

# Intermediate Report

## Roundtable on Risks Associated with the Settlement of Foreign Exchange Transactions

August 2017

Financial Services Agency

# 1. FX Settlement Risk

## Definition of “Foreign Exchange Settlement Risk”

Risk of loss when a financial institution pays out the selling currency but fails to receive the buying currency due to counterparty failure through the FX settlement

⇒ Implementation of Payment-versus-Payment (PvP) settlement between different currencies is a principal counter-measure

【Background】

### June 1974 Collapse of Bankhaus Herstatt

Due to the collapse of the West German bank Bankhaus Herstatt, US banks paid Deutsche marks to the bank but could not receive US dollars for their FX settlement

### July 1991 Liquidation of BCCI

Due to the liquidation of BCCI, foreign banks including Japanese banks could not receive US dollars for their FX settlement

### 1996 Allsopp Report by BIS • CPSS

Encouraged industry groups to develop and offer multi-currency settlement services to reduce the risk

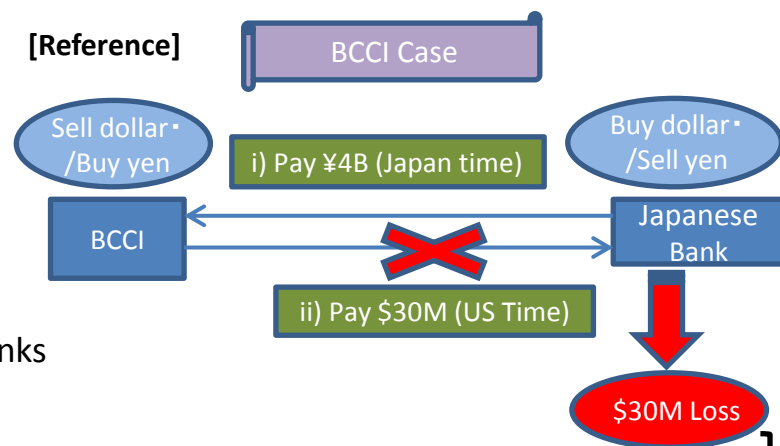
### ⇒ 2002 CLS Bank Launched for Implementing PvP Settlement

### 2008 Case of KfW

During the financial crisis, the German bank KfW paid euro to Lehman under the cross currency swap agreement but did not receive US dollars in exchange. (Cross currency swap was not covered by CLS (PvP settlement) at that time. On the other hand, Lehman’s FX trades were settled properly within CLS, proving that it successfully reduces settlement risk.)

### February 2013 Supervisory Guidance by BCBS

Encourages a bank to use FMI that provide PvP settlement when settling FX transactions



## 2. FSA Supervisory Approaches to FX Settlement Risk

- ✓ The FSA committed to promote PvP settlement to mitigate the FX settlement risks on its statement of 2016-2017 Strategic Directions and Priorities
- ✓ Conducted a survey to check the current situation of FX settlement risks
  - **Large banks and securities companies**  
Interbank FX transactions have been largely settled through PvP except for FX exotic currency trading and cross currency swap transactions
  - **Regional banks**  
Some regional banks settle FX interbank transactions through PvP while others do not in light of their relatively small risks associated with FX settlement
  - **Trust funds**  
Have not settled any transactions through PvP even though risks of some transactions are relatively high



Established “Roundtable on Risks Associated with the Settlement of Foreign Exchange Transactions” to promote PvP settlement for FX transactions by trust funds (December 2016)

# 3. Summary of Discussion at the Roundtable

- ❑ Participants of the roundtable have reached a consensus to **introduce PvP settlement for FX transactions by trust funds as soon as possible** despite various challenges

## Necessity of introduction of PvP

- ✓ **Mitigation of FX Settlement Risk**
  - Principle risk in interbank FX transactions have already been removed by using PvP settlements
- ✓ **Global Trend**
  - PvP settlement in the fund transactions is growing in Europe and the US after the financial crisis
  - “FX Global Code” published by BIS in May 2017 recommends the utilization of PvP settlement mechanisms
- ✓ **Enhancement of efficiency and stability of FX transactions**
  - The share of PvP settlements has increased and its introduction may enhance efficiency and stability of FX transactions

## Challenges

- ✓ **Intraday Liquidity**
  - Intraday liquidity could be needed due to the limited window available for PvP settlements
- ✓ **PvP settlement only for 18 currencies**
  - CLS-eligible currencies are limited to 18 currencies
  - The operational flow could be divided in two since there are currencies that cannot be settled through a PvP arrangement, which may complicate banks’ operations
- ✓ **Customer’s acceptance of cost**
  - Acceptance by customers or beneficiaries of the cost associated with PvP settlements would be needed
- ✓ **Coordination among related parties**
  - Relevant parties, such as trust banks, FX banks, asset management companies, and global custodians, need to make coordinated efforts for smooth implementation

## 4. Phased Approach (i)

- ❑ Adopt a two phased approach for the implementation of PvP settlements, corresponding to estimated period of time for preparation; initial phase for targeted transactions and full-fledged phase for broader transactions

- ✓ Foreign-affiliated asset management companies and FX banks commonly use PvP settlement for fund transactions abroad and can introduce PvP settlement for those in Japan relatively early by utilizing the existing infrastructure
- ✓ PvP settlement can be implemented relatively earlier by prioritizing the transactions with higher risks in the Japanese market



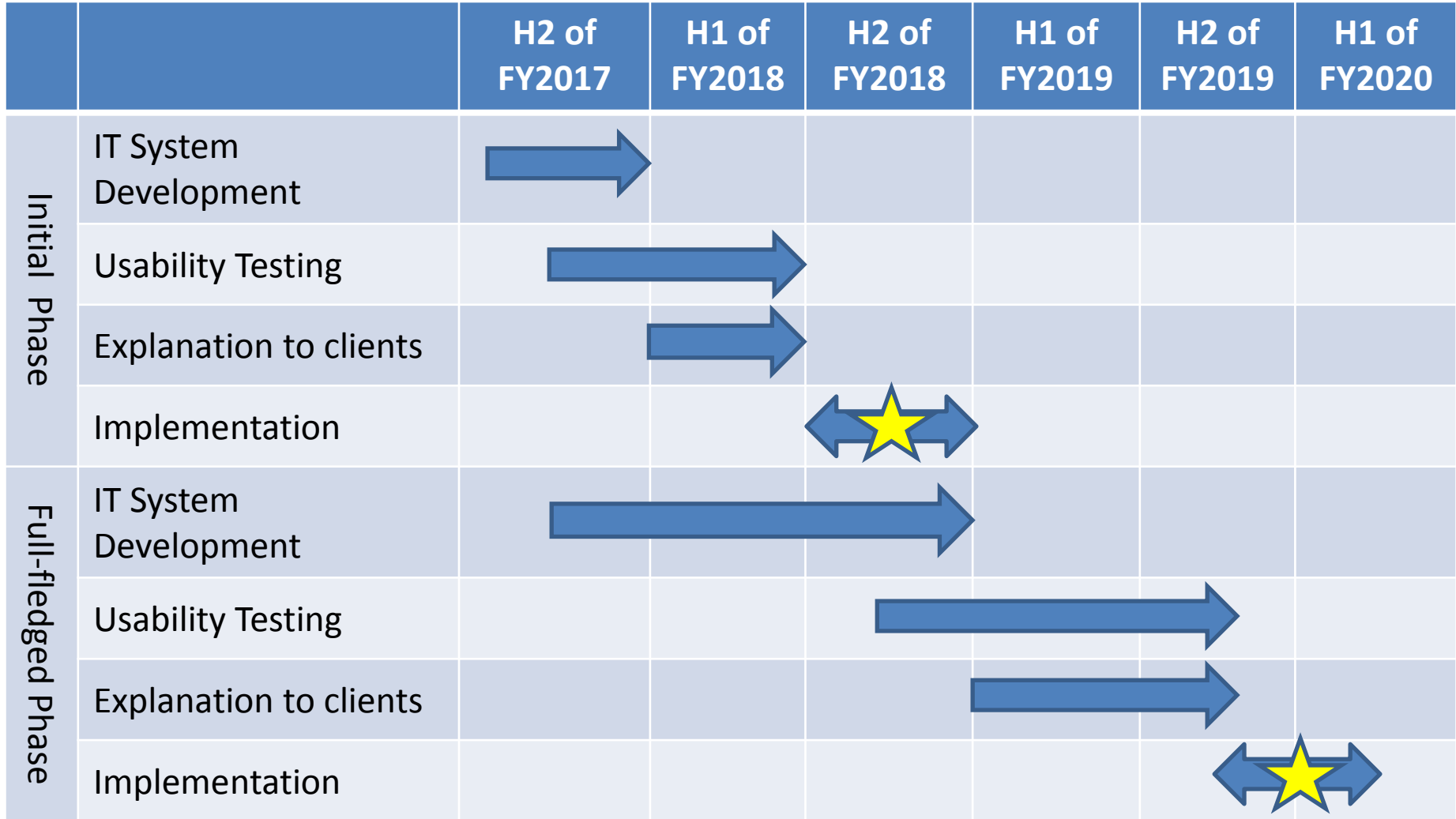
**“Initial phase” goes live in the second half of FY 2018**

- ✓ As for the transactions outside initial-phase scope, a certain period of time will be necessary for Japanese market participants to address practical challenges and restrictions, discuss the new market practices, and improve IT systems for the expansion of the target transactions



**“Full-fledged phase” goes live in the second half of FY 2019 - the first half of FY 2020**

# 5. Phased Approach (ii)



★ Target Date, H1 First Half, H2 Second Half

## 6. CLS Participation Models

- The following is the list of possible CLS participation models in each phase: initial phase or full-fledged phase. Each trust bank can adopt multiple types of models.

| Model                 | Scheme                                    |   | CLS Settlement Member    | Main FX Counterparty | Supplier of Intraday Liquidity | Initial phase | Full-fledged phase |
|-----------------------|---|---|--------------------------|----------------------|--------------------------------|---------------|--------------------|
| Custodian Model (i)   | “TB instruction (Uchi-Soto)” scheme (iii) | Trust bank sends FX instruction to global custodian             | Global Custodian         | Domestic FX Dealer   | Global Custodian               | ○ (v)         | ○                  |
|                       | “AM instruction (Soto-Soto)” scheme (iv)  | Overseas asset manager sends FX instruction to global custodian | Global Custodian         | Overseas FX Dealer   | Global Custodian               | ○             | ○                  |
| Trust Bank Model (ii) | Third party scheme                        | Trust bank settles FX via affiliate or third party              | Affiliate or Third Party | Domestic FX Dealer   | Affiliate or Third Party       | △ (vi)        | ○ (vi)             |
|                       | Settlement member scheme                  | Trust bank directly settles FX                                  | Trust Bank               | Domestic FX Dealer   | Trust Bank                     | ×             | △ (vii)            |

(i) A trust bank entrusts the operation of Pvp settlement to a global custodian which holds non-Japanese securities and cash

(ii) A trust bank settles FX through a third-party CLS settlement member, affiliate settlement member, or by becoming a direct settlement member

(iii) A trust bank sends FX instructions to an overseas custodian

(iv) An overseas asset manager sends FX instructions (or prior notification) directly to an overseas custodian based on agreement among related parties

(v) Implement Pvp settlement manually only for limited transactions with relatively higher risks (for example, large amounts) until the new practice in the domestic market is established in the full-fledged phase and each stakeholder completes developing its operation system

(vi) Considered in the initial phase and likely to be introduced in the full-fledged phase

(vii) CLS has introduced a new membership model. This allows clients the option to have more than one entity within their corporate group to become a settlement member under certain conditions. Each trust bank should consider the application of this model considering its business strategy and policies, subsequent to the “third party scheme,” in the full-fledged phase.

# 7. The Way Forward

- ❑ Establishment of Project Team
  - ✓ The Tokyo FX Market Committee and the Trust Companies Association of Japan set up the Fund PvP Project Team composed of trust banks, FX banks, asset management companies, the Bank of Japan, and the FSA to establish new market practices. The team will encourage stakeholders to develop a uniform operational scheme for fund transactions
  - ✓ The team will examine CLS participation models applied by trust banks and their operational flows, and discuss technical issues such as:
    - whether or not to exchange SSI for the consistency with the interbank trades
    - how to specify transactions for CLS settlement
    - how to comply with the rescind rule when trade details are changed after matching
- ❑ CLS's plan on service enhancement
  - ✓ Expand funding and settlement timeframe for certain currencies
  - ✓ Introduce bilateral netting calculation services for currencies besides 18 currencies
  - ✓ Implement the new membership framework which allows clients to have more than one settlement member within their corporate group (Affiliated Settlement Membership)
- ❑ The FSA will host the 4<sup>th</sup> meeting of the Roundtable in approximately one year to monitor the progress towards PvP settlements of funds