Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
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Re: Supervisory guidance for Managing Risks Associated with the Settlement of
Foreign Exchange Transactions. Consultative Document, August 2012

The Global Foreign Exchange Division (“GFXD”) of the Global Financial Markets Association (“GFMA”) welcomes the opportunity to comment on behalf of its members on the consultative document on supervisory guidance in relation to settlement risk in foreign exchange transactions issued by the Basel Committee on Banking Supervision (“BCBS”).

The GFXD was formed in cooperation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 22 global foreign exchange market participants, collectively representing more than 90% of the foreign exchange dealer market. Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

Introduction

The foreign exchange market is the world’s largest financial market. Effective and efficient exchange of currencies underpins the world’s entire financial system. Corporations and investors regularly participate in the market for operational needs: to reduce risk by hedging currency exposures; to convert their returns from international investments into domestic currencies; and to make cross-border investments and raise finance outside home markets.

With the encouragement and at the direction of central banks and supervisors, foreign exchange market participants have been working diligently through a series of individual and collective actions to reduce risks generally in the foreign exchange market over the past several decades. The current regime of encouraging prudent supervision, practice guidelines and capital implications appropriately addresses the risks inherent in this market. Settlement risk, the predominant risk for foreign exchange transactions, has been dramatically reduced through the development and use of CLS Bank International (“CLS”). Further, the reduction of replacement

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2 According to Euromoney league tables.
cost risk is part of these efforts, as evidenced by high usage of credit support annexes and the trend towards even greater usage. These two risks are central to, but not the sole, risks that need to be addressed in the FX market as is recognized by the paper’s coverage of, inter alia, operational and legal issues.

In 1996, the governors of the central banks of the Group of Ten (“G10”) industrial countries 3 agreed and set in motion a strategy for the reduction of settlement risk in the foreign exchange market as a key priority for the industry. The supervisory guidance issued by the BCBS demonstrates the on-going implementation of this strategy. GFXD supports the approach taken by central banks, supervisors and market participants in reducing the risks inherent in the foreign exchange industry and believe that this cooperative framework should be leveraged for the purposes of addressing these important issues further. As such, the GFXD broadly supports the key aims laid out in the consultative document but also welcomes the opportunity to set out views in response to a number of the more detailed points.

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Guideline 1: Governance

A bank should have strong governance arrangements over its FX settlement-related risks, including a comprehensive risk management process and active engagement by the board of directors.

A number of practices are used within the industry to ensure that FX settlement risk is identified and properly understood. Traditionally it has been controlled by credit groups within the banks. Analysis of risk by date forms part of the management process and in many firms daily settlement risk modeling takes place and is managed via the credit function.

Settlement risk is a component of credit risk. As such credit risk committees continue to evolve their measurement techniques to ensure that settlement risk is properly identified and expect to work with regulators continually to enhance this area. Whilst there have been very few examples of settlement failure, all market participant are acutely aware of the risk that a Herstatt event poses to them and understand the importance of continuing both to increase usage of settlement-risk reduction techniques as well as ensuring senior management is aware of the risk.

The paper suggests that when assessing a bank’s dependence on other institutions, risk mitigants may include establishing dual or backup correspondent or settlement banks. Use of more than one correspondent bank needs to be considered carefully in the context of potential difficulties in maintaining hot-stand-by STP links to a second bank. These are likely to be only called on in the event of failure of the primary bank, and this type of dependence may in fact introduce operational risk and risk breaks in the confirmation process. This might best be analyzed not only in the context of what is feasible i.e. the potential to have some form of warm stand-by arrangement but also against the probability of failure actually occurring.

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.

Eliminating principal risk using PVP settlement

For the past three decades central banks and foreign exchange dealers have prioritized efforts to address settlement risk, noting it as the key source of systemic risk for the FX industry – and of far more systemic relevance than replacement risk.

