NEVIS FINANCIAL SERVICES DEPARTMENT

# MODULE 5

Guidance to completing the Settlement Risk module of BSL/2

NEVIS FINANCIAL SERVICES DEPARTMENT

# Settlement risk

## Introduction

Under Basel II banks should develop, implement and improve systems for tracking and monitoring credit risk exposures arising from unsettled and failed transactions, as appropriate. They should produce management information that facilitates action on a timely basis.

## Settlement Risk reporting forms

**MODULE 5**

**SETTLEMENT RISK**

**Delivery Versus Payment**

| A | Number of trades | Nominal of trades | Days past due | Factor | Loss if trade fails | Capital charge |
|---|---|---|---|---|---|---|
| A.1 | | | 5 – 15 | 8% | | 0 |
| A.2 | | | 16 – 30 | 50% | | 0 |
| A.3 | | | 31 – 45 | 75% | | 0 |
| A.4 | | | 46 or more | 100% | | 0 |

| B | Capital charge | Risk weighted assets equivalent |
|---|---|---|
| B.1 | - | - |

**Free Delivery**

| C | Number of trades | Mark-to-market receivable | Counterpaty risk weight | Risk weighted assets |
|---|---|---|---|---|
| **C.1** | **4 Days or less since delivery** | | | |
| C.1.1 | | | 0% | 0 |
| C.1.2 | | | 20% | 0 |
| C.1.3 | | | 50% | 0 |
| C.1.4 | | | 100% | 0 |
| C.1.5 | | | 150% | 0 |
| **C.2** | **Over 4 Days since delivery** | | | |
| C.2.1 | | | 1250% | 0 |

| D | Risk weighted assets equivalent |
|---|---|
| | - |

**Total risk weighted assets equivalent for settlement risk**

| E | Risk weighted assets equivalent | - |
|---|---|---|

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**Guidance on completion of the Settlement Risk reporting forms**

## SECTION 1 OVERVIEW

### Introduction

**1.1** This guidance relates to the completion of the settlement risk reporting forms. The forms and guidance cover settlement risk, the risks that arise through failed trades and non-delivery versus payment transactions. This treatment is the same throughout the bank.

1.2 Subsidiaries are reminded of the requirement that they adhere to the 8% minimum risk asset ratio and minimum capital requirements at all times. Where material positions are permitted, these capital requirements must be calculated daily. Settlement risk must be calculated daily for all banks that could have failed trades.

## SECTION 2 SETTLEMENT RISK

### Introduction

**2.1** Settlement risk arises through *failed delivery versus payment ("**DvP**") trades* and for all non-DvP trades (*free deliveries*).

### Failed DvP trades

2.2 Whether or not a transaction involving the delivery of an instrument against the receipt of cash attracts a capital charge for counterparty credit risk during its life, a capital charge should apply in cases of unsettled transactions where delivery of the instrument is due to take place against the receipt of cash, but which remains unsettled five business days after the due settlement date.

2.3 In principle, banks' systems should be set up in such a manner that, where a deal attracts a counterparty risk charge, this charge continues to apply when settlement is due but has not been completed. Banks are expected to adopt this for all such transactions.

2.4 No capital charge in respect of settlement risk on spot and forward foreign exchange transactions is considered necessary.

Treatment

2.5 Unsettled transactions should attract a capital cost based upon the difference between the amount due and the current market value of the instrument, if this has a potential loss. The capital requirement should be this potential loss multiplied by the Factor in the table below.

2.6 This applies only to trades where a loss may arise for the bank if the trade fails to settle. Failed trades must be reported once the date is more than four days after the agreed settlement date.

2.7 Note that the capital requirement for such transactions is not multiplied by a counterparty risk weight.

| Number of working days after due settlement date. | Line | Factor |
|---|---|---|
| 5 – 15 | A.1 | 8% |
| 16 – 30 | A.2 | 50% |
| 31 – 45 | A.3 | 75% |
| 46 or more | A.4 | 100% |

2.8 The figures that must be reported are:

2.9 Line A

| Line | Description | COMPLETION NOTES |
|---|---|---|
| A.1 to A.4 | Number of Trades | Report number of failed trades, by time band. |
| | Nominal of Trades | Report total amount receivable on the trades, by time band. |
| | Loss if trade fails | Calculate the mark to market loss of each trade and report the sum of these, ignoring gains. |
| | Capital Charge | This line is system generated and is the risk multiplier multiplied by the figure in the Loss if Trade Fails line. |

Risk Weighted Asset Equivalent

2.10 Line B calculates the total capital charge from Line A and the equivalent Risk Weighted Asset figure, being 12.5 times this charge

**Free Deliveries**

2.11 A free delivery occurs when a bank has paid away (or received) its side of a transaction and has yet to receive (or pay away) the securities/cash concerned. This generates an immediate exposure. The bank that has made the delivery will be deemed to have a claim on the other party for the amount of the cash or equivalent to the current market value of the securities, whichever is still outstanding.

2.12 The capital requirement for free deliveries should be calculated as:-

- Four working days or less past settlement date:

  The risk weighted amount should be the counterparty claim multiplied by the counterparty risk weight;

- More than four working days past settlement date:

  The counterparty claim must be deducted from capital.

2.13 For clarity, this treatment should also be applied to exchange traded contracts involving physical delivery.

2.14 No capital charge in respect of delivery risk on spot and forward foreign exchange transactions are considered necessary.

2.15 Where the transaction is effected across a national border, the Regulator considers that there is a window of one working day before the exposure should be included.

| Line | Description | COMPLETION NOTES |
|---|---|---|
| C.1: 4 days or less | Number of Trades | This is the number of trades which are four days or less past settlement, by counterparty weight. |
| | Mark-to-market receivable | Report receivable mark-to-market, by counterparty weight. |
| | Counterparty Risk Weight | Weights are in accordance with the credit risk approach used by the entity. |
| | Risk Weighted Assets | This line is system generated and is the mark-to-market receivable multiplied by the counterparty weight. |
| C.2 More than 4 days | Number of Trades | This is the number of trades which are more than four days past their settlement date. |
| | Mark-to-market receivable | Report receivable mark-to-market. |
| | Counterparty Risk Weight | The 1250% risk weight is used here as a proxy for a deduction from capital. |
| | Risk Weighted Assets | This line is system generated and is the capital charge multiplied by 12.5. |

Risk Weighted Asset Equivalent

2.16 Line D calculates the total equivalent Risk Weighted Asset figures from Line C.

Summary of Settlement Risk

2.17 Line E calculates the total equivalent Risk Weighted Asset figures from Line A for DvP failed trades and Line D for all non-DvP trades (free deliveries).