Annex – 1

Saudi Banks Comments on the BCBS Consultative Document Entitled "Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions"

BANK # 1

Guideline 2: Principal risk

A bank should use FMIs that provide PVP settlement to eliminate principal risk when settling FX transactions. Where PVP settlement is not practicable, a bank should properly identify, measure, control and reduce the size and duration of its remaining principal risk.

Comment

The papers appears to be focused on major banks that have substantial volumes across different FX products. Some time ago the Bank did investigate the possibilities of joining the CLS but concluded that with the Bank's relatively low FX volumes that it would have been impractical to participate.

Some structured product transactions, which use FX as the underlying instrument may generate different cash flows based on market situations, and depending on the structure, FX settlement risk could vary. There should be guidance as how to handle FX risk arising from such structured products.

The importance of managing FX settlement risk during times of stress is highlighted. However, the document does not provide guidelines on how FX settlement risk should be considered during stress testing. Such guidelines are crucial for a bank in deciding whether or not to implement PVP and collateral arrangements.

A bank should consider whether such participation in an FMI may possibly leads to an overall higher level of risk. It may require margin deposits/collateral being placed with the FMI and being actively managed. These requirements may represent additional cost which should be factored in when considering the cost of capital for FX transactions. The document should highlight this in order for a bank to understand the cost involved in minimizing principal risk.

Guideline 3: Replacement cost risk

Effective collateral management framework should be in place that incorporates the full range of market practices and accounts for the bank's scale of FX activity.

A bank should employ prudent risk mitigation regimes to properly identify, measure, monitor and control replacement cost risk for FX transactions until settlement has been confirmed and reconciled.

Comment

The concept of proportionality should be considered dependent on the complexity of the FX business being transacted with counterparties. The Bank does not agree with the idea mooted in the CP that all counterparty banks should sign an ISDA for simple FX transactions where normally a customer treasury agreement would suffice.

Failure to settle a FX transaction by a counterparty may require a bank to extend credit lines to the bank's customer i.e. resulting in additional credit risk. The document does not provide detailed guidelines on how to manage and monitor this type of credit risk which should be assessed and monitored separately from other credit risks.

Guideline 5: Operational risk

A bank should properly identify, assess, monitor and control its operational risks. A bank should ensure that its systems support appropriate risk management controls, and have sufficient capacity, scalability and resiliency to handle FX volumes under normal and stressed conditions.

Comment

As an industry practice, FX systems are managed separately from the bank's core banking system and normally do not have 'live' integration. The implementation of the CP's requirements may lead to substantial investments in new, or upgrades to systems which are either 'live' integrated or in one system which serves both purposes i.e. FX and core banking activity. These developments/upgrades will take time to develop and implement and will probably involve considerable cost.

Guideline 6: Legal risk

A bank should ensure that agreements and contracts are legally enforceable for each aspect of its activities in all relevant jurisdictions.

Comment

The paper highlights the importance of the ISDA to minimize settlement risk and encourages the adoption by international counterparties and customers.

However, there is substantial work that needs to be undertaken in this area to review and ensure that netting and collateral arrangements, including provisions for close-out netting and obligation netting are legally enforceable in all relevant jurisdictions in order to reduce replacement cost risk.

Guideline 7: Capital for FX transactions

When analyzing capital needs, a bank should consider all FX settlement-related risks, including principal risk and replacement cost risk. A bank should ensure that sufficient capital is held against these potential exposures, as appropriate.

Comment
The paper highlights that when banks are analyzing capital requirements for particular exposures, they must consider all foreign exchange settlement-related risks, including principal risk and replacement cost risk.

Under BASEL 2 Pillar 2 capital is allocated for settlement risk following an internal approach that accounts for all future FX transaction deliveries where the Bank is paying first and receiving later. No bilateral netting is recognized for capital calculations pertaining to FX settlement risk i.e. calculations are made on a gross basis as the legal aspects relating to netting arrangements have not been tested locally.

Under BASEL 2 Pillar 1 capital requirements pertaining to counterparty default risk banks generally use the current exposure method. This method requires calculation of MTM value (replacement cost) of FX transactions with an add-on for potential future exposures. We believe capital requirements are adequately addressed for all FX settlement related risks.

The document includes the concept of Banks differentiating cost of capital charged to their business units who manage FX settlement risk differently based on the risk profiles of their foreign exchange transactions. It would be useful if the document provided detailed guidelines on the basis for such differentiation.

BANK # 2

Foreign Exchange (FX) transactions have grown substantially in recent years and in managing settlement risk credit institutions have striven to select sound counter-parties in their FX transactions and have considered themselves to enjoy a satisfactory degree of security in this respect, since no major FX settlement failures have been experienced in most countries.

In view of this, the new BCBS guidelines are a welcomed addition aimed at further assisting banks in better managing the risk of settlement of FX transactions.

