TRANSMITTAL LETTER

ACCOMPANYING COMMENTS ON THE CONSULTATIVE PAPER *SUPERVISORY GUIDANCE FOR MANAGING SETTLEMENT RISK IN FOREIGN EXCHANGE TRANSACTIONS*

Mr. William Coen
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
Fax: 41 61 280 9100

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Dear Mr. Coen:

The Foreign Exchange Committee appreciates the opportunity to comment on the July 1999 consultative paper *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*.

We wish to congratulate the Basel Committee on its commendable work in producing this paper. We believe the paper helps to further define and encourage market measures to reduce settlement risk. As indicated by your bibliography, our Committee has been at the forefront of identifying settlement risk since 1994, when we introduced a definitive method of settlement risk measurement.

We were unanimous in our approval of the paper's intent and most of its content. The thoroughness and specificity in covering the subject's complex issues were very much admired. However, we did feel that there were areas within the paper and the appendices that could be modified. Attached are the comments that represent our concerns and suggestions on several specific topics. I also attach, for your reference, a list of the current membership of the Foreign Exchange Committee. Please feel free to contact me or the Committee's Executive Assistant regarding any aspect of these comments.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

THE FOREIGN EXCHANGE COMMITTEE'S COMMENTS ON THE BASEL COMMITTEE PAPER *SUPERVISORY GUIDANCE FOR MANAGING SETTLEMENT RISK IN FOREIGN EXCHANGE TRANSACTIONS*

The Foreign Exchange Committee (the Committee) supports the efforts of the Basel Committee on Banking Supervision (the Basel Committee) to reduce foreign exchange settlement risk. In the interest of encouraging successful implementation of further measures to reduce settlement risk, the Committee welcomes the opportunity to comment on the recommendations made in *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*.

The Committee respectfully submits its comments in two parts. The first section provides general observations and recommendations concerning settlement exposures, contingency planning, and policy involving fails. The second section suggests specific clarification or correction to several paragraphs discussing settlement exposures, setting and using limits, netting, and the role of supervisors.

SECTION 1

(1) The Measurement of Settlement Exposures

The Committee acknowledges the efforts of the Basel Committee to establish a common approach to the measurement of settlement exposures. The Committee understands that banks might be more willing to subscribe to such an approach if other institutions pursue the same course.

The Committee recognizes that the measurement of settlement risk advocated in the paper diverges from models developed at financial institutions and still in widespread use in the private sector. At the very least, the proposed methodology requires more precise calculations and an extensive restructuring of the existing models.

The Committee believes that the difficulties in implementing the "limit-monitoring" practice of settlement risk as defined by the Basel Committee lie in the pre-transaction checking required of banks. Today's market practice typically necessitates a check of availability for a transaction's notional amount against a gross settlement limit for a given day. The proposed checking process would require a more complicated "what-if" analysis incorporating variables such as currency pair, purchase or sale, netting capability, payment cutoff times, and estimated reconciliation completion times.

These calculations would need to be available and monitored for any day on which a counterparty may settle a foreign exchange transaction, resulting in a significant logistical challenge for many institutions. It is felt that the time involved to generate a "what-if" check of limits might seriously impede the timely execution of routine transactions.

Finally, the benefits of such a cumbersome process are likely to be fewer than expected (this is also discussed in Section 2). Many banks have signed settlement-netting agreements with their most active counterparties. The extension of a settlement period can, in practice, have little impact on the amount of netted exposure between two active trading counterparties precisely because they trade so frequently with each other. When this trading activity involves the purchase and sale of multiple currencies, there is often little net settlement risk remaining, regardless of the definition of the settlement window.

Counterparties who trade infrequently often do not have settlement-netting documentation in place, but in this instance the use of the Basel settlement definition also rarely increases the amount of settlement risk actually incurred, simply because the counterparties by definition do not trade very frequently.

