Comments on the Basel Committee on Banking Supervision’s Consultative Document: 
Supervisory guidance for managing risks 
associated with the settlement of foreign exchange transactions 

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on the consultative document: Supervisory guidance for managing risks associated with the settlement of foreign exchange (“FX”) transactions, released on August 17, 2012 by the Basel Committee on Banking Supervision (BCBS).

[General Comments]
We understand the importance of the various risk management methods associated with the settlement of FX transactions proposed in this consultative document, as well as BCBS’s promotion of the use of payment-versus-payment (“PVP”) arrangements, where practicable, to reduce principal risk. Further, we strongly support the following comment that the BCBS stated in the Executive summary: “The BCBS expects banks and national supervisors to implement the revised guidance in their jurisdictions, taking into consideration the size, nature, complexity and risk profile of their banks’ FX activities”. From this viewpoint, it is expected that sufficient discussions are held with foreign exchange market participants that have various transaction volume and risk profiles in FX settlement.

Based on our position stated above, with a view to further clarifying the purpose and scope and enhancing the effectiveness of risk management that these guidelines aim to achieve, we respectfully request the BCBS to consider our comments below regarding the seven guidelines.

[Specific Comments]
1. Promotion of PVP arrangement

The consultative document makes the following statements, in promoting PVP arrangements: “Since industry participants are critical to endorsing the development and use of such market infrastructures, supervisors should facilitate their efforts, where practicable.” (paragraph 2.11), and “Currently, CCPs for FX trades involving an exchange..."
of payments at settlement are rare, but they may become more widespread in the future.” (Annex paragraph 25).

In this regard, given the use of CCPs for FX trades are currently rarely used, it is considered more realistic to promote PVP settlement through the use of existing CLS Bank International in order to expand the scope of products which are settled by PVP.

In order to facilitate such promotion, it is needless to say that commitments from the industry participants are necessary. At the same time, support by supervisors is also considered to be essential, and hence their proactive involvement and initiative for that direction are highly helpful.

2. Selection of an FMI

It is considered impracticable to uniformly impose requirements of due diligence and monitoring associated with the use of or participation in a financial market infrastructure (“FMI”) (the paragraph 3.1.10).

In cases of indirect participation in a FMI, a bank is to rely on information that is publicity available or passed on from direct participants. However, direct participants do not necessarily have a responsibility to pass on such information. Accordingly, indirect participants would have difficulty in due diligence because of such limitation. Also, in cases of even direct participation, there would be no choice but to depend on information through FMI. In this view, it is considered appropriate to add the following statement to the paragraph 3.1.10: “Both direct and indirect participants are encouraged to conduct due diligence on a best effort basis, to the extent that information is available”.

3. Reducing the size of remaining principal risk

The paragraph 3.2.18 states that “If a counterparty’s chosen method of settlement prevents a bank from reducing its principal risk, then the bank should consider decreasing its exposure limit to the counterparty or creating incentives for the counterparty to modify its FX settlement methods.” We understand the intention of facilitating the reduction of principal risk. However, we concern about incidental inducement of systemic risk due to this requirement and think it quite important to consider keeping the business relationship between counterparties.

More specifically, the method to consider decreasing a bank’s exposure limit to the counterparty, if encouraged, might induce systemic risk including settlement risk. Moreover,
the method to create incentives for the counterparty to modify its FX settlement methods might be difficult to address, depending on the business relationship between counterparties and whether such option is available for other banks. Therefore, even if a bank has difficulty in reducing its principal risk, it is considered appropriate to allow the settlement method based on negotiations and discussions between counterparties rather than based on mandatory requirement.

Accordingly, we believe it appropriate to add the language “where practicable” to the paragraph 3.2.18 in order to clarify that this paragraph does not encourage a unified treatment across banks, and to avoid any incidental systemic risks occurring.

4. Identify and manage liquidity needs

The consultative document specifies that “A bank should identify, measure, monitor and control its liquidity needs in each currency, taking into consideration the settlement method and applicable netting arrangements” in the paragraph 3.4.3. The scope of currencies subject to identification, measurement, monitoring and management of liquidity needs in each currency should be limited to major currencies for each financial institution, while ensuring consistency with the Basel III liquidity management regime and intraday liquidity management framework, which is under consideration in the BCBS, and taking into account cost-effectiveness and materiality.

Therefore, the term “major currencies” should be added to the paragraph 3.4.3 to identification and management of liquidity needs, considering the extent of monitoring and management level between major currency and minor currency.

5. Liquidity risks associated with the use of correspondent banks

As pointed out in the paragraph 3.4.8, we recognise the potential of operational or financial disruptions at correspondent banks to disrupt a bank’s own liquidity management. However, on the basis that it is difficult to assess the operational risk and other risk of other banks, including their operational management system, we would suggest to delete the following sentence “A bank should assess such risks and consider appropriate mitigants, such as establishing alternative settlement arrangements to ensure it can continue to meet its FX obligations on time.”
6. Legal enforceability of agreements and contracts

While the necessity of obtaining and reviewing legal opinions is understandable, with respect to identifying legal risk, reasonably obtaining and reviewing a legal opinion using the most appropriate method on a best effort basis should be allowed.

Therefore, it is respectfully requested that the methods for obtaining legal opinions as specified in the paragraph 3.6.2 should not be limited to in-house or external counsels who are licensed to practice laws; rather review by a broader legal community including a bank’s legal division should also be permitted. Further, we would like to confirm that a legal opinion is not required to be obtained on a transaction-by-transaction basis.

7. Capital for FX transactions

In terms of capital for FX transactions, in order to clarify the purpose and scope specific to this requirement, and to facilitate efficient management that the guidelines aim, consideration should be given to avoid duplication with other principles and guidelines already being issued or introduced and to ensure consistency.

Guideline 7 sets out that “When analysing capital needs, a bank should consider all FX settlement-related risks, including principal risk and replacement cost risk.” Since the capital requirements are not necessarily imposed on principal risk under the already-issued or introduced principles and guideline by BCBS, it is requested that consistency with other international principles and guideline be ensured.

Exposures related to FX transactions, noted in “Capital for FX transactions” in Guideline 7 and defined in the first key consideration include various risks, some of which shall not necessarily be covered by the capital, such as foreign currency liquidity risk while some of them are subject to capital charges, such as replacement cost risk. Given such differences, “a bank should consider all FX settlement-related risks, including principal risk and replacement cost risk.” in the Guideline 7 shall be changed to “a bank should consider risks associated with the settlement of FX transactions, referring to the Basel Capital Accord framework for capitalizing risks”.