# GFMA Global FX Division

## GFXD recommendations for FX Settlement Netting

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## Background to the Global Foreign Exchange Division

The Global Financial Markets Associations (GFMAs) Global Foreign Exchange Division (GFXD) was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 25 global foreign exchange (FX) market participants[1], collectively representing around 80% of the FX inter-dealer market[2]. Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

## Disclaimer

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[1] Bank of America Merrill Lynch, Bank of New York Mellon, Barclays, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, MUFG Bank, NatWest Markets, Nomura, RBC, Scotiabank, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac

[2] According to Euromoney league tables

## Executive Summary

- **The GFXD supports that FX market participants should make every effort to agree and settle FX payments on a netted basis rather than settling payments gross ("settlement netting").**
- **Counterparties should agree, as part of their relationship documentation, the operational parameters for settlement netting, and should make every effort to adhere to these on an ongoing basis.**
- **For each individual settlement net, there should also be minimum standard set of data to be validated during the netting process to allow the net to be agreed as efficiently as possible.**

## Introduction

Settlement netting can be defined as the act of aggregating payments between counterparties into a single amount or cashflow per currency, for settlement on a specific value date.

Settlement netting remains one of the key tools available to operations managers in the management of risk. The GFXD Operations Committee, consisting of senior FX operations professionals from GFXD member banks, whilst noting the industry preference