Suggested Change in Recommendation

In reviewing institutional adherence to settlement-risk-reduction procedures, supervisors should recognize the work of many banks in developing settlement risk measures and internal risk procedures. It is the Committee's opinion that the validity of the internally developed methods should be allowed by supervisors, particularly when the methods are viable and when settlement risk is not underestimated. This opinion is consistent with comment by the Committee on Payment and Settlement Systems (CPSS) in *Reducing Foreign Exchange Settlement Risk: A Progress Report* (July 1998).

A bank could, for example, periodically take "snapshots" of its portfolios, calculate settlement risk according to the Basel definition, and contrast these measures with its internal settlement risk measurements. If the internal measures prove to be reasonably accurate proxies for the Basel Committee definition of settlement risk, their use should be allowed subject to frequent verification and periodic review by regulatory authorities. In that way, the financial community's significant progress over recent years in measuring and curtailing settlement risk would be encouraged and supported.

The Committee also suggests that Appendix 2, "Possible Questions for On-Site Reviews," include an introductory paragraph indicating that the questions are meant as a broad guide for an interviewing regulator. The Committee encourages regulators to modify questions according to the type of institution and the institution's role in the foreign exchange market.

(2) Managing Fails

The Committee agrees that fails should be identified and properly monitored. However, the Committee is concerned that undue emphasis may be placed on fails. In the opinion of the Committee, fails are a routine part of a business characterized by high volume and complexity. Given the routine nature of fails, many banks already have in place systems to quickly address and remedy the situation. It is suggested that regulators should judge an institution's approach to fails accordingly. Concern is that an overreaction to each fail could, in itself, slow processes and cause systemic problems.

(3) Contingency Planning

The Committee is cognizant of the limited resources available for contingency planning in many organizations and is concerned that too many contingency plans could make applications unduly difficult. It is suggested that an institution may want to prioritize events based on its individual needs and circumstances and emphasize the most likely event in its contingency plans. In addition, planning can be made more efficient if foreign-exchange-related contingencies dovetail other business contingencies, for example, those related to the trading room.

(4) Suggested Additions to the Paper

The Committee notes that the paper would benefit from the inclusion of a substantive discussion of other important settlement-risk-reduction measures, such as improved payment cutoff times, enhanced nostro communication, and a heightened focus on large exposures and activities of less creditworthy counterparties. The Committee also sees benefit in supplementing the report with updates on bilateral netting systems and the multilateral settlement system of CLS (Continuous Linked Settlement) Bank.

SECTION 2

Measurement of FX Settlement Exposures

Paragraph 11, page 3

The wording of this paragraph appears to provide a misleading picture of the amount at risk. It focuses on the amount of each currency under currency trades as opposed to actual amounts of currency that the relevant branch of each party is legally obligated to settle on a given day. As a result, the paper appears initially to suggest that the correct measure of risk is always the aggregate gross settlement obligations under all transactions to be settled on a given day. Netting as it appears in paragraphs 21 and 22 is not effectively linked to this discussion.

It is suggested that the second sentence of paragraph 11, which states that "the full value of the trade is at risk," be revised to start with the following:

During the period of irrevocability, the amount of currency that a party is obligated to settle will be at risk. If a party has entered into a legally enforceable settlement netting agreement, as described in paragraphs 21and 22 below, the amount of risk will be the netted amount of each currency for the applicable office of the party. If a legally enforceable settlement-netting arrangement is not in place, then the full face value of the trade is at risk during this period, which can last overnight or up to two or three full days.

Paragraph 13, page 4

If the parties have agreed to settlement netting—the method known as running account—the individual currency pairs of the original transactions will be irrelevant. As a result, the second sentence of the paragraph focuses somewhat inaccurately on currency pairs, rather than on the net amount of each currency to be settled. As currently drafted, this sentence continues the misleading focus on *gross* settlement and individual transactions that is evident in paragraph 11.

Setting and Using Limits

Paragraph 15, page 5

Because the paragraph seems to suggest that settlement limits must be enforced after an event occurs, it seems to indicate that a bank can control the consequences of such an event. This is not correct. Settlement obligations arise from transactions that have been agreed upon in advance of the settlement date. If a market disruption event occurs after the date that transactions are entered into, but on or prior to the settlement date, it may be the case that settlements will be delayed and may roll over to the succeeding business day(s).

