Progress in Reducing Foreign Exchange Settlement Risk

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Presentation overview:

- CPSS assessment:
  - Central bank strategy has achieved significant success
    - Most notably, 55% of FX obligations settled through CLS
    - Reflects the strong policy commitment, resources and efforts of many financial institutions
  - But further action is needed
    - To tackle remaining exposures that may still present systemic risk
    - To guard against potential backsliding
- G10 strategy
- Key findings of global survey
- Recommended actions

G10 Strategy: 1996 Allsopp Report

- Key findings
  - FX settlement exposures were not just “intraday”
  - Exposures to a single counterparty could exceed a bank’s capital
  - Exposures were poorly understood and controlled
- Three-track strategy
  - Action by individual firms, to control exposures appropriately
  - Action by industry groups, to develop well-constructed multi-currency services
  - Action by central banks, to encourage timely, market-wide progress

Assessing progress: global survey

- April 2006 survey
  - 27 central banks
  - 109 institutions
  - 80% of FX market in 15 currency areas
  - $3.8 trillion average daily FX obligations
- Quantitative
  - size
  - duration
  - concentration
- Qualitative
  - measurement
  - management
  - control
- Updated and extended surveys in 1996 and 1997

Key findings:

- Major reduction in aggregate FX settlement exposures
  - 55%, or $2.1 trillion, of surveyed obligations are settled through CLS
- But substantial exposures remain…
  - 32%, or $1.2 trillion, are still subject to FX settlement risk
  - Half of FX settlement exposures last overnight
  - Bilateral exposures can be large relative to capital, and not well controlled
    - 63% of firms underestimate their bilateral exposures
- …and the risk of backsliding is significant
  - Many firms use incomplete risk measurements and cost-benefit calculations
  - Business units often face narrow financial incentives and cost pressures
  - Can prevent fully informed and appropriate choices among settlement methods
- Changes in trading patterns can create particular tensions
  - High-volume, low-value activity: prime brokerage and algorithmic trading
  - Settlement costs may be a significant share of profits
  - Can lead firms to consider less safe settlement methods

Recommended action

- Individual institutions: control remaining exposures
  - Reduce remaining large and long-lasting exposures
  - Ensure appropriate risk controls and incentives across business units
- Industry groups: extend services and encourage progress
  - CLS et al: continue developing FX settlement services
  - FX committees et al: encourage further progress
- Central banks: encourage progress and guard against backsliding
  - Where relevant, extend RTGS hours, improve local laws, monitor developments
  - Work with supervisors and regulators to ensure firms:
    - Apply appropriate controls to bilateral settlement exposures
    - Reduce remaining large exposures
    - Guard against backsliding