addition, several items were removed from the foreign exchange reports, one form was eliminated, some document preservation requirements that the intermediaries demanded from businessmen were discontinued, and the whole process was set up to be done digitally.

### 2. Measuring and Controlling Risks

Secondly, the framework had to guarantee that the risks that come from foreign flows and transactions in foreign currency were properly measured and controlled. Although these risks may be understood as financial and already mitigated through prudential regulation, they possess a special characteristic. External shocks have strong impacts on mid-size and open economies like the Colombian one. Therefore, the framework of the inflation targeting policy with a floating exchange rate expects the exchange rate to be the variable that initially “absorbs” the external shocks, thus “protecting” the stability of the interest rate and seeking to soften any impact on the output. In order for this to work, it is important that the fluctuations in the exchange rate do not threaten the stability of the financial system nor the health of the real sector. That is why preventing major currency mismatches becomes relevant for the authority that is responsible for ensuring the operation of the entire policy framework.

It is hardly likely that the Bank would be able to limit mismatches in the real sector since there is no single supervisory authority that could guarantee compliance. However, currency flotation brings with it the risks of the same exchange rate volatility that normally leads agents to exercise a prudent management of these mismatches. In any case, the Bank constantly monitors these mismatches in search of warning signs.

The financial system has a different nature. This is not only because it has a consolidated supervisor that can ensure compliance with the regulations, but also because the intermediaries that it consists of are likely to end up accumulating many of the risks generated by all the transactions with their customers. Significant flaws in the financial system may jeopardize the proper functioning of basic elements in an economy such as the supply of loans and the payment systems. It was expedient, therefore, to review the kind of activities the different types of intermediaries had been authorized to carry out and remove inconsistencies that could have been generated over the years and as a result of specific reforms of regulations. Finally, there was an effort to make the license

<sup>1</sup> Summary based on what is contained in the technical document entitled “New Regulatory Framework for Foreign Exchange Market Operations” (Nuevo marco normativo para las operaciones del mercado cambiario), written by Ana Fernanda Maiguashca, *Banco de la República*. <http://www.banrep.gov.co/es/publicaciones/documento-tecnico-nuevo-marco-normativo-para-las-operaciones-del-mercado-cambiario>.

for intermediaries in the foreign exchange market (FEMI) a possibility for the entities, rather than an obligation, thus recognizing that there may be different business strategies within each group that do not necessarily involve carrying out a foreign exchange transaction.<sup>2</sup>

With respect to the risk to the balance sheets of these entities, the Bank started a process of upgrading the foreign currency risk regulation for the FEMI a few years ago. This transitioned from measuring the so-called “proprietary position,” which only considered the risk of fluctuations against the US dollar, to measuring and controlling for the mismatch risk in other currencies without losing control of the entire exposure in foreign currency. To do this, an indicator of liquidity risk denominated in those currencies was built. The exchange risk indicator (ERI), used to measure the overall exchange risk, and the individual and consolidated short-term exposure indicators, used to measure the liquidity risk in foreign currency at the individual and consolidated levels, were created through this process to encompass the entire balance sheet of the financial groups in conformity with the spirit of the law with respect to conglomerates (Act 1870/2017).

Once the mechanisms of control and measurement of balance sheet risks were strengthened, the foreign currency exchange operations could be simplified. In the case of loans denominated in foreign currency, in particular, the regulation focused on clearly revealing the foreign exchange risk in the balance sheet and lifting the currency restrictions on disbursement and payment in order to benefit the business owners who carry out these transactions. Foreign credit transactions denominated in Colombian pesos were also expected to occur and this process was facilitated since it was understood that they do not create any foreign exchange risk.

It was also found that the restrictions imposed on collateral and guarantee transactions did not have any conceptual support. This was because their risk could be revealed as long as the existence of the contingencies was known, and that when they were finally converted into debt, they would be covered under the corresponding regulation. To

that extent, these restrictions were eliminated seeking, of course, to ensure that the information on the contingencies generated for the financial system by that collateral or guarantee was properly reported.

With regard to the derivative transactions, many of the rules that covered them were made more flexible. A special chapter was drawn up for the operations known as *credit default swaps*, which includes those transactions that should be managed with greater prudence, such as credit risk derivatives. Certain precautions are maintained here although the rules authorized for the FEMI have been relaxed. In particular, these derivatives may be freely acquired regardless of whether or not they are being used as a hedge for any investment. However, no FEMI can issue them.

