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An Analysis of Currency Risk Exposure in Commercial Banks and Mechanisms for Its Reduction

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ABSTRACT : This article discusses the risks in the implementation of foreign exchange operations by commercial banks and ways to reduce them, the dependence of such factors on a number of factors as the development of banking operations, constant adaptation to social and economic conditions, the development of new strategies and tools for banking activities, effective management of bank risks, and the reduction of problematic processes. Also, the relevance of the development of commercial banks' activities today is undeniable, since the successful functioning of the entire financial system of the country depends on it. The author's approaches and proposals for their elimination are presented.

KEYWORDS: currency risks, currency, currency policy, banking activity, banks' currency operations, financial decisions, financial assets, receivables, credit, non-financial assets, real assets, funds, financial strategy of the bank, financial security of the bank, bank management.

INTRODUCTION

Forecasting the exchange rate is a very complex activity compared to forecasting other macroeconomic indicators. For accurate forecasting of the exchange rate, the work of the Central Bank to regulate the correct monetary policy and the level of inflation is important. It is also necessary to take into account the level of openness of the economy. Because the more open the economy, the higher the correlation between the exchange rate and the level of inflation.

In this regard, the Resolution of the President of the Republic of Uzbekistan “On the Strategy for Reforming the Banking System of the Republic of Uzbekistan for 2020–2025”, adopted on May 12, 2020, In the Decree No. PF-5992, " the analysis of the current situation in the banking sector showed the presence of a number of systemic problems that prevent the development of the banking sector in accordance with the needs of the economy and society, such as high level of state intervention in the banking sector, insufficient quality of management and risk management in state-owned banks, low level of financial intermediation in the economy " [1] .

Also, on September 11, 2023, the Decree of the President of the Republic of Uzbekistan "On the Strategy of Uzbekistan-2030" was adopted. The strategy provides for accelerating reforms in the banking system, increasing the volume of the banking services market and developing competition in the sector, bringing the annual lending volume in the banking and financial system to $ 40 billion, and increasing the volume of bank deposits by 4 times. In order to develop banking services and increase the volume of lending, it is necessary to form bank resources and improve currency operations. The need to form information in this area at the level of international standards and positive experiences of foreign practice in order to systematically solve existing problems requires extensive research on the topic.

Eliminating the possible negative impact of the national exchange rate on the price of consumer goods occupies an important place in the currency policy of central banks. This is because there is an inextricable link between inflation and the exchange rate.

ANALYSIS OF RELEVANT LITERATURE

The adoption of the Decree of the President of the Republic of Uzbekistan No. PF-5177 “On Priority Measures for Liberalizing Currency Policy” dated September 2, 2017 was aimed at radically reforming the current currency regulation system, liberalizing currency policy, and creating equal conditions for all business entities in carrying out foreign trade activities[2]. The active stage

of reforming the banking sector in our country, which began in 2017, made a great contribution to the liberalization of the foreign exchange market. In connection with the adoption of a new edition of the Law of the Republic of Uzbekistan No. ZURQ-573 "On Currency Regulation" on October 22, 2019, all types of currency transactions existing in practice were covered, and the norms in the legislation were reduced to the maximum[3].

The results of scientific research by a number of Uzbek economists show that the level of diversification of foreign exchange reserves of commercial banks in our republic is very low, and the main part of their foreign exchange reserves (more than 90 percent) is made up of reserves in US dollars [4].

Also, today, many scholars have deeply analyzed the essence and content of currency transactions and carried out important scientific developments in this direction. In particular, C. Nobes and R. Parker in their work "Comparative International Accounting" showed the differences between international financial accounting systems. Their research suggests ways to solve the complexities of managing currency transactions of commercial banks by adapting them to international standards [5]. It is worth noting the work "Financial and Managerial Accounting" by B. Needles and M. Powers [6]. This book provides an in-depth discussion of international standards of the financial accounting system, in particular, the application of IFRS rules for accounting for currency transactions. They emphasize the need to modernize accounting systems to reduce risks associated with changes in exchange rates. D. Diamond and P. Dybvig, who paid attention to liquidity issues in banking activities, emphasized that currency transactions play an important role in ensuring the financial stability of commercial banks. They studied methods for banks to increase customer confidence by accurately reporting transactions [7].

