

## RISK MANAGEMENT SUBCOMMITTEE REPORT

The Risk Management Subcommittee facilitates the understanding of risk management issues and promotes improvements in the quality of risk management techniques in foreign exchange and related financial markets. During 1996, the Subcommittee coordinated the work of two working groups to produce the papers Management of Operational Risks in Foreign Exchange (April 1996), and Guidelines for Foreign Exchange Settlement Netting (January 1997).

Working in conjunction with the Operations Managers Working Group, the Subcommittee produced the Management of Operational Risks in Foreign Exchange paper identifying fifty best practices for controlling specific operational risks associated with, but not limited to, the foreign exchange business. The paper identifies several prominent best practice “themes”:

- separating the duties of the sales and trading group and the operations group responsible for confirmation and settlement;
- increasing management’s understanding of operational risks;
- developing confirmation practices consistent with the Foreign Exchange Committee’s report, ensuring that all trades are confirmed in a timely manner;
- creating settlement instructions that ensure funds will be transferred to the right place;
- introducing reconciliation practices that ensure that all discrepancies, between the sales and trading group and operations, between operations and the general ledger, and between the foreign exchange participant and its counterparties or nostro banks are identified and corrected in a timely manner;
- hiring and retaining quality staff who understand the foreign exchange process flow and understand how the flow affects the level of risk an institution incurs;

- reporting management and exception information so that all appropriate people in the organization know about problems in the foreign exchange process flow;
- automating services, particularly in the form of straight-through processing; and
- ensuring that on-line global credit line and availability information, including netting status is available to sales and trading staff around the clock.

While many market participants may be aware of some of the points raised in the paper, the Committee firmly believes that all market participants will benefit from gaining a better understanding of less familiar issues. Management of Operational Risks in Foreign Exchange is reprinted on pp. 33 - 61.

In collaboration with the Risk Managers Working Group, the Subcommittee authored the Guidelines for Foreign Exchange Settlement Netting. This paper is the Committee’s most recent endeavor in an ongoing commitment to help foreign exchange market participants reduce settlement risk. The Committee’s netting work began with its October 1994 paper, Reducing Foreign Exchange Settlement Risk, which paper demonstrated that the bilateral netting of payments due between foreign exchange counterparties could significantly reduce foreign exchange settlement risk. Following publication of Reducing Foreign Exchange Settlement Risk, the Committee presented several seminars on the paper in the global trading centers.

At the seminars, the Committee received numerous questions on how individual firms should address reducing settlement risk. In response to these follow-up requests for information, the Committee undertook a 1995 survey of its members’ current netting practices. Market participants’ questions and the study revealed a real need for a “how to” guide for implementing settlement or payment netting arrangements. The Guidelines for Foreign Exchange Settlement Netting was developed to provide such guidance. In analyzing the benefits of settlement or payment

netting, an analysis requires a clear understanding of many issues, including:

- the quantifiable and unquantifiable benefits;
- the increasing importance that regulatory authorities are placing on the need to reduce foreign exchange settlement risk; and
- related direct and indirect expense issues.

Generally, a firm must analyze the composition of its foreign exchange business and then determine which of the several approaches to settlement or payment netting is best for its purposes. The Committee would like to reinforce the view that the netting of foreign exchange payments is one of most effective ways to reduce foreign exchange settlement risk. The Guidelines for Foreign Exchange Settlement Netting are reprinted in this Annual Report on pp. 63 - 99.