For the rest of derivatives, both financial and commodity, the restricting authorizations that existed were overridden: there is no list of operations or authorized underlying assets anymore. As a result, it is not necessary to regularly include the innovations generated in this market, which is quite dynamic and, in fact, seeks to provide customers with more efficient methods of managing their risk. This implies that the FEMI may participate in the commodity derivatives market. Up to now, permission was only given for residents to hedge themselves with agents abroad. Moreover, the conditions that had been established for all derivatives in terms of compliance were eliminated and, therefore, this compliance may now be financial or effective. This decision is now left to the parties under the agreement.

Lastly, some exceptions to credit transactions that are included in the requirement of a deposit for external debt were eliminated. This requirement is now 0%, but it is still a cornerstone of the Bank’s macro-prudential regulation.

This deposit is the answer to a second dimension of the risk that the regulation must control: the one generated by flows. International experience has shown that enthusiasm spreads across borders when there are large flows of liquidity from abroad, and that the local financial intermediaries can amplify this trend. This can lead the real sector to become excessively indebted under the illusion that the good times will never end, which is common to all economies. However, if there was an excessive assumption of risk on the part of the real sector and the financial sector also played the role of intermediary, then the undoing of the distorted results will be painful and its costs can persist over time once the trend of the flows from abroad go in reverse. The Bank, and the Colombian authorities in general, have been very successful in maintaining a counter-cyclical framework of action during these rising and falling tides. When enthusiasm seems to overflow, several instruments handled by different authorities make it possible to bring this back to a state of calm through an increase in marginal costs of certain transactions. This is

2 In the end, there were five FEMI categories which allowed different types of activities based on their licenses and equities. The credit establishments, which had the largest number of authorized activities, were placed in categories 1 and 2. The main difference between these two groups is that the former can obtain and grant financing denominated in foreign currency and transact derivatives, while the latter must restrict the investment denominated in foreign currency to credit cards and cannot transact derivatives. Both are allowed to be intermediaries of funds denominated in pesos coming from external agents. The stock brokerage firms which have an equity that reflects the fact that their operation appropriately manages the risks considered fall into category 3. This category limits the leverage these entities have for transactions with derivatives that are settled in a central counterparty risk clearinghouse, thus guaranteeing that this entity is the one that manages the counterparty risk in the transaction. The debt operations are reserved for groups 1 and 2 which, being credit institutions, have the expertise to be professional managers of this type of risk. The entities which are focused on remittances, transfers, and payments such as the Sifes and Sedpes are the ones which are part of groups 4 and 5.

how some provisions imposed by the Office of the Financial Superintendent, the marginal reserve requirement administered by the Bank, and the deposit for indebtedness abroad have worked. The national government has the power to impose a deposit on foreign portfolio investment flows under this same logic.

Since derivative transactions can duplicate debt or be highly leveraged, the Bank created another method of indirect measurement and control for them. The limits to the gross leverage position (GLP) and the proprietary cash position (PCP) were designed to reduce the ability of the FEMI to act as intermediaries of derivatives for their customers. However, unlike the cases of deposits for external debt and portfolio investment, the limits to the PCP and the GLP functioned continually. This did not follow the countercyclical logic sought by this type of macro-prudential instruments and, therefore, the decision was made that the entities would continue calculating these two indicators even though their limits were eliminated. This makes it possible to reinforce the derivatives market and its provision to the real sector, thus creating opportunities for companies and other customers in terms of better risk management. However, just as in the case of the deposit for external indebtedness, the Board of Directors of the Bank may impose new limits on these positions if it decides that there are reasons for their use at any given time.

the fact that, in any case, there is a record for each transaction regardless of its size. Others affect more specific targets, such as expanding the types of accounts denominated in pesos that non-residents can have with Colombian intermediaries; or the one that combines the regulation of public rediscount entities with the more homogeneous field of the general regulations of foreign exchange risk mitigation.

### 3. Avoid the Dollarization of Liabilities in the Financial System

Last of all, the regulations must ensure the autonomy of monetary policy. To that end, all the rules intended to reduce the dollarization of liabilities in the financial system were revised and the limits on such liabilities were maintained. The experience of other Latin American countries confirms the benefits of avoiding this kind of dollarization so that no restriction on the autonomy of the monetary authority in terms of the inflation targeting strategy with a floating exchange rate and ensuring that the best transmission of the monetary policy takes place. If the deposits were dollarized, the movements in the Bank's benchmark interest rate would have a limited effect on the interest rate of those deposits. That is why the currency breakdown of the liabilities in the financial system is significant for an effective transmission of the monetary policy.

### 4. Other measures

In a comprehensive review of the standards, such as the one carried out, there are many changes that cannot be listed in detail in the present box. Some of them affect the general public. One example is the increase in the limit on cash transactions from USD 3,000 to USD 10,000 for foreign exchange professionals. This aligns the amount with the one subject to a customs declaration and keeps in mind