Based on their stated belief that private sector institutions have the ability, through individual and collective action to solve for this challenge, and building upon the results of the extensive studies conducted and on market surveys, G10 central bank governors endorsed a three-track strategy which was constructed by the CPSS for significantly reducing the systemic risks associated with foreign exchange transactions:

- Action by individual banks to control their FX settlement exposures
- Action by industry groups to provide risk-reducing multi-currency services
• Action by central banks to induce rapid private sector progress

This strategy has proven to be extremely effective for the foreign exchange market. In response, a study and efforts by a group of major financial institutions resulted in the “continuous linked settlement” concept, namely the simultaneous exchange – “payment vs. payment” – of each of the two legs of a foreign exchange transaction as the mechanism for eliminating settlement risk. This led to the formation in 1997 of CLS, which by 1998 had 61 major financial institutions as shareholders and had acquired and consolidated the two existing providers of foreign exchange netting and clearing services. Central banks played a critical role in this effort by achieving key enhancements to their national payment systems and in strengthening laws in their respective jurisdictions to support this effort of the private sector. CLS was established as an Edge corporation in November 1999 following approval by the Federal Reserve, and went live with its service in 2002. It is regulated by the Federal Reserve under a cooperative oversight arrangement with central banks whose currencies are settled in CLS. While historically regulated and overseen as a “systemically important payment system” since it launched its service, CLS is now widely recognized as a “financial market infrastructure” and was designated this year as a “systemically important financial market utility” by the Financial Stability Oversight Council in the United States.

The efforts of central banks to raise awareness of settlement risk and to improve banks’ self-monitoring of settlement risk have been remarkably successful. CLS has extended its settlement risk reduction services for global foreign exchange activity from 7 currencies for 39 members in 2002 to 17 currencies and 63 members and their 7,000 third parties. The tremendous growth in trades settled by CLS since its inception is illustrated in the chart below. While the head or home offices of CLS’s members are located in 23 jurisdictions, the foreign exchange activity of CLS’s members and their customers are transacted, confirmed and processed world-wide. CLS has had zero settlement failures since it was created. It now settles a large portion of foreign exchange transactions, including 87.7% of inter-bank foreign exchange trades, the transactions most relevant to systemic risk.

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CLS currently provides PvP settlement services in 17 currencies: Australian dollar (AUD), Canadian dollar (CAD), Danish krone (DKK), Euro (EUR), Hong Kong dollar (HKD), Israeli shekel (ILS), Japanese yen (JPY), Korean won (KRW), Mexican peso (MXN), New Zealand dollar (NZD), Norwegian krone (NOK), Singapore dollar (SGD), South African rand (ZAR), Swedish krona (SEK), Swiss franc (CHF), UK pound sterling (GBP) and US dollar (USD).

5 As such, CLS was subject to the CPSS Core Principles for Systemically Important Payment Systems.


Approximately 7,000 third parties participated indirectly in CLS during the first three quarters of 2011. While over 90% of such third parties are funds, this group also includes banks, as well as corporations and other non-financial institutions.

8 CLS. The reduction in transactions settled by CLS Bank around September 2008 appears consistent with the reduction in financial activity generally during the 2008 financial crisis.

It is worth noting that whilst CLS provides the largest and most well known PVP method of settlement risk reduction, it is not the only method used by market participants to reduce settlement risk. In 2010 the Foreign Exchange Committee at the Federal Reserve Bank of New York undertook analysis\(^{10}\) demonstrating that c. 77% of total traded volume settled without settlement risk either because it was conducted within CLS or was settled internally or externally without settlement risk\(^{11}\). Around 23% remained subject to settlement risk, of which c. 15% was activity which could be eligible for settlement in CLS.

\(^{10}\)See FXC response to US Treasury November 2010. 12 firms responded with data on settlement risk equating to some $98.5 trillion in notional value

\(^{11}\)Internal transactions can be settled without settlement risk when they are between affiliates of the same corporate entity. Settlement risk for external transactions may similarly be reduced through obligation netting.
Since that time, the industry has identified that creating a unified methodology for describing settlement activity on a more consistent basis would be extremely useful. To that end in early 2012 the Operations Sub Group of the Bank of England FXJSC initiated a project to describe in more detail a common methodology and set of descriptors to allow data on settlement risk reduction techniques to be identified and measured. Once completed, this will provide a common basis for regulators worldwide to ask banks to capture data in a standard format. It is also possible that these data descriptors could be enhanced still further – for example to capture information on duration – to enhance the granularity of data available for regulators.

Whilst efforts to increase use of PVP systems continue, it is still clear that there is a point at which the usage of such systems tails off. This is due in part to two main reasons:

a) Where clients are not members (either direct or third party) of a PVP platform
b) Where currencies are not admitted to a PVP platform.

