foreign exchange committee
FXC
COMMITTEE LETTER

November 22, 2010

Since its creation in 2002, Continuous Linked Settlement (CLS) has enabled its users to mitigate settlement risk through the use of payment-versus-payment settlement of certain foreign exchange transactions. This type of settlement has helped to support confidence in the ability to establish and meet global payment obligations as well as to significantly reduce systemic risk. Indeed, in a November 2009 paper, the Foreign Exchange Committee observed that the availability of CLS was a key contributor to the robust functioning of the foreign exchange market during the recent period of financial market disruption.

To capture the benefits of CLS across a greater share of the foreign exchange market, the Committee encourages all significant players in foreign exchange to become familiar with the risk-reducing settlement services provided by CLS and to consider using them. Additionally, the Committee also encourages CLS to undertake efforts to increase the scope of its traditional settlement services.

Accordingly, the Committee has decided to update its "Management of Operational Risk in Foreign Exchange" document to better reflect the important risk-reducing benefits of payment-versus-payment services, such as those offered by CLS. Accordingly, current Best Practice no. 34, "Understand the Settlement Process and Settlement Exposure," has been amended as follows:

"Understand the Settlement Process and Settlement Exposure **and Use Settlement Services wherever possible to Reduce Settlement Risk within the Market.**

Market participants should measure and monitor settlement risk exposures. *All senior managers should obtain a high-level understanding of the settlement process* ***as well as of the tools that exist to better manage settlement risk****. Additionally, both credit and risk managers (those managing position risk and credit risk) should be cognizant of the impact their internal procedures have on settlement exposure.*

Settlement risk may be reduced if those involved in the process better understand the ramifications of its possible failure. Senior management, sales and trading, operations, risk management, and credit management should understand the process and be aware of the timing of the following key events in the process: when payment instructions are recorded, when they become irrevocable, and when confirmation of counterparty payment is received with finality. Knowledge of these items allows the duration and amount of FX settlement exposure to be better quantified.

Both credit and risk managers should develop accurate methods to quantify settlement risk. A bank's actual exposure when settling an FX trade equals the full amount of the currency purchased, and lasts from the time a payment instruction for the currency sold can no longer be canceled unilaterally until the currency purchased is received with finality.

Market participants should adequately utilize settlement services that reduce their exposures to settlement risk whenever possible, for example, through the use of payment-versus-payment services, such as those offered by CLS, for the settlement of eligible foreign exchange transactions. Counterparties currently unable to use such services should be encouraged to consider ways to use them."

Best,

Jeff Feig
Chair
Foreign Exchange Committee