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INTERNATIONAL BANKING

Expert Analysis

New Guidelines Proposed to Manage Foreign Exchange Settlement Risk

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Internationally active banks are likely to participate in complex foreign exchange (FX) agreements involving their head offices and other offices of the bank; these agreements usually involve multilateral netting and collateral arrangements. Effective risk management is key to a bank being able to engage in these transactions on a safe and sound basis.

On Aug. 17, 2012, the Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) issued a consultative document proposing new guidance on managing the risks that arise in the settlement of foreign exchange transactions.[1] This guidance updates and replaces guidance issued in 2000, which has became outdated as more sophisticated methods of engaging in these transactions were developed.[2] Comments on the proposed new guidelines are due by Oct. 12, 2012.

This month's column will highlight key points of the proposed guidelines, which, when finalized, would then need to be adopted by the banking supervisors in each individual country. International banks may want to review and evaluate the proposed guidelines against their current foreign exchange settlement risk management procedures to determine if any improvements may be necessary.

Introduction

The proposed new guidelines contain seven specific recommendations, the principles of which are to be incorporated into a bank's foreign exchange settlement procedures. Some of the proposed new guidelines are in fact not new, but reflect recommendations having been made previously, while others take into account new technology and how it can be used to reduce risk.

The proposed guidelines also recommend the use of alternate structures to reduce risk, including the use of financial market infrastructures (FMIs), which are multilateral systems used for the purpose of settling various financial transactions. FMIs are the subject of a recent report issued by the BIS Committee on Payment and Settlement Systems and the International Organization of Securities Commissions that sets out principles and responsibilities that should govern the operation of an FMI.[3]

The proposed new guidelines are to be utilized by banking supervisors in examining foreign exchange settlement operations at the banks they supervise. In determining whether the foreign exchange settlement risk management systems at a particular institution are appropriate, supervisors will need to adapt their review to the specific risk profile posed by a particular institution.

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Specific Proposed Guidelines

The foreign exchange settlement process begins when a trade is agreed to between the parties and ends when each party in the transaction can confirm that it has finally and irrevocably been paid in the new currency and has satisfied its own obligations to its counterparty.

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 recommendation on adoption by a bank's board of directors of policies and procedures with respect to any of its operations is not new.

Key recommendations include:

• Banks should institute a comprehensive risk management framework that addresses all material risks, ensures the effectiveness of the bank's internal audit processes and includes a process that clearly defines which incidents require up-the-line reporting to senior management or the board of the bank

• Banks should establish "meaningful" exposure limits that take into account principal risk and replacement cost risk; there should be a process that enables swift identification of failed transactions.

• Banks should ensure that it maintains strong computer systems that can effectively handle FX settlement transactions and provide reports on a bank-wide basis to management.

Guideline 2: Principal Risk. A bank should use FMIs that provide PVP (payment vs. payment) settlement to eliminate principal risk when settling FX transactions. PVP ensures that final payment on an FX transaction is made only when each party is able to make final payment on its part of the transaction. Where PVP settlement is not practicable, a bank should properly identify, measure, control and reduce the size and duration of its remaining principal risk.

Principal risk in settlement of FX transactions is the risk of a total loss due to counterparty failure.

Key recommendations include:

• Banks should utilize settlement mechanisms such as FMIs that use PVP settlement.

• Absent use of PVP, the bank should set firm and binding prudent settlement limits, with a system in place to track exposure as each trade is executed, and seek to be able to unilaterally cancel a transaction as late as possible in the process.

• The bank should have master netting agreements with each counterparty, and reduce exposure to a counterparty where the counterparty's choice of a settlement method prevents the bank from reducing its principal risk.

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.

Replacement cost risk is the risk of loss due

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to unsettled transactions with a counterparty because of the exposure of having to replace the original transaction at then-current market values.

Key recommendations include:

• Banks should adopt effective risk management tools such as use of legally enforceable bilateral or multilateral netting arrangements.

• These arrangements should include close-out netting in the case of the failure of a counterparty.

• Effectively managed collateral arrangements would reduce risk of losing the entire trade and having to replace it at higher cost.

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.

Liquidity risk is the risk that a bank is unable to make payments due to a shortage of liquidity that prevents a counterparty from settling the transaction in full at the agreed-upon time.

