



BANK OF ENGLAND



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Dear Chief Risk Officer,

Pre-settlement counterparty credit exposure management and controls for DvP Clients

In recent years, we have observed a number of incidents involving defaults by clients who transact solely in cash products settled on a Delivery versus Payment (DvP) only basis (“**DvP Clients**”). These defaults typically happened during periods of high price volatility, and in some cases, led to material losses at firms.

In late February and early March 2020, the highly liquid US Treasuries markets experienced high price volatility leading to implications for counterparty risk management practices. Consequently, we reviewed the risk controls and arrangements related to DvP Clients at a number of UK regulated firms.

This letter shares our observations on good practices that we encourage firms to incorporate within their control framework, to more effectively monitor and mitigate counterparty credit risks in this area. For the avoidance of doubt, these observations on good practices are relevant to all trading activity with DvP Clients including electronic trading platforms.

Good practices regarding DvP Clients risk management

On-boarding of new accounts

- Whilst Anti Money Laundering and ‘Know Your Customer’ checks are fundamental to the on-boarding of DvP Clients, firms also undertake more comprehensive measures to establish the bona fide identity of their clients.
- At a minimum, a risk-based policy framework, developed and overseen by a credit function independent of the front office, is implemented to ensure that at least the basic credit profile of every client is within the firm’s risk appetite. More extensive credit analysis and potential escalation within the framework is required for higher risk accounts, such as those which have no financial track record

or audited financial statements. Additional consideration is given to the periodic refreshing of information upon which this due diligence is based.

- At the account opening stage, the accountable salesperson or internal owner of the new account formally signs off on the trading strategy that the client will be expected to follow, including guidelines for the typical size, type, and frequency of transactions that the account would be expected to undertake.

Credit Risk Framework

- Every client account, regardless of whether it intends to transact on a DvP-only settlement basis, is subject to a pre-settlement credit exposure limit. At a minimum, individual credit exposure limits are derived from a risk-based matrix or hierarchy that is developed and owned by an independent credit function.

On-going oversight of clients

- There is a clear internal ownership of the client account, to enable consistent oversight of the client. A monitoring system is developed to assess the actual trading profile of the client as compared with its expected trading profile. Parameters are set such that any material deviation from the expected strategy is flagged and escalated to the salesperson, front office management, and an independent control function. On-going client monitoring also covers risks related to financial crime and money-laundering.

Client exposure monitoring

- An automated monitoring system is established to reconcile pre-settlement exposures to risk limits for each client account, with appropriate in-built escalation procedures. Any exceptions to the pre-settlement credit limit process, including all limit exceptions, are systematically escalated to the independent credit function for approval. Settlement fail reports incorporate relevant details in relation to pre-settlement exposure. For individual clients, who transact on an electronic basis, in-built system triggers and trading halt parameters are established for aggregate open exposures that exceed pre-established risk limits.
- Market risk exposure on failed trades, which may increase considerably during high market volatility, is monitored closely. Appropriate close-out policies and procedures are established to minimise losses that may occur as a result of failed/unsettled trades.

Escalation procedure

- There is a robust trade fail management process with systematic and pre-defined escalation trigger points for individual client accounts, ensuring that the rapid escalation of fails to both the front office and independent control functions is achieved. The fails reporting is linked to the automated monitoring system that reconciles aggregate pre-settlement risk exposures to risk limits. The policies and procedures that govern the fail management process include consideration points for individual client accounts, including the imposition of trading restrictions or halts until the fail management issues have been resolved.

Conclusions

We encourage firms to consider fully the above-mentioned practices, with a view to incorporating them in your risk management of DvP Clients. We also encourage firms to consider any associated conduct risk issues while implementing measures related to above-mentioned areas.

We request an update from you outlining what steps you have taken on the back of this letter by the end of Q4 2021, through the usual supervisory channels.

We will continue to maintain a strong focus on significant loss events in the market and expect firms to conduct risk management reviews within their own organisations as such events occur.

Yours sincerely

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