A study by René M. Stulz examines how risk management can be ineffective. He cites the limitations of risk management systems (human factors, misaligned motivations, lack of information), and the role of professional and corporate culture as key factors. The author argues that risk management in financial institutions is not only about models, but also about the organization's attitude to risk and the decisions it makes [8].

Philippe Jorion explains the concept of Value-at-Risk (VaR) in terms of practical and theoretical aspects in assessing market risks. He also recommends the use of RiskMetrics and models adapted to the Basel II standard [9].

Aswath Damodaran sees risk not only as a threat but also as an opportunity in his research. He analyzes the theoretical and practical aspects of strategic risk management in corporate and banking. Decision-making in risk management, risk presents optimization theories [10].

In his scientific works, local scientist Professor F. Kholmamatov proposed increasing the level of diversification of the loan portfolio in order to prevent credit risk. According to him, it is possible to increase the quality of assets by diversifying the loan portfolio based on clients, loan currencies, sectors, and regions [11].

Sh. Normatov studies theoretical and practical methods of managing credit, liquidity, operational and market risks in banks. He made proposals for assessing the effectiveness of risk models and their application in Uzbek banks [1 2]. N. Khidirov's scientific works cover a wide range of theoretical and practical issues of finance and risks. The author analyzes the concept of risk, its economic essence, types and methods of their assessment. He also provides information on risk management strategies and their impact on financial decisions [1 3].

The purpose of forecasting the exchange rate is to focus on increasing the efficiency of companies and banks, as well as other currency market participants in making decisions and defining plans, and improving currency risk insurance. Also, forecasting is important in the activity of financial speculators, because they can achieve high profits through exchange rate differences, changes in interest rates, and changes in the exchange rate of valuable securities.

RESEARCH METHODOLOGY

This In preparing the article, a comparative and critical analysis of the legal and regulatory documents, the literature and Internet information used, and the scientific and theoretical views of economists on the topic were conducted. In the course of studying the topic, along with general economic methods, systematic analysis, generalization, abstract-logical thinking, and statistical methods were used.

ANALYSIS AND RESULTS

There are a number of problems related to risk management in the activities of the banks of our republic, and their elimination, establishment of a modern risk management system based on international standards will further strengthen the stability of the banking system of our country.

Scientifically based classification of risks shows the exact position of each risk in their general system. Classification of risks makes it possible to apply appropriate methods and measures for their management. In modern economic literature, there are several classifications for the purposes of bank risk analysis and management.

The optimal level of balance between the efficiency and risk of foreign exchange operations summarizes the complex requirements for each aspect of the activity:

1. Profitability (minimum level of profitability in personal funds).
2. Liquidity (the minimum allowable amount of the liquidity coefficient for periods).
3. Risk (the maximum permissible level of risk for the bank and for individual operations). The optimal balance between operational efficiency and risk, as well as the optimality of the bank's goals, is one of the complex selection criteria of the asset management strategy. The trade-off between the level of risk and the efficiency of operations is determined separately based on the priority of the current activity of a specific commercial bank.

The certain strengthening of the real effective exchange rate in our country in the last months of 2024 was short-term in nature and was formed under the influence of the depreciation of the currencies of some trading partners and the high inflation rate in our country compared to them. In the second half of 2025, as the inflation rate decreases, the real effective exchange rate is expected to return to its medium-term trend level.