This type of market disruption occurred in the case of the Indonesian rupiah in 1998. The same may be true of operational problems. It is not uncommon for a payment failure to occur, resulting in an increased settlement amount on the next business day. The only time that a market disruption or operational problem should become a credit decision is when an amount of time has elapsed such that any applicable cure period for the failure has elapsed and a decision is being made to wait an additional amount of time, or if another intervening event has occurred that would give rise to the potential exercise of legal rights to close out the affected currency obligation. At this point in time, there is a credit decision as to whether any payments should continue to be made to the affected party.

As a result, it is suggested that paragraph 15 be written as follows:

The limits applied by the bank to its FX settlement exposures should be binding—i.e., any excesses should be subject to approval by the appropriate credit management personnel. If an event occurs that causes a settlement to be delayed, such as an operational problem or market disruption event, credit management personnel should be advised of such a delay as soon as possible. The consequences of any continuing delay should be evaluated with credit management personnel and legal advisors in order to adequately evaluate the credit risks arising from any ongoing delay in settlement.

Managing FX Settlement Exposure

Paragraph 18, page 5

Although this paragraph appropriately suggests that payment cancellation deadlines should be managed carefully, it does not remind readers that payment cancellation is a remedy that should be resorted to only when a party has the legal right to do so. The following could be added after the last sentence of the paragraph:

Banks should be careful in using cancellation of payment as a risk management tool. In general, a bank is entitled to cancel a payment only when its counterparty has defaulted on its obligations to the bank. The effect of cancellation underscores the need to evaluate a bank's legal rights: cancellation of a payment to a counterparty can have a domino effect, causing the counterparty to have insufficient funds to settle other obligations, leading to further defaults and potentially resulting in settlement gridlock. As a result, a bank should carefully consider its legal rights and the legal consequences of cancellation before taking such action.

Managing FX Settlement Exposure and Use of Netting

Paragraphs 20-22, page 6

The Committee suggests amending the following paragraphs (the suggested additions or changes to the text are italicized) to read as follows:

20. Appropriately managed collateral arrangements *and written agreements governing netting of payments* settlement (see below) are also important risk management tools that can reduce the amount of a bank's exposure to a particular *level of trading*.

21. Banks can reduce the size of their counterparty exposures by entering into legally binding agreements for the netting of settlement payments.[1] *Such agreements provide that payment obligations in the same currency with the same settlement date will be netted within a pair of trading offices—for example, Bank A's London Office will enter into FX transactions with Bank B's Tokyo office*. Legally binding *payment* netting arrangements permit banks to offset trades against each other *entered into within a designated branch or designated pair of branches* so that only the net amount in each currency is paid or received by each institution. *Such payment netting agreements are contemplated in the industry standard bilateral master agreements covering FX transactions, but must be elected by counterparties to such agreements*. Depending on trading patterns, *payment* netting can significantly reduce the value of currencies settled. *Payment* netting also reduces the number of payments to one per currency either to or from each counterparty. *Payment* netting is most valuable when the counterparties have a considerable two-way flow of business; as a consequence it may only be attractive to the most active banks. To take advantage of risk-reducing opportunities, banks should be encouraged to establish procedures for identifying *payment-netting* opportunities.

22. To allow exposures to be measured on a net basis, the legal basis for *payment*-netting arrangements should be sound. (*It is suggested the second sentence in the original paragraph be removed.*) *It should be noted that the enforceability of payment-netting agreements is a contractual rather than a statutory matter. In contrast, the enforceability of closeout netting arrangements most frequently is governed by local and other relevant insolvency or bankruptcy laws.*

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[1]Netting of payment obligations should not be confused with "closeout netting," which requires counterparties to settle on a net basis all contracted but not yet due obligations immediately upon the occurrence of a defined event, such as the appointment of a liquidator to one of the counterparties. Although closeout netting may be a useful part of a bank's overall risk management, it is not discussed further here as it does not, by itself, reduce FX settlement exposures.