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December 2022 Edition

- **BIS Quarterly Review** – two stories that caught our attention.
- **Taxing times ahead (again!) –** we return to a common theme of previous **Horizons** in 2022.
- In this month's SKADI Spotlight, we look at **Back-to-Back bookings** from an ops perspective.

The month in review

In December the Bank for International Settlements (BIS) published its latest Quarterly Review. Two papers in particular were picked up by the Financial press, and both piqued our interest. First, "*Dollar debt in FX swaps and forwards: Huge, Missing and Growing*" – citing concerns from $65 trillion of debt held off-balance sheet by non-US institutions, and second "*FX settlement risk: an unsettled issue*" raising concerns around settlement risk within FX derivatives.

FX settlement risk is not the hazard of FX cash flows being paid late, or to incorrect SSIs (Standard Settlement Instructions). BIS defines FX settlement risk as: "*the risk that settlement will not take place as expected, it comprises both credit and liquidity risk.*" The report focuses on principle risk, a form of credit risk, Principal risk is the risk that a counterparty loses the full value involved in a transaction.

As of April 2022, FX settlement risk has increased to $2.2 trillion of FX cash flows on any chosen day. To mitigate this risk, options exist - bilaterally counterparties can offset their obligations (pre-settlement netting) or settle via a payment-versus-payment (PvP) facility. Under PvP arrangements, final payment is dependent on whether the opposing leg is paid. Alternatively, participants can settle via the same clearer (on-us) where both payment legs settle across one institution, to be protected both legs must settle simultaneously or within preauthorised credit lines.

As Dave Bridges, SKADI's operations SME, notes...

"*Control functions should have a clear line of sight of turnover exposed to settlement risk where PvP and other fail-safes are not available. Where settlement processing is outsourced, governance functions in London should have robust controls and oversight in place to quickly detect and manage outstanding nostro breaks and understand the root causes behind them to mitigate further occurrences.*"

Forward-Looking

More taxing times ahead…

The FT once again raised the issue of taxes in an opinion piece mid-December entitled "UK business needs to brace itself for much higher taxes". This returns to a theme SKADI have mentioned a number of times throughout 2022. With governments dealing with increased interest payments on their debt, plus public sector increased wage demands, the sensible thing to ask is "where is this money going to come from?"

On the same theme, we were intrigued by Saxo Bank's "Outrageous Predictions 2023", and specifically the "Tax haven ban kills private equity" story published 12-Dec. Read into it what you will (don't worry – it's a very short read!) but, with tax havens estimated to cost governments $500bn - $600bn annually in lost corporate tax revenue, you have to think it might be a tempting area for governments to start. As we have re-iterated throughout the 2022 Horizon publications, tax issues should be front and centre of control function's priorities. Any tax efficient products or structures should be checked to ensure that documentation is watertight.

SKADI Spotlight: Back-to-Back bookings

Back-to-Back bookings facilitate payment between an investment bank and a counterparty who cannot settle against the entity they traded with. Consider an example: an investment bank's London office sells Gilts to a client based in the US who always face the bank's New York (NY) office. Instead of completing lengthy due diligence processes to face the bank's London office, the trade settles on a Back-to-Back basis.

When the bank executes the trade, the static data configuration for the client is applied which automatically creates the following trades: London sells to NY, NY buys from London, NY sells to the client. Reconciliation, trade matching, and settlement take place, delivering the Gilts to the client's custodian in CREST via the NY office.

Front-end systems in London will show the counterparty as the client (rather than NY) to feed correctly into credit risk systems, whilst trade confirmation will be issued from the US office.

The SKADI Podcast

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