Participation in PVP settlement services are naturally subject to clear and rigorous eligibility criteria in order to protect the stability of the settlement environment. As regards membership, these will determine the institutions that may qualify for direct membership or, alternatively, "indirect" or "third party" participation through a direct member. However, usage of PVP services are not without cost and this has proven to be a barrier for some market participants. The direct ‘per transaction’ cost forms part of this, but for those participants acting as direct members the operational cost and complexities of connecting and maintain such links to a PVP platform are also significant. This is in addition to managing the liquidity risk associated with such settlement systems i.e. the ability to make and manage very large, timed / periodic payments to effect settlement, in contrast to standard payment processes. Direct members that provide third party services must also be capable of managing the additional liquidity risk presented by providing these services.

The overall cost and complexities involved with participating in PVP systems may continue to be a barrier for some time to come – especially if other regulatory costs become mandatory. For example if current BCBS proposals\(^{12}\) to implement mandatory initial and variation margin are applied to FX forwards and swaps there will be a shift that detracts attention from settlement risk (the most systemic risk in FX) to replacement risk mitigation. Whilst efforts to encourage wider participation in PVP systems continues on behalf of the industry, regulatory support will be a key driver in ensuring that new users are introduced and therefore more risk is mitigated.

With respect to currencies, similar eligibility criteria apply. In order to meet those criteria, there is a heavy dependency upon central banks in respect of the various operational, legal and more general requirements for support of the local banking system. Strong sponsorship by central banks of non-participating currencies is therefore a prerequisite when encouraging the addition of new currencies.

Where settlement risk is not mitigated externally through PVP methods, banks address this through active management of individual credit risk exposures. In particular, where a

\(^{12}\)BCBS Consultative Document: Margin requirements for non-centrally-cleared derivatives, July 2012
counterparty’s credit status deteriorates, firms can effect internal ‘safe settlement’ techniques whereby currency is not delivered until the counterparty concerned has paid the currency due. However, it is acknowledged that this is a single-sided risk reduction measure and needs to be taken in the context of wider counterparty credit considerations.

Controlling remaining principal risk
GFXD supports the paper’s guidance as it relates to the controlling of remaining principal risk. As is set out, the primary focus should be on developing appropriate methodologies and mechanisms for ensuring that remaining principal risk can be robustly monitored and hence controlled. The key to effective implementation is likely to be the level of granularity to which monitoring is required, both in the context of limits and of payment reconciliation. Moves towards more real-time monitoring in both circumstances are sensible but may be more practicably approached by monitoring positions on an intra-day basis rather than a trade-by-trade basis. In any event, the appropriate solution will need to take into consideration how to smooth out intra-day volatility of available limits (as essentially these could / would be highly variable the more ‘real-time’ monitoring becomes) and also for the purposes of reconciliation of payments, the impact that time zones would have on outstanding settlement for e.g. APAC vs. non-APAC trading.

With regard to unilateral payment cancellation deadlines/guarantees, it is worth noting that these are not generally automated or standardized amongst industry participants. Whilst this might be a longer term goal, with the objective of STP processing enabling effective unilateral payment deadlines to move closer to correspondent bank guaranteed cut-off times, it would need to be balanced by any impact automating such processing might have. An unintended consequence of moving to a standardised cancellation guarantee deadline may be that cut-off deadlines are brought forward, thus removing from participants the flexibility they currently have in correcting errors and also making adjustments for clients in the run-up to payment.

Reducing the size of remaining principal risk
With regard to netting agreements, consideration needs to be given to any requirement to net all settlement exposures without exception. Whilst using obligation netting to reduce the size of principal exposures is clearly helpful, there are certain counterparties for whom gross settlement is necessary in order to meet their business and liquidity needs.

Guideline 3: Replacement cost risk

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.

As discussed the industry has, over the past three decades, worked with central banks and supervisors to address the risks inherent in the foreign exchange market. This approach has recognised that there are a series of risks that apply during the lifecycle of a foreign exchange transaction. It also recognises that the magnitude and impact of those risks is different, which has led to a framework that prioritises settlement risk, although rightly not to the exclusion of others.
GFXD supports the end-to-end approach that has been taken to date and believes that it is not appropriate to deal with risks on a piecemeal basis. Accordingly, international efforts to address replacement cost risk should be coordinated within the framework of overall risk mitigation.

The nature of the foreign exchange market is different to OTC derivatives. It is a global payment system that underpins the global economy by facilitating and supporting international trade and cross-border activity. Its products are essential in providing a critical source of liquidity and funding. The vast majority are cash products (either spot, forwards or swaps) which are physically settled through an exchange of two currencies. This distinguishes them from most derivatives which are financially (cash) settled products whose value and settlement amounts are derived by reference to one or more underlying assets. They are also overwhelmingly short term when compared with, for example, interest rate swaps and credit default swaps whose terms to maturity are generally between two to thirty years, and five to ten years, respectively.

