Foreign Exchange Risk for Small Business Banks: Case Study on XacBank

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Webinar objectives

- **Foreign exchange risk:**
  - Definition
  - How measured
  - Why important

- **XacBank:**
  - Overview
  - FX risk management challenges and innovations
  - Lessons learned
SME FX risk definition

Foreign exchange risk:
The possibility of financial loss to the bank arising from adverse movements in foreign exchange rates.
FX risk is a form of market risk

Credit Risk

Operational Risk

Market Risk

FX risk can lead to credit risk

Foreign exchange (FX) risk
Measure FX risk through net open position

<table>
<thead>
<tr>
<th>(in trillions of togrog)</th>
<th>MNT</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS (A)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans to customers</td>
<td>382</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>148</td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>530</td>
<td></td>
</tr>
<tr>
<td><strong>LIABILITIES (L)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Borrowed funds</td>
<td>377</td>
<td></td>
</tr>
<tr>
<td>Other liabilities</td>
<td>159</td>
<td></td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>535</td>
<td></td>
</tr>
<tr>
<td><strong>Net open position=A-L</strong></td>
<td>-6</td>
<td></td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>122</td>
<td></td>
</tr>
<tr>
<td><strong>(1-2)/3 Net open position as % of equity</strong></td>
<td>-5%</td>
<td></td>
</tr>
</tbody>
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Net open position:
- Per currency
- Institution can set position limits
- Regulator may set prudential limits
There are three categories of FX risk hedging

**Natural hedge**

**Non-derivatives:**
- Back to back loans
- Letters of credit
- Guarantees
- Indexation

**Derivatives:**
- Cross currency swaps
- Forwards (deliverable & non-deliverable)
- Options
Origin of XacBank’s FX risk

- International lenders issue loans:
  - Most in USD, not MNT
  - 3-year average tenor
  - Creates USD B/S liabilities

Local currency: togrog (MNT)
Natural hedge more prevalent until 2013

USD loan portfolio was a "natural hedge" to borrowed USD funds

- Loans to Customers
- Borrowed Funds

USD funds or loans in MNT trillions

Years:

CapPlus
CapitalPlus Exchange
2013 steep depreciation reminiscent of 2008-2009

Monthly MNT per USD: 2008 - 1Q 2016

1,524
1,742
1,144
1,436

...and depreciated 43% since 2008 financial crisis
Which was worse: FX losses or higher credit costs?

- Data analyzed from 2008-09 for 2013-14
  - FX losses
  - NPL
  - Provisioning

“Forecasts and models supported our gut feeling.”
Xac had sense of urgency re: rising FX risk

“We couldn’t sit idly on our hands waiting for things to get worse.”

• Role of:
  o Executive Bank Committee
  o Asset-Liability Committee (ALCO)
  o Board
Hard to convince clients to convert to MNT loans

- 50/50
- Explanatory Excel sheet
- Customer education
- Revised credit policy
Dollar loans dropped from 37% in 2013 to 15% in 2015
Lessons learned

1) Conundrum:
   o Raising hard currency from abroad
   o Lending in local currency

2) Analyze USD lending impact on:
   o Customers
   o Bottom line

3) Innovate to address FX risk

4) No silver bullet
Key takeaways

- **Quality of earnings** matters most
- Changed 5-year strategy:
  - *Was*: Be largest bank in Mongolia
  - *Now*: Be most profitable bank in Mongolia
Parting words

“The past year has been a challenging year for so many companies in Mongolia given the depreciating currency...

We are working together with our clients to overcome these challenges and we believe this collaboration would strengthen our relationship with clients.”
Questions & Answers
Thank you!