Key recommendations include:

• A bank needs to be able to effectively identify, measure, monitor and control its liquidity needs in each currency, and incorporate these needs into the bank's overall liquidity risk management system.

• If the bank uses an FMI, then it must assure itself that the FMI's rules and procedures include an effective liquidity risk management process that addresses the consequences of a counterparty being unable to fully settle.

• In addition to the bank's careful consideration of a potential counterparty and use of an effective FMI in managing liquidity risk, the bank also needs to choose a correspondent bank that will be most able to assist the bank in facilitating final settlement of FX transactions.

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.

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, systems or external events.

Key recommendations include:

• A bank's systems and processes need to comply with current Basel Committee guidance[4] and be effectively monitored on an ongoing basis so that problems can be identified before disruption occurs.

• If possible, the bank's systems should be able to use "straight-through" processing—an automated processing method that allows certain data to be entered into technical systems once and then used for subsequent processing of transactions, uses standard settlement instructions and provides quick post-trade confirmation.

• Systems should have the capacity to be able to handle current and projected levels of FX settlement at any time, and flexible enough to accommodate operational changes such as a greater level of increased activity due to a stress situation.

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.

Legal risk deals with the risk that contractual agreements entered into by a bank with a counterparty would not be enforceable should there be a disruption in settlement.

Key recommendations include:

• Some of the risk reduction methods recommended in the proposed new guidelines (FMIs, PVP settlement, and master agreements that contain netting and collateral provisions) may not be legally permissible in a particular jurisdiction and as a result, a bank must carefully review the laws in the jurisdictions in which it contracts for FX transactions and monitor these laws on a ongoing basis in order to identity any changes.

• Banks should obtain legal enforceability opinions (updated on a regular basis) for every jurisdiction in which it engages in FX transactions, either provided by in-house or external counsel licensed to practice in the relevant jurisdictions, or issued to a trade organization of which the particular bank is a member; the legal opinions should include discussion of when settlement in various transactions is considered final and the impact of insolvency and resolution regimes in those countries on settlement.

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.

• A bank's agreement with its correspondent banks should include a provision that specifies the point at which funds are received with finality.

For example, provisions contained in the 1991 Federal Deposit Insurance Corporation Improvement Act (codified at 12 U.S.C. 4402(1)(B) and 4402(9)), require that, subject to certain limited exceptions, the covered contractual payment obligations and the covered contractual payment entitlements between any two financial institutions must be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of any applicable netting contract. In addition, the provisions of any security agreement or arrangement or other credit enhancement related to one or more netting contracts between any two financial institutions are enforceable in accordance with their terms and not stayed, avoided or otherwise limited by any state or federal law, except for certain exceptions.[5] The Federal Reserve Board's Regulation EE, 12 CFR Part 231, expands the number of financial institutions that may make use of those statutory provisions.

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.

Banks should follow its country's Basel III implementation in ensuring that sufficient capital is maintained to address all FX settlement-related risks.

Key recommendations include:

• In determining its exposure and related capital needs for an FX transaction, banks should measure the risk from the moment the trade is executed to the moment of receipt of final payment.

• Banks should determine the last date for unilateral cancellation of the transaction by the bank, as well as any reconciliation process timelines.

• Banks should provide appropriate incentives to employees to reduce FX settlement risks, such as by differentiating the costs or capital charges incurred by business units based on the risk profiles of their FX transactions and passing those costs onto them as a balance sheet charge, and levying a smaller charge on a business unit that uses close-out netting arrangements in an FX settlement.

Conclusion

In the past year, the Basel Committee has been busy issuing consultative papers and final recommendations on a whole host of topics, but many with a common theme: How can a bank more successfully manage its risks? FX transactions may be simple or complex, but all contain an element of risk. The proposed new guidelines are aimed at assisting banks in better managing the risks associated with settlement of these transactions.

1. "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions," August 2012, which can be accessed on the website of the Bank for International Settlements at www.bis.org.
2. "Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions," September 2000, accessible on the BIS website.
3. "Principles for financial market infrastructures," April 2012, accessible on the BIS website. An example of an FMI would be The Depository Trust & Clearing Corporation.
4. See "Principles for the sound management of operational risk," June 2011, accessible on the BIS website.
5. See 12 U.S.C. §4403.