As such, the balance of risks inherent in FX products as compared to OTC derivatives is different. The current BCBS proposals on margin requirements suggest implementing a mandatory initial and variation margin regime to address replacement cost risk for uncleared derivatives. This would include foreign exchange ‘derivatives’ such as forwards and swaps. Current industry measures (explained below) for addressing replacement cost risk within the existing framework of supervisory guidance have been successful. Whilst there is yet further to be done to reduce such risk, moves to implement a mandatory regime for replacement risk may cause a shift of focus away from addressing settlement risk.

Addressing replacement risk
The foreign exchange market has increasingly adopted use of master netting agreements and CSAs to manage counterparty credit risk. According to a recent study conducted by the FXC, the number of CSAs grew by 51% between 2007 and 2010; and as of September 2008, of the reporting firms, 88% of the total mark-to-market exposures of those firms was covered under CSAs. This is corroborated by initial analysis completed by the Global FX Division in 2010 covering 66% of the dealer market that estimated 85% of the mark-to-market credit risk for FX swaps and FX forwards is effectively covered by CSAs.

CSAs are widely used in the foreign exchange market to mitigate counterparty credit risk, including but not limited to replacement cost risk. CSAs used in the foreign exchange market mainly provide for VM, but also IM if warranted following an assessment of the credit risk profile of one’s counterparty. As illustrated in the chart below, the vast majority of mark-to-market exposure is related to counterparties that are covered by CSAs to standard

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13 BCBS Consultative Document: Margin requirements for non-centrally-cleared derivatives, July 2012
14 Foreign Exchange Committee (“FXC”), Overview of the OTC Foreign Exchange Market: 2009 (November 9, 2009) (“FXC Overview”). The Foreign Exchange Committee is an industry group that has been providing guidance and leadership to the global foreign exchange market since its founding in 1978. The FXC includes representatives of major financial institutions engaged in foreign currency trading in the United States and is sponsored by the Federal Reserve Bank of New York. Aware of the strong integration of the global foreign exchange market, the FXC is also an active partner to other foreign exchange committees and industry associations worldwide. http://www.newyorkfed.org/FXC/.
15 See FXC letter to U.S. Department of Treasury (November 29, 2010) in response to request for comment on determination of foreign exchange swaps and forwards.
16 See GFXD letter to US Treasury, (November 15 2010) in response to request for comment on determination of foreign exchange swaps and forwards.
International Swaps and Derivatives Association (“ISDA”) master agreements.\(^7\) While very high, current industry practice of using CSAs is not universal for a number of reasons. Firstly, for many foreign exchange market participants such as corporates, exchanging currencies represents a basic treasury management or banking activity that falls within the normal credit parameters of their relationships with their banks and custodians. The only portion of the foreign exchange market where trades generally are unsecured is where transactions are effected with corporates. Corporates use FX transactions to hedge business risks and do not generally have excess capital to use for margining purposes. Secondly, for a significant number of participants (e.g., a long-only unleveraged pension fund or asset manager) who may present very little credit risk, requiring margin makes little commercial or economic sense.

![Diagram showing collateral management by category](attachment:collateral_management.png)

The ability of parties to implement effective collateral management programs benefits from the significant price transparency that exists in the foreign exchange market. Foreign exchange market participants can reliably determine the net amount of their exposure and the appropriate amount of collateral because the market is highly liquid, with prices widely available 24 hours a day. The deep liquidity of the market and simple structure of its transactions also enables a non-defaulting party not only to get out of, but also back into, positions with extreme ease by executing spot, forward, or swap transactions (or any combination thereof) with other market participants during the course of any day and regardless of tenor.\(^8\)

Additionally, a key and unique feature of the foreign exchange market which makes credit risk much easier to manage in absence of a CSA than for other OTC derivative contracts is the short-dated nature of the vast majority of contracts. Jump-to-default risk is virtually non-existent, as counterparties very rarely go from AAA to default overnight. Accordingly, there is a period of weeks or months of progressive deterioration before a final event that

\(^{17}\) Oliver Wyman analysis.