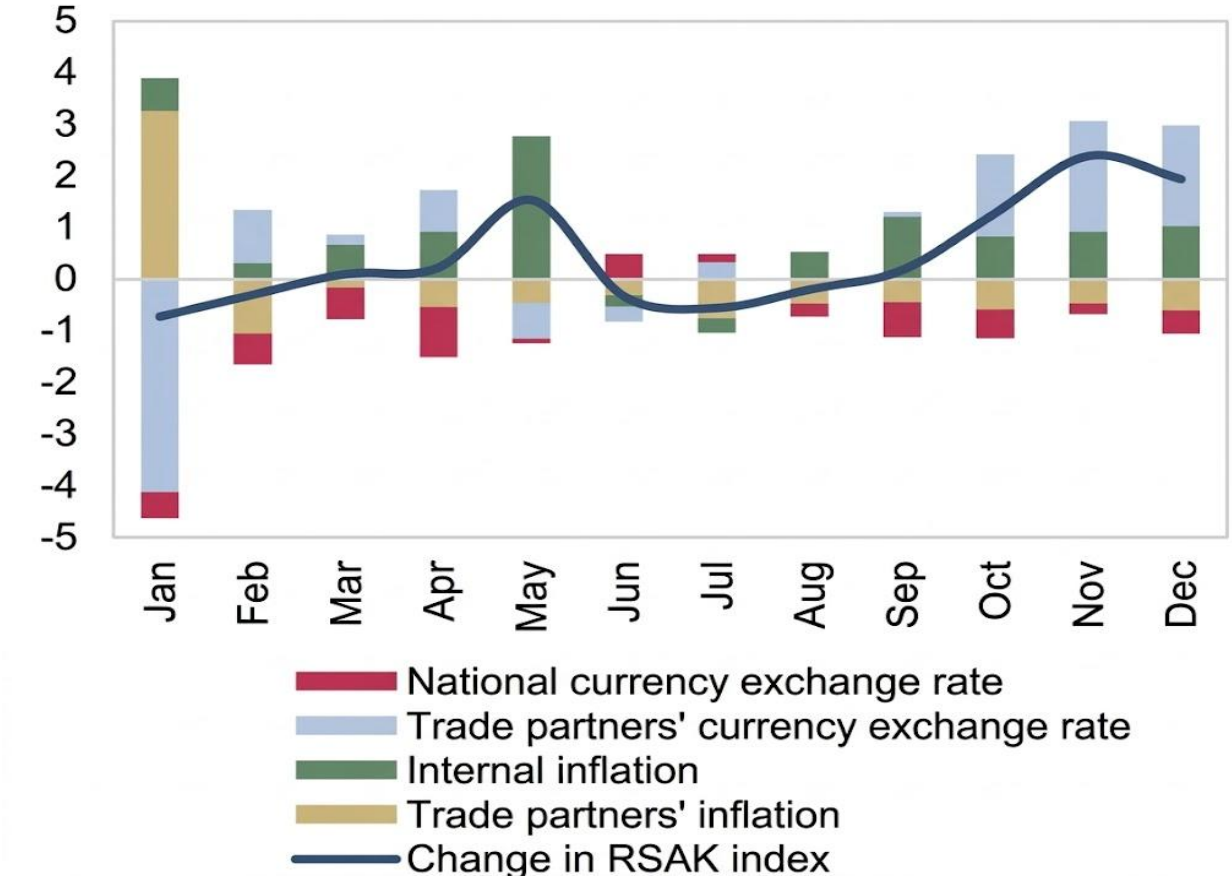


Figure 1. Decomposition of the real effective exchange rate[1]

From the data of Figure 1 above, it can be seen that in 2024, the real effective exchange rate of the soum strengthened by 5.9 percent. This was formed due to the devaluation of the currencies of the main trading partners in the last months of 2024 and the higher level of domestic inflation compared to the trading partners.

Also, in 2024, the total volume of foreign exchange transactions between banks and individuals increased by 19% ($4 billion) compared to 2023 and amounted to $25.5 billion. During this period, individuals sold foreign currency to banks in the amount of $16.1 billion, or 31% more than in 2023 ($12.3 billion in 2023). At the same time, the volume of foreign currency purchased by individuals from banks increased by 3% compared to 2023 and reached $9.4 billion ($9.1 billion in 2023). As a result, the volume of foreign currency sold by individuals to banks exceeded the volume of foreign currency purchased by $6.7 billion, and this positive difference, in turn, served as a source of additional supply in the domestic foreign exchange market.

