HONG KONG MONETARY AUTHORITY
香港金融管理局

Circulars

14 May 2008

BIS Report on Progress in Reducing Foreign Exchange Settlement Risk

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14 May 2008

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

BIS Report on Progress in Reducing Foreign Exchange Settlement Risk

The Committee on Payment and Settlement Systems of the Bank for International Settlements (BIS) has recently published a report on Progress in Reducing Foreign Exchange Settlement Risk, a copy of which is available at the BIS website (http://www.bis.org/publ/cpss83.htm). You are recommended to study the report and its recommendations carefully and take appropriate actions to reduce your institution's foreign exchange settlement risk.

While the report recognises that the financial services industry has made significant progress in dealing with foreign exchange settlement risk in the last decade, it recommends that further actions should be taken by individual institutions, industry groups and central banks to reduce and control the remaining foreign exchange settlement exposures that may still present systemic risk and to guard against the risk of reversing the progress that has already been made. Insofar as individual institutions are concerned, the following actions are recommended:

a. Control remaining exposures appropriately -

   i. where they continue to exist, large and long-lasting exposures can be reduced through the use of currently available settlement services such as CLS or other payment-versus-payment arrangements (including the RTGS payment systems in Hong Kong),

   ii. institutions should shorten the duration of settlement exposures by adjusting internal payment practices and correspondent banking arrangements,

   iii. irrespective of any other measures taken, institutions should take immediate steps to avoid underestimating the risk they incur both intraday and overnight given the full size and duration of their remaining foreign exchange settlement exposures,

iv. institutions should maintain or establish clear senior-level responsibility and authority for managing exposures with individual counterparties and appropriate daily management procedures for these exposures which are similar to those of other short-term credit extensions; and

b. Ensuring that institution-wide business policies, through appropriate risk measurement and cost-benefit calculations, are based on fully informed and appropriate choices among available settlement methods that take into account the institution's risk-reduction effects, and that individual business units have appropriate incentives and controls to follow the institution-wide policy.

As you are aware, the HKMA has taken initiatives to help banks in Hong Kong reduce their foreign exchange settlement risk. In particular, payment-versus-payment (PvP) settlement arrangements for foreign exchange transactions between the Hong Kong dollar, the US dollar and the Euro currencies are made available via the respective Real Time Gross Settlement Systems in Hong Kong. Authorized institutions (AIs) are expected to make use of these systems to settle their foreign exchange transactions between the above currency pairs as far as possible. AIs should also refer to the module entitled "Foreign Exchange Risk Management" (TA-2) of the Supervisory Policy Manual (SPM), which sets out the HKMA's supervisory approach on AIs' foreign exchange risk, and provides guidance to AIs on the key elements of effective foreign exchange risk management, including the control of foreign exchange settlement risk. While the SPM module will be updated in due course to incorporate the recommendations of the BIS report, AIs are expected to review and strengthen where necessary their risk management systems and practices relating to foreign exchange settlement risk taking into account the BIS recommendations contained in the report.

As the report points out, there is still a lot of work ahead in order to achieve the ultimate goal of making settlement risk a historical term and to avoid the risk of backsliding. The HKMA will continue to work with the industry to further reduce foreign exchange settlement risk.

Yours faithfully,

Y. K. Choi
Deputy Chief Executive

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