Progress in Reducing Foreign Exchange Settlement Risk

Lawrence M. Sweet
Chairman, CPSS Sub-Group on Foreign Exchange Settlement Risk
Senior Vice President, Federal Reserve Bank of New York
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

• 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