[1] https://cbu.uz/upload/medialibrary/b59/hjkruz90vcqwon2ta6c7aje3r4iy0dz6/Pul_kredit-siyesati-shar_i-2024-yil-IV-chorak.pdf

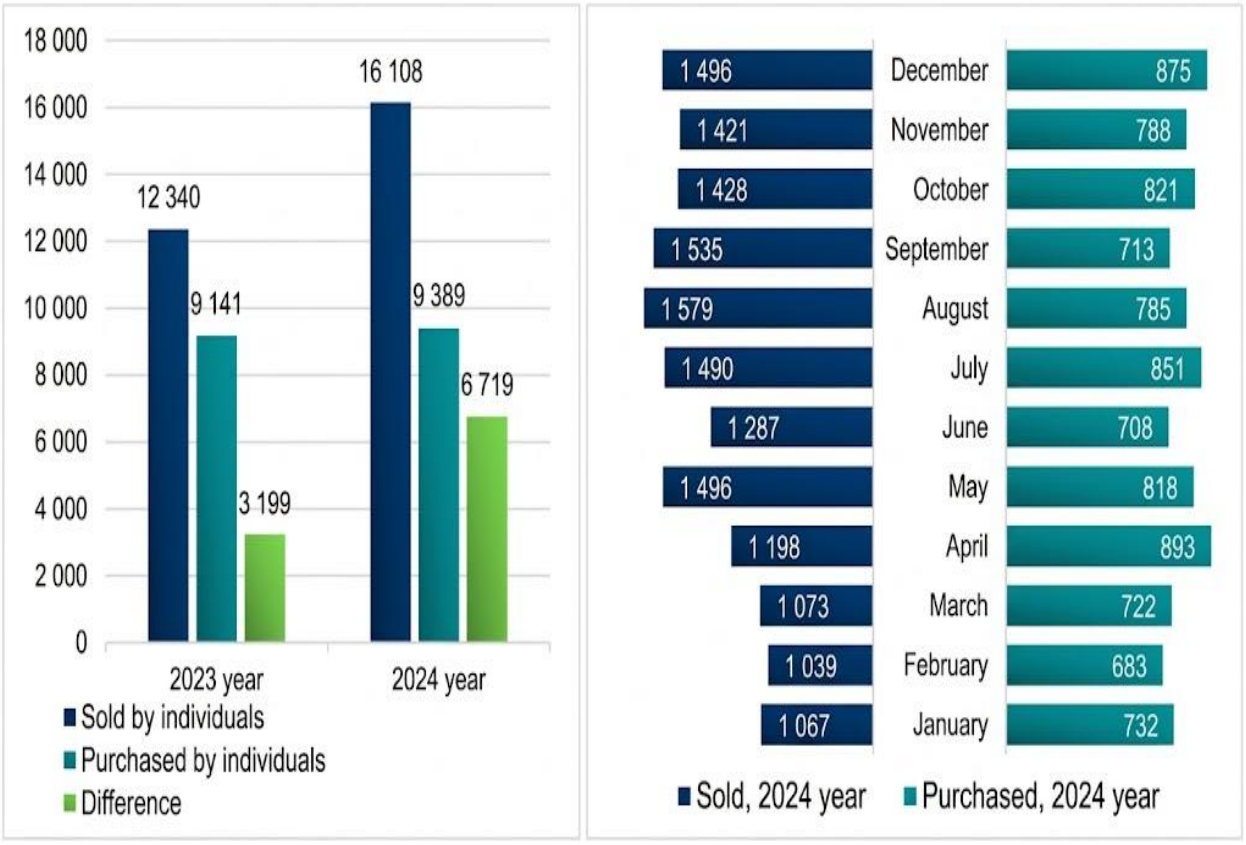


Figure 2. Dynamics of the volume of currency exchange operations in Uzbekistan in 2023-2024 [2], *million dollars*

Also, appropriate measures are being taken to develop the currency exchange infrastructure of banks, expand their network and ensure their uninterrupted operation. In particular, in order to expand the coverage of the currency exchange infrastructure for the population, the total number of currency exchange branches of banks throughout the republic increased by 20 percent during the year, bringing this process to 6.2 thousand. At the same time, the number of automated currency exchange ATMs operating 24/7 is more than 3.4 thousand, which are located in densely populated areas, tourist areas, airports, train stations, hotels and shopping malls.

