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News release

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Bank of England Publishes Two Articles from the upcoming Financial Stability Review

The Bank of England is today pre-releasing the following two articles from its upcoming Financial Stability Review, which will be published on Monday 13 December.

BANK STABILITY AND TRANSPARENCY

Banks that disclose more information tend to be less at risk of falling into financial distress, all other things being equal. That is what Erlend Nier finds in his analysis of 550 banks from 32 countries, published in 'Bank Stability and Transparency'. This underscores the importance of transparency and market discipline for overall financial stability. Improved disclosure is able to reduce the incidence of banking crises. Hence Basel II Pillar 3 disclosures could bring major dividends for overall financial stability.

CONTINUOUS LINKED SETTLEMENT (CLS) AND FOREIGN EXCHANGE SETTLEMENT RISK

Central banks and supervisors have made clear their interest in how banks manage the risks to which they are potentially exposed in foreign exchange transactions. They continue to monitor whether enough has been done to reduce foreign exchange settlement risk, and to consider what further steps may be necessary.

Participation in CLS provides a means of eliminating the major part of settlement risk. David Sawyer's article points out, however, that, according to surveys, well over half, by both value and volume, of foreign exchange transactions are not yet settled through CLS. Amongst the transactions excluded are most of banks' trades with investment funds, hedge funds and non-financial corporations, as well as some interbank trades. The number of CLS users continues to grow, and four additional currencies became eligible for settlement in CLS this month. This will allow more institutions to reduce principal risk. But where institutions decide not to participate in CLS, or transact with counterparties outside CLS, they must manage foreign exchange settlement risk in other ways.

Notes to Editors

The revised Basel framework is based on three 'Pillars': Pillar 1: Minimum risk-based capital requirements, Pillar 2: Supervisory review, and Pillar 3: Market discipline. The third Pillar requires banks to make specific disclosures on various aspects of their risk profile and their risk management processes to the market at large. The revised Framework was finalised in June this year. It is expected that Basel II will be implemented in the EU and other BCBS countries from 2007.

In 1996 the Governors of the central banks of the Group of Ten (G10) industrial countries set out a strategy in which the private and public sectors could together seek to reduce and control the systemic risk inherent in the prevailing arrangements for settling foreign exchange transactions. A core recommendation of the strategy was that the private sector should develop risk-reducing multi-currency settlement services. The banking industry's response has been to build the Continuous Linked Settlement (CLS) system, which went live in September 2002. CLS removes principal risk by settling both sides of foreign exchange transactions simultaneously.

The currencies which became eligible for settlement in CLS this month are the Hong Kong dollar, the Korean won, the New Zealand dollar and the South African rand. Eleven currencies were already eligible (further detail is available in the article).

Key Resources

Bank Stability and Transparency
http://webarchive.nationalarchives.gov.uk/20100114080129/http://www.bankofengland.co.uk/publications/fsr/2004/fsr17art10.pdf
Continous Linked Settlement (CLS) and Foreign Exchange Settlement Risk
http://webarchive.nationalarchives.gov.uk/20100114080129/http://www.bankofengland.co.uk/publications/fsr/2004/fsr17art5.pdf