Bank supports the BCBS strategy to reduce the settlement risk on FX transactions and will participate in the work to implement this strategy where applicable to the local jurisdiction. This particularly applies to market participants whose exposure to settlement risk is very large in relation to their equity capital.

The proposed new guidelines contain several recommendations, the principles of which are to be incorporated into a bank's FX settlement procedures.

Anticipated points of consideration with these principles are as follows:

As a general observation, we believe there should be a distinct guideline on Credit risk which should also be defined in the Glossary since credit risk is the key cause of settlement and pre-settlement risk.

Guideline 1: Governance

Each bank will need to perform a gap analysis to compare its current risk management process against the comprehensive risk management process including active engagement by the Board of directors mentioned in the guidelines.

Each bank's risk management framework to manage FX settlement-related risk should also cover Credit Risk as a material risk, in addition to the risks listed under point 2 of 'Key Considerations' on page 6.

In paragraph 3.1.4, we recommend an amendment to include pre-settlement risk. "A bank should set formal , meaningful counter-party exposure limits for FX trading and settlement , including pre-settlement.

In paragraph 3.1.11, apart from the financial condition of the correspondent bank, the risk rating of the country in which it operates should also be included as an assessment factor.

Guideline 2: Principal risk

In paragraph 3.2.7 we recommend that the ex-ante process should include management triggers approved by a governance committee of the Board.

Referring to paragraph 3.2.10, to limit the number of agreements/SLAs between banks and their correspondents it is recommended that international standards should be implemented to establish the latest time a correspondent may guarantee a cancellation request.

There may be certain legal obstacles in some jurisdictions pertaining to netting agreements. Without the applicability of netting rules, regulators should be encouraged to review the guidelines in paragraphs 3.2.16 and 3.2.17.

Guideline 4 : Liquidity risk

A Financial Market Infrastructure (FMI) may not currently exist in certain jurisdiction managing FX payment obligations. In the absence of any netting agreement, this will be a future consideration for the local regulator and banks.

Guideline 7 : Capital for FX transactions

Creating an internal incentive structure from a practical perspective would depend on how advanced an organization is in its application of a more complexed risk based allocation where the costs of FX settlement-related exposures are allocated to a business unit.

Regulators may work with local banks on an individual basis to identify the most practical approach based on trading volumes of each bank.

Annexure and Glossary

Paragraph 6 of the Annexure should note that Principal Risk can sometimes be greater than the full value of the trade due to replacement costs as well.

We recommend that the Glossary includes a definition of OTCs covering mandatory clearing and the identification of OTC derivatives that should be cleared.

Reference to Basel Accord

We recommend that the consultative Guidance Document should make a reference to Annexure 3, page 252 and 253 of the BIS handbook ("International Convergence of Capital Measurement and Capital Standards" dated June 2006). This is relevant to Capital Treatment for Failed Trades and Non-DvP Transactions.

BANK # 3

Bank's Comments

We think that the document/proposal to enhance the management of settlement risk emanating out of foreign exchange transactions is very comprehensive and detailed and will enable the regulators to better manage this risk while allocating sufficient capital buffers. But all the same time it will also require lot of market participants in the financial market infrastructure to upgrade their policies, procedures and will entail lot of investment in systems and resources.

On the Governance side, in our institution FX specific delegations for settlement risk limits are approved by the executive committee of the Board of Directors. Settlements limits are instituted for counterparties based on their risk grades and requirements and these limits are monitored and controlled on a counterparty basis and are escalated to the relevant level of approval up to Executive Committee depending on total facilities amount and Risk Rating. We think that beyond this, getting the Board of Director's approval for detailed Settlement procedures can be unnecessarily onerous.

While we view PVP as very desirable as risk mitigation, presently, its use is quite low and we are majorly accepting the settlement risk limits on highly rated financial institutions for our FX deals. We do not expect that the market will be ready for wide-spread use of PVP in the near future and have invested in enhancing our settlement risk monitoring systems. We have executed ISDAs/CSAs with large counterparties and are endeavoring to cover all of the major ones.

On the replacement cost risk, our system provides replacement cost of all FX transactions during the time it is in the Pre-settlement risk category and up to the scheduled day of settlement as opposed to day of actual settlement. Once a transaction moves into settlement risk category we currently don’t monitor the replacement cost. Implementing this particular recommendation should require enhancement in the existing system. Cost and benefits of such an enhancement are difficult to quantify for the time being and would require a thorough study. As highlighted above, FX counterparties having ISDA credit support annexes allow bilateral nettings and collateral arrangements and hence facilitate to reduce this risk. We also note that certain jurisdications may not specifically recognize the concepts of netting and its impact in the event of bankruptcy. Alignment in local jurisdictions with respect to this issue would be an enabler if the margining concept was to be rolled out on a larger global scale.

A robust liquidity management framework is required to ensure banks liquidity need in various currencies. We are managing our liquidity needs and risks in accordance with the international supervisory guidelines and these are appropriately represented in the bank's liquidity risk management policies and procedures.

