

Ways of Coping with the Rise in FX Settlement Risks

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FOREIGN EXCHANGE (FX) settlement risk arising from different time zone, or alternatively Herstatt risk, is one of the biggest concerns in today's international banking community.

As the transaction volumes in the FX market continues to increase remarkably and the average daily turnover today exceed \$US4 trillion, it is no surprise that FX settlement risk has gained much of the discussion from most central banks around the world.

Basically, settlement risk arises because the two legs of a foreign exchange transaction are delivered in different currencies and often in different time zone. While time zone differences are an important determinant of FX settlement risk, banks' settlement practices can also affect the "size" and "duration" of their settlement exposures.

The 2008 report of BIS (Bank for International Settlements) points to the growing risks of FX settlement exposure. It also shows that the risks incurred by many major banks tend to be reasonably higher than the banks' capital base.

Similarly, as reflected in the survey by EMEAP (Executives' Meeting of East Asia-Pacific Central Banks), the size of the exposure to FX settlement risk of many commercial banks in the East Asia Pacific region tended to be large relative to their capital. This highlights the need to put in place extra mechanisms for a more effective management of settlement risk.

One of the most successful initiatives has been the introduction of Continuous Linked Settlement (CLS) in September 2002. Under this system, both sides of the FX transactions are settled simultaneously under the principle of Pvp (Payment versus Payment). Overall, settlement of FX transactions via CLS

reduces settlement risk considerably compared with traditional settlement methods, including settlement via correspondent banks.

To date, settlements under the CLS system account for about 58% of all global FX trades. There are currently 17 major currencies participating in CLS system. Of these, four currencies are from Asia, including Japanese yen, Singapore and Hong Kong dollars, and Korean won. Currently, the FX transactions being settled through these 17 eligible currencies account for around 95% of daily FX transactions.

The collapse of Lehman Brothers in September 2008, which has sparked the new round of global financial crisis, has prompted many important participants in the foreign exchange markets to opt for the use of an infrastructure service like CLS as a measure to reduce FX settlement risk.

Inevitably, even if it might mean an increase in costs, demand from financial institutions to reduce settlement risk via the CLS access has continued to increase, especially in times of uncertainty about the solvency of participants as reflected in the recent financial crisis.

As for Thailand, recent BOT survey suggests that Thai banks are well aware of the presence of FX settlement risk and that they use various risk management strategies to keep the "size" and "duration" of their exposures in line with their presumptions. Apparently, "counterparties' settlement limit", along with additional supporting measures such as streamlining the back-office systems that can cope with high volumes of transactions, has sufficiently held mitigate settlement risk. Besides, banks are investigating alternative settlement strategies, including bilateral netting, for further elimination of this risk.

However, in light of the rapid increase in FX market turnover and the recent global financial crisis, Thailand like many non-CLS member countries may need to revisit a prospective application to join CLS. It has become clear during the crisis that a more secure and reliable infrastructure to minimize these risks becomes increasingly important.

Looking forward, if we have a vision to reinforce our position as a key node in the global financial system, we may have to start looking into the path and prepare ourselves to bring Thai baht as part of prospective eligible currencies under the CLS system.

(The views expressed in this column are the writer's own.)

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