Box 2 Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions[1]

1. *The nature of settlement risk:*
   - Banks should understand the nature and effect of settlement risk.
   - Banks should treat FX exposures as being equivalent to other credit exposures.
2. *Senior management responsibilities:*
   - Senior management should ensure that they fully understand the FX settlement risks incurred by the bank.
   - Senior management should formulate a policy on settlement risk and review it regularly.
   - Banks should have clear procedures for measuring and managing exposures.
   - Adequate training should be provided to all staff responsible for the various aspects of FX settlement risk.
   - Senior management should exercise appropriate oversight of settlement exposures.
   - Settlement risk should be integrated into other risk management.
3. *Duration of FX settlement exposure:*
   - Banks should know and apply methods for measuring the duration of settlement exposure.
   - Banks need to be certain when the unilateral cancellation deadline is for each currency.
4. *Measurement of FX settlement exposures:*
   - Recognised methods should be used to measure both minimum and maximum risk.
   - Measurement of settlement risk should constitute part of general risk assessment and management.
5. *Setting and using limits:*
   - A normal limit should be set for exposures to each counterparty.
   - Methods should be devised to determine a limit for exposures to each counterparty.
6. *Procedures for managing fails and other problems:*
   - Banks should have procedures for quickly identifying fails and taking appropriate action.
   - Banks need to strike a balanced approach in their reactions to fails.
7. *Contingency planning:*
   - Banks should undertake contingency planning and stress testing.
   - Contingency plans should be established to include a broad spectrum of stress events.
   - Contingency planning for FX settlement problems should be coordinated with planning for other problems.
   - Contingency plans should be tested periodically.
8. *Improving the management of FX settlement exposures:*
   - Banks should develop recognised methods for management of FX risks.
   - The duration or size of the settlement exposures relating to FX deals should be reduced.
   - Banks should negotiate better cancellation cut-off times with correspondents.
   - Methods for identifying receipts should be improved.
   - Internal processing should be improved.
   - Collateral arrangements should be managed properly.
   - Netting agreements should be legally sound.
9. *Use of bilateral netting:*
   - The advantages of establishing bilateral netting towards counterparties should be assessed.
   - Sound methods should be developed for measuring the effect of netting on settlement risk.
   - The legal basis for payment netting arrangements should be sound.
10. *Alternative arrangements for FX settlement risk reduction:*
    - Banks should assess the advantages of adopting new risk-reducing arrangements, in particular with direct or indirect participation in CLS Bank settlements.
    - Banks should assess the effect of participation in CLS Bank on all risk factors in their operation.
11. *Internal audit:*
    - Banks should have in place adequate internal audit coverage of the FX settlement process.
    - A bank's board of directors should ensure that the scope and frequency of the FX settlement internal audit programme is appropriate to the risks involved.
12. *A bank's responsibilities to its counterparties:*
    - A bank needs to be aware that its own behaviour affects the settlement risk faced by its counterparties.
    - A bank should take account of its counterparty in order to preclude settlement problems.
13. *The role of supervisors:*
    - Supervisors should make sure that banks measure, monitor and manage FX settlement risk appropriately and use risk management methods consistent with them.
    - Supervisors should share information about FX settlement risk problems.

1. Based on: Basel Committee on Banking Supervision, pp. 2-13.