With regards to the operational risk, key considerations presented in the document seem appropriate and should be implemented.

All exposures arising either through the pre-settlement are subject to capital requirements. Currently, these are being treated as part of credit risk. We view the concept of taking capital against settlement risk as being difficult to achieve.

Overall, we think that some of the recommendations in the guidelines would require substantial costs and efforts on the operational and technology side.

BANK # 4

Action points:
Bank's Risk Management:

In the case of our bank, Risk management team can validate that policy and procedures of all relevant entities in FX trading, settlement and reconciliation activities are comprehensive in their nature including but not limited to:

- *Policies and procedures of front office, back office, middle office and Risk Management team*
- *Limit structure on monitoring Principal, Replacement cost and liquidity risk including capital calculation*
- *Management information systems and key risk indicators for an early warning system*
- *Fails management by reconciliation units and*
- *Escalation procedures on fail trades by relevant parities to senior management and periodic review by Internal audit and compliance program*

The document suggests that banks; risk management framework should also look into the procedure on the methods used while selecting:

- *FMI*
- *Selection of a correspondent bank*
- *Dependence on other institutions*

Use of FMI:

National Supervisor may ascertain the needs to ask local banks to use PVP mechanism based on the volume (value) being traded by them on domestic and abroad. Once an affirmative decision is taken then it will further require the analysis of readiness of the local banks to follow these guidelines.

Use of netting arrangement:

National supervisor may also ask the banks to enter into netting arrangements with their counterparts so that the settlement risk could be further reduced including replacement cost risk.

BANK # 5

Comments

We have reviewed the guidance contained in the said document and agree with its contents on managing Settlement and other attendant risks arising out of these transactions.

However, we have the following comments related to the full application of this guidance:

1. Should be noted that the PVP (Payment Vs Payment) platform may not be available for some local currencies transactions. However, the inclusion of such currencies for membership into PVP system may further mitigate the FX settlement risk.

2. Legal enforceability of netting within some jurisdictions, under ISDA-CSA, may not yet be clear.

BANK # 6

We would like to highlight our concurrence that risk associated with FX transactions should be incorporated as part of a bank's capital planning. However, we draw to your attention that the risks identified should also be assessed by bank as part of their ICAAP process and that pre-settlement risk in particular, should also be a major component of bank stress testing framework.

<u>BANK # 7</u>

<u>Implementation by supervisors</u>

Paragraph 2.7

Banking supervisors should incorporate the guidelines in this document into their supervisory framework for banks under their authority. As part of their on-going supervisory activities, they should assess whether each bank that is engaging in FX trading is meeting the guidelines, taking into consideration the size, nature, complexity and risk profie of its activities.

<u>Bank's response</u>

It is proposed that the scope of the implementation of the guidelines will not extend to any bank that is not engaging in any FX trading, or with the negligible FX trading volume, or the FX business activitiy is limited to cater to the customer requirements. It is suggested that BCBS's supervisory guidance should clearly state that under any of these circumstances the requirements in this document will not apply to such banks.

The national regulators are proposed to adopt the same principle, i.e. these guidelines should be mandatory only for the banks that have significant FX trading volumes, with the term "significant" appropriately defined.

BANK # 8

Our views on the proposed framework and its impact are presented below.

The key tenet of the paper is a guideline on managing principal risk, which is defined as the risk of outright loss of the full value of a trade resulting from counterparty failure. It proposes that banks must eliminate principal risk through the use of Financial Market Infrastructures (FMIs) that provide payment-versus-payment (PVP) settlement, implying a call for greater use of Continuous Linked Settlement (CLS) and where PVP settlement is not practicable, principal risk should be properly identified, measured, monitored and controlled. At our Bank, we recognise the importance of the proposed changes and have the following response to some of the key questions.

We believe growth of regional FMIs should be encouraged to settle trades in regional currencies and facilitate banks to collectively enjoy the benefits of cross-currency settlement (other than regional currencies) through global FMIs like the CLS Bank. In line with similar arrangements prevalent in Hong Kong, Japan, India, and Malaysia, this will provide key advantages to such banks. These advantages included reduction in Settlement Risk, expansion of foreign exchange trading with access to more counterparties, availability of real time information on trade status, settlement and funds flow, eliminating the need for counterparty confirmations, use of local currency as collateral and leverage of local institutional infrastructure.

Consideration maybe given by regional grouping of smaller banking systems support the development of uniform guidelines on close-out and obligation netting to reduce the size of principal risk exposures.

While the paper recommends that banks should hold sufficient capital to cover potential foreign exchange settlement-related risks, it leaves it to the individual institutions to develop the framework and methodology to measure its capital needs for FX transactions. This can be believe an onerous task and more so during times of stress and market disruptions. In this regard some guidelines from local regulatory authorities will be useful to commence development of the framework and methodology.