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12 October 2012 <u>By email: baselcommittee@bis.org & post</u>

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

<u>Consultation Document on Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions</u>

We refer to the above consultative document issued by the Basel Committee on Banking Supervision (BCBS) in August 2012.

On behalf of our members, we would like to provide our comments as follows:

1. <u>Guideline 5: Operational Risk</u>

    (a) Section 3.5.4 requires banks to establish processes and procedures for confirming or affirming FX trades after execution as soon as practicable. While footnote 34 states that trade confirmations may take the form of voice confirmations over a recorded phone line, footnote 35 defines trade affirmation as involving *"signing and returning a counterparty trade notification or electronic confirmation"*. We seek BCBS' confirmation that voice affirmation is an acceptable form of trade affirmation.

    (b) The fifth key consideration requires banks to "*monitor trading volumes in a timely manner to prevent them from reaching a critical level.*" Rather than focusing only on the preventive effort, we would suggest banks to put in place a robust capacity management plan in dealing with exceptions. It is also important for banks to have a sound contingency plan in place in case of triggering events (e.g. when exceptionally high trading volume is observed). Accordingly, we suggest the first sentence of the fifth consideration be revised to read as follows: *"A bank should monitor trading volume <u>and capacity utilization of key systems</u> in a timely manner, <u>and to put in place a robust capacity management plan</u> ~~to prevent them from reaching a critical level~~...".*

2. <u>Guideline 7: Capital for FX transactions</u>

   (a) This Guideline requires banks to ensure sufficient capital be held against potential exposures of all FX settlement related risks, including principal risk and replacement cost risk. A bank's analysis of its capital needs should complement the current Basel capital framework, and consider the impact of risk mitigants, internal controls, and method of settlement on the size and duration of the risks, etc.

   Since FX settlement risks can be effectively reduced via the use of PVP settlement and collateral requirement, we believe the residual settlement risk should focus on non-PVP settled transactions. These transactions constitute a small sub-set of the global FX trades and the associated settlement risks would be further mitigated by collateral posting. Accordingly, we urge the BCBS to weigh between the cost and benefit, and provide more specific guidance on how this capital need analysis is expected. In addition, please clarify how the additional capital charges should be reflected on the existing Basel capital framework.

   (b) This Guideline also asks banks to create an internal incentive mechanism to reduce risks associated with FX settlement, where practicable. Suggested examples include lower cost allocation for PVP settled trades and trades covered under a close-out netting arrangement.

   While we acknowledge BCBS's intention to promote industry best practices, we wish to point out that different cost allocation mechanism could add unnecessary complexity and burden to banks' internal pricing / cost structure. As a matter of fact, the industry prefers the use of PVP settlement, close-out netting agreements, etc. to reduce its own FX settlement-related exposures. The use of alternative measures is typically due to external difficulties, particularly in emerging markets. For instance, counterparties may choose to stay outside of PVP due to infrastructure or cost issues. Also, in certain jurisdictions, netting agreements are not legally enforceable. Furthermore, corporate clients may not have the back office infrastructure or the eligible collateral for CSA operations.

We hope you would find our comments useful. For any questions, please do not hesitate to contact us.

Yours faithfully

Ronie Mak
Secretary

c.c. Ms Karen Kemp, Executive Director (Banking Policy),
Hong Kong Monetary Authority