

Foreign Exchange Intervention Rules for Colombia

This note explains the rules of foreign exchange intervention by the Central Bank (CB) that were implemented in November of 1999, following the adoption of the floating exchange rate regime in September of 1999. The CB intervenes in the foreign exchange market following predefined well-known rules that are posted in the Bank's web page.

Under the foreign exchange regulation, the Central Bank (CB) has the possibility to intervene in the foreign exchange market, by auctioning, put or call, dollar-peso options (American style). Put options give the right, to the owner, of selling dollars to the CB and, call options grant the right of buying dollars from the CB.

The CB intervenes in the foreign exchange market to:

- 1) Increase or decrease the level of international reserves
- 2) Control the volatility of the exchange rate (peso-dollar).

1. Increasing or decreasing the level of international reserves.

a. Intervention to increase international reserves

In order to build up international reserves, the CB has the possibility of selling monthly (dollar/peso) put options in a discretionary amount set by the CB Board of Governors. The Auction must be announced at least one working day in advance.

These put options are valid from the first to the last working day of the month immediately following the day of the auction (they have usually coincided with calendar months) or in the period specified in the announcement. The options can be exercised, partially or totally, any working day during its term, whenever the exchange rate market (TRM- certificated by the Superintendencia Bancaria) is beneath its 20-day moving average in this month.

b. Intervention to decrease international reserves

The CB can occasionally announce, at least one day in advance, an auction for call options, in an amount determined discretionarily by the Board of Governors.

The term for the call options is of one month, starting as of the following working day of the auction. Call options can be exercised, partially or totally, any working day during its term, whenever the TRM is above its 20-day moving average in this month.

Note: In case these put/ call options are totally exercised, before their expiration date, the Board of Governors could announce new auctions. The maturity of the new put options will be from the first working –day, following the auction, until the last working day in the same month or in the term set in the last auction. For the new call

options the maturity extends from the following working day of the auction until the last working day of expiration of the previous call option.

2. Intervention for exchange rate volatility control

If the exchange rate is 4 % or more below (above) its last 20 working-day moving average, volatility auctions are held to sell put (call) options. It is required that the last volatility options have expired, regardless of whether they have been exercised or not.

The amount to be auctioned in volatility options have been established by the CB Board of Directors in USD180 million. The term of the options is of one month since the day of the auction. Options can be exercised any working day during its term, that the exchange rate is 4% or more below (put) or above (call) its last 20 working-day moving average.

In addition, If the TRM is 4 % or more below (above) its last 20 working-day moving average, the CB may announce and hold new auctions for the control of the exchange rate volatility, even if the options that were last auctioned have not expired. The amount of these new volatility auctions is determined in a discretionary way by the CB and it is announced at the time the auctions are called. Terms and exercise conditions are similar to those described in the previous paragraph.

3. General Characteristics

The agents authorized to trade contract options with the CB are: the Ministry of Finance and authorized exchange intermediaries such as commercial banks, and other financial institutions, excluding stock-brokerage firms and foreign exchange dealers (*casas de cambio*).

The CB currency options are auctioned under the following general conditions:

- They are auctioned under the Dutch auction mechanism: the bids are sorted in descendent order in terms of their offered option premium. The bids approved are those with an equal or higher premium than the cut off premium. All the positions approved pay the same option premium.
- The CB has established a maximum number of five bids by participant, which cannot surpass the amount of the auction. In case of detecting a non-acceptable concentration of bids, the CB can admit only partial positions. Bids must be in multiples of USD100.000
- Failure to pay the option premium generates a penalty and cancels out the approval of the bid. Also, failures to exercise an announced option will be punished with the cancellation of the unexercised amount of the option.
- Options can be exercised at any time on or before the maturity date of the option, that the strike condition is place.
- The strike price of the options will be the market exchange rate of the day before the exercise date. This rate is certified by the Banking Superintendency as the Representative Market Rate (TRM) of the exercise day.
- Options can be traded among those authorized to participate in the primary auction.