\(^{18}\) See [http://www.bankofengland.co.uk/markets/Documents/forex/fxjsc/fxpap090923.pdf](http://www.bankofengland.co.uk/markets/Documents/forex/fxjsc/fxpap090923.pdf)
triggers default and/or bankruptcy. The short dated nature of foreign exchange products is such that when a counterparty begins to show signs of impairment, most of the existing foreign exchange contracts, and therefore replacement cost risk, with the counterparty institution will roll off during the initial signs of stress as those contracts come to maturity. (This is in contrast to the much longer-dated OTC derivative contracts for which counterparty credit risk is comprised almost exclusively of replacement cost risk.) In this situation, while dealers and custodians could stop creating new foreign exchange exposures with the counterparty, alternatively and more commonly, they will limit activity to shorter-dated foreign exchange trades with or without IM, and longer-dated foreign exchange trades with IM only. In this way, the dealer or custodian can readily control its future exposures to a counterparty, thereby allowing firms to keep trading with a credit-impaired participant flexibly and safely.

Alongside the use of CSAs, capital may also be set aside to address replacement risk via the risk-weighted assets calculation. If, during the life of the transaction, the credit appetite of a firm changes, internal ratings would reflect this and capital adjusted accordingly. This contributes to a firm’s active monitoring of default risk and appropriate capital treatment.

**Guideline 4: Liquidity risk**

A bank should properly identify, measure, monitor and control its liquidity needs and risks in each currency when settling FX transactions.

GFXD supports the principles set out regarding management of liquidity risk. Clearly this would need to take into account liquidity risk management on a per currency basis and, accordingly, management of any collateral held to match against those needs.

**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.

As part of standard operating procedures banks continue to monitor and manage their risk controls. These will include the use of statistical analysis, control committees and operational risk systems. Measures also include the ability to make allowances, via operational risk capital for operational failure.

In addition, the Non-Investment Products Code (NIPs)\(^{19}\) drawn up by the Bank of England and market practitioners, lays down best practice on how the industry should work towards achieving commonality of approach in operational risk matters regarding settlement risk and usage of CLS and continues to demonstrate industry activity in line with BCBS Guidance.

The NIPs code also provides best practice guidance on capacity and in particular states that firms:

\(^{19}\)The NIPs Code Nov 2011 has been drawn up by a wide cross-section of market participants including the Bank of England and the Financial Services Authority. http://www.bankofengland.co.uk/markets/Documents/forex/fsjsc/nipscode1111.pdf
• Should ensure that sufficient technical and operational capability is employed to ensure that end to end transaction processing can take place in both normal and peak market conditions without undue impact on its processing timeline
• Should have clearly defined capacity and performance management processes in place
• Should have defined mechanisms in place to respond to extreme changes in demand.

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.

GFXD supports the principles set out regarding management of legal risk. However, it would be useful for the guidance more clearly to distinguish between the level of comfort (e.g., via a legal opinion) that is sought for bilateral contracts (e.g., ISDA master agreements between a bank and its counterparty) as compared to multilateral rules and relevant contracts (e.g., those of/with a settlement, payment or clearing system such as CLS or RTGS systems), as well as where the responsibility rests for obtaining such comfort. In the case of CLS, e.g., it (not a bank) obtains jurisdictional legal opinions from each country where a direct member has a head/home office and for each currency for which it provides settlement services.

Guideline 7: Capital for FX transactions

When analysing 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.

GFXD believes that a mandatory framework for capital charges to address principal exposures is unnecessary, in the context of present efforts to reduce outstanding principal exposures.

With regard to any capitalisation of settlement risk, the implied security of a capital charge – unless set at a level to making FX trading economically unviable and therefore disruptive to global trade and investing – would be small compared to the value of any actual settlement failure. Prevention of settlement risk occurring therefore becomes paramount – rather than attempting to insure against the loss.

The industry is acutely aware of the need to maintain focus in this area. GFXD believes the market is best served by continuing its present collaborative approach between central banks and supervisors on the one hand and private sector market participants on the other, with a focus on settlement risk reduction combined with continued growth in the usage of CSAs as appropriate.

The development of a robust framework for identifying and measuring settlement risk and its duration should provide the correct level of oversight, and bilateral discussions with market participants should serve to provide supervisors with the information they require to
make an assessment of settlement risk and its systemic importance – both to that participant and to the overall market as a whole.

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GFXD appreciates the opportunity to share its views on this consultation paper issued by the BCBS. Please do not hesitate to contact me at +44 (0) 207 743 9319 or at jkemp@gfma.org should you wish to discuss any of the above.

Yours sincerely,

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20 The Global Financial Markets Association (“GFMA”) brings together three of the world’s leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA.