

Provisional Translation

Final Report

Roundtable on Risks Associated with the Settlement of Foreign Exchange Transactions

September 2018

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

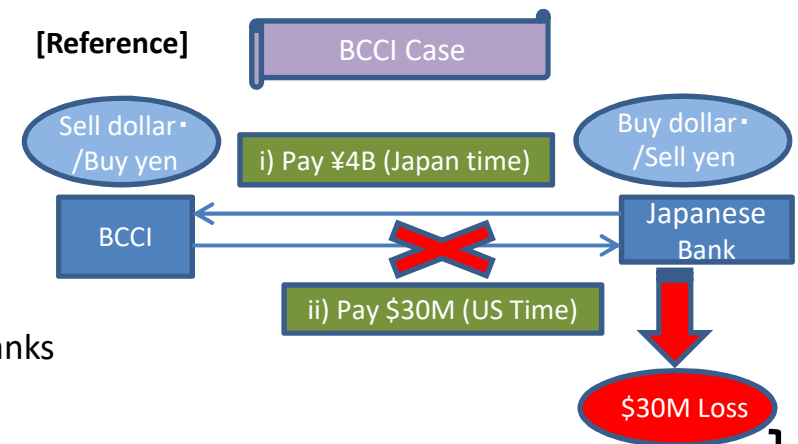
⇒ 2002 CLS Bank Launched for Implementing PvP Settlement

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 FMIs 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



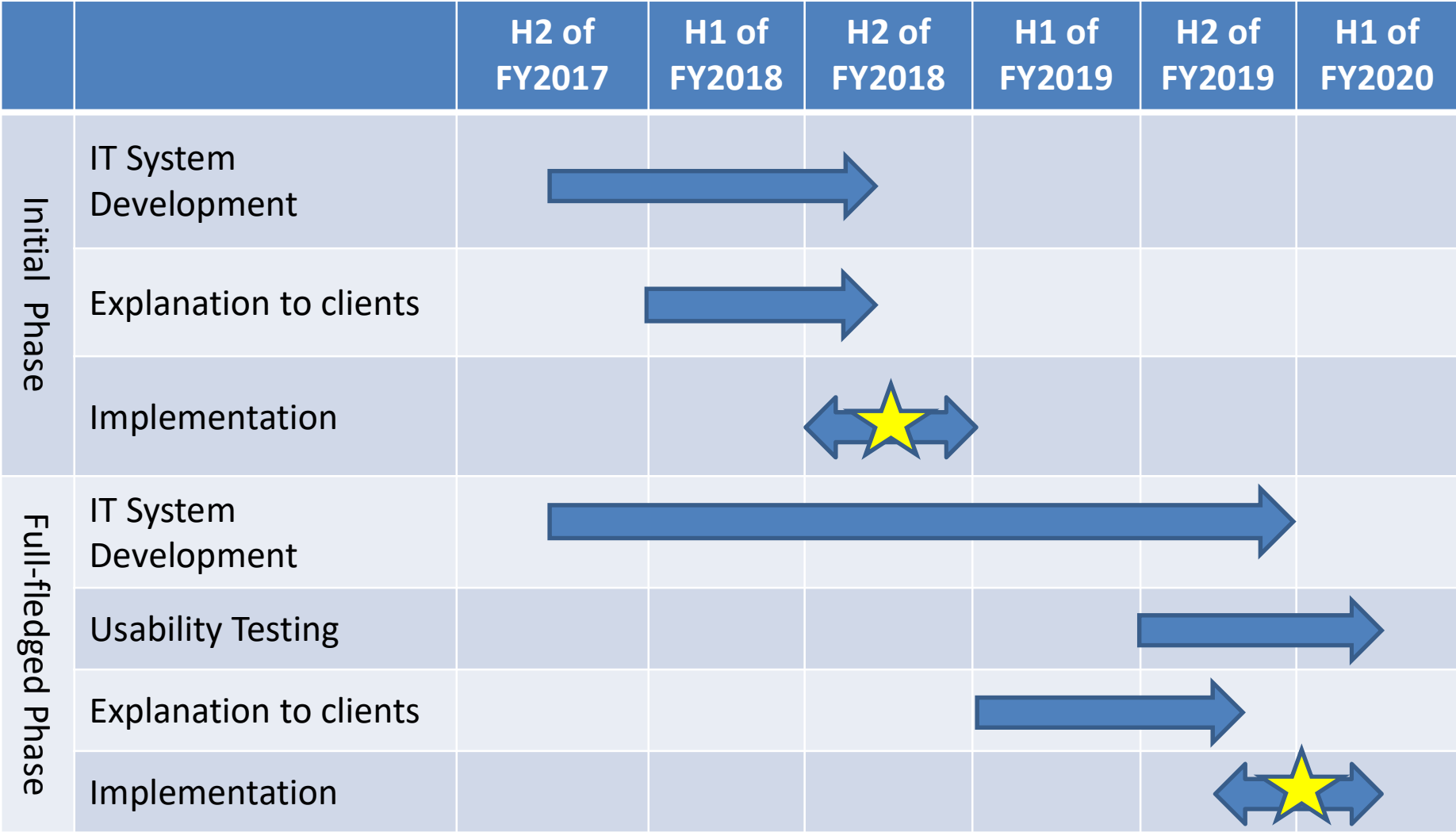
“Initial phase” goes live in the second half of FY 2018

- ✓ 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. Establishment of New Market Practices

- ❑ The Tokyo FX Market Committee and the Trust Companies Association of Japan set up the Project Team on Fund FX PvP composed of trust banks, FX banks, asset management companies, CLS, the Bank of Japan and the FSA, with a view to establishing new practices.
- ❑ In March 2018, the PT established new practices on PvP settlement for Japanese fund FX transactions toward the full-fledged phase. (The abstract is as follows.)

Contents		New practices	Transitional measures
When opening trading accounts	SSI※ exchange	<ul style="list-style-type: none"> • For all funds that are expected to settle their FX transactions in CLS, SSI should be exchanged for each currency before live operations start. • Transactions that are changed from “to be settled in CLS” to “non-CLS” after execution should be settled using the exchanged SSI. 	<ul style="list-style-type: none"> • Transactions that are compelled to be non-CLS can be settled in the current way by gross settlement (i.e. by sending MT202 for each transaction).
On each transaction	Specification of the transaction to be settled in CLS	<ul style="list-style-type: none"> • As a matter of principle, all funds transactions in CLS eligible currency pairs should be settled via CLS. • If CLS eligible currency pair transactions need to be settled outside CLS due to unavoidable reasons, it should be specified as a non-CLS transaction at the time of execution. 	-
	Netting Settlement	<ul style="list-style-type: none"> • The current netting practice involving third party payments among different FX banks (for non-CLS settlement) should be abolished and replaced by the new practices set by the PT (i.e. to be settled in CLS in principle). 	<ul style="list-style-type: none"> • The current netting practice involving third party payments can only be regarded as a temporary exception until the new practice is in place.

※SSI: Standing Settlement Instructions

8. The Present Status and the Way Forward

- ❑ CLS's plan for service enhancement
 - ✓ Expand the funding and settlement timeframe for certain currencies
 - ✓ Introduce bilateral matching and netting calculation services for currencies besides the 18 currencies
 - ✓ Implemented a new membership framework that allows clients to have more than one settlement membership within a single corporate group (Affiliated Settlement Membership)
- ❑ Financial institutions' efforts
 - ✓ Certain major FX banks are ready for Fund FX PvP settlement in the initial phase and the full-fledged phase. However, many FX banks require that PvP settlement needs to apply to all transactions in principle by a fund assigned to CLS settlement.
 - ✓ A foreign asset management company already had the first Japanese-domiciled funds to settle FX transactions in CLS.
 - ✓ Japanese asset management companies will introduce PvP settlement to transactions with higher risk to the extent practicable in the initial phase.
- ❑ Cross-industry efforts
 - ✓ Considering a framework that enables market participants across industries to join and make a trial run of their IT systems on the specific date to be ready for the full-fledged phase
 - ✓ The PT continues to exist for monitoring the status of each firm and addressing the remaining issues.
 - ✓ Concerning the issue of additional costs associated with the introduction of PvP settlement, all the relevant parties are expected to make a concerted effort in addition to obtaining the understanding of customers such as beneficiaries.
- ❑ The FSA will continue to monitor and encourage the relevant institutions such as trust banks and asset management companies to implement PvP settlement on Japanese fund FX.