

Enhancing the Safety of Foreign Exchange Settlement

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Intro: progress in reducing FX settlement risk

- The 1996 central bank strategy achieved significant success
 - Most notably, majority of FX obligations are now settled through CLS
 - Reflects strong public policy commitment and substantial industry efforts
- FX settlement was a crucial source of strength in recent stress
 - Bear Stearns, Lehman,...
 - The FX market was “the dog that didn’t bark”
 - Experience stands in stark contrast to 1974 failure of Bankhaus Herstatt
- But further action is still needed
 - To tackle remaining exposures that may still present systemic risk
 - To guard against potential backsliding

Presentation overview

- Central bank strategy to reduce FX settlement risk
- Key findings of CPSS 2008 progress report
- Recommended actions
- Discussion questions: how to achieve further progress?

Central bank 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

CPSS 2008 progress report

- Global survey conducted during April 2006
 - 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 CPSS surveys in 1996 and 1997

Key findings

- Major reduction in aggregate FX settlement exposures
 - 55%, or \$2.1 trillion, of surveyed obligations were settled through CLS
- But substantial exposures remain...
 - 32%, or \$1.2 trillion, were still subject to FX settlement risk
 - Half of FX settlement exposures lasted overnight
 - Bilateral exposures can be large relative to capital, and not well controlled
 - 63% of firms underestimated 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: more currencies, more counterparties, same-day settlements
 - 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
 - BCBS *Supervisory guidance for managing settlement risk in foreign exchange transactions* (2000)

Discussion: how to achieve further progress?

- What are the most significant remaining risks in settling FX trades?
- What are the main sources of those risks?
- What are the opportunities for reducing those risks?
- What are the challenges to reducing those risks?
- Do your institutions/industry groups see the need for further progress?
- How are your institutions/industry groups supporting further progress?