A national clearing center began operating in Uzbekistan in 2023. It will help facilitate foreign exchange operations of commercial banks and reduce their risks. The clearing center, which has been operating for almost a year, helps commercial banks to facilitate foreign exchange transactions and reduce their foreign exchange risks.

In particular, since the first years of Uzbekistan's independence, the republic's foreign exchange exchange has been organizing exchange trades in various foreign currencies (US dollars, euros, Chinese yuan, and Russian rubles), currency swap transactions, government securities, and derivatives.

In addition, our exchange organizes an interbank money market, deposit and credit auctions of the Central Bank, and REPO operations are also carried out.

Clearing (from the English "clearing") refers to the identification and accounting of mutual claims and obligations of clearing participants under concluded transactions.

Information about the transactions concluded in the currency exchange trades is entered into the account clearing system. Through clearing, the mutual obligations of clearing participants are defined, clarified and taken into account.

Let me make it simpler and explain on the example of 2 transactions made on the stock exchange. Let's say you sold 100,000 US dollars for 12,000 soums and bought 100,000 euros for 13,000 soums.

So, under the first transaction, your obligation (the amount of money you must transfer to us) for selling US dollars is 100 thousand US dollars, and your claim (the amount of money we must transfer to you) is 1 billion 200 million soums.

According to the second transaction, your obligation is 1 billion 300 million soums, and your demand is 100,000 euros. As a result of our clearing (netting method), that is, after calculating the total demand and liabilities, your liability for two transactions

[2] https://cbu.uz/upload/iblock/fa2/bosg9g712b0257ovp9z2t937n063neyh/ZHismoniiy-sharkh-2024.pdf

is 100 million soums (the difference between the demand for the first transaction (1 billion 200 million soums) and the liability for the second transaction (1 billion 300 million soums), 100,000 US dollars, and your demand is 100,000 euros does.

If you enter into a direct transaction with a bank, not with a Central Counterparty (national clearing house), then settlements are made separately for each transaction. In the first stage, you transfer 100 thousand US dollars to it, in turn, that bank transfers 1 billion 200 million soums to you, in the second transaction you enter into, you transfer 1 billion 300 million soums to the bank, and the bank transfers 100,000 euros to you.

Today, clearing sessions are held at different times in each market, we calculate the obligations and claims for each asset, clarify them and provide appropriate reports on them. The reports indicate the claims and obligations of the currency exchange and trading participants. This process is called "clearing".

The process of transferring the funds indicated in the report to our account by the relevant banks and our transfer of funds to the banks for our obligations is called "settlement".

CONCLUSIONS AND SUGGESTIONS

To summarize, the first element of risk management is margin. Simply put, to place an order to buy or sell an asset, you need to deposit a margin of approximately 3-10 percent of the order amount. This margin protects against the risk of an increase in the market value of the asset. If the market value of the asset increases by more than 10 percent, the central counterparty manages the default by using guarantee funds. In cases where the guarantee fund is insufficient, the loss is covered by the reserve fund. The central counterparty can also manage the default by concluding overnight currency swap and REPO transactions on behalf of defaulting trading participants.

The presence of a central counterparty is a standard situation for developed markets, and today its activity is introduced in the currency spot and derivatives market.

The central counterparty acts as the seller for the buyer and the buyer for the seller in each transaction concluded in the financial market. Its main purpose is to reduce the risk of non-fulfilment of obligations under transactions, that is, to reduce credit risk, to guarantee the execution of concluded transactions by managing default situations, and to reduce the transaction costs of trading participants through netting.

Since the organization performing the function of a central counterparty assumes the responsibility for risk management, this organization must form a reserve fund at its own expense and a guarantee fund at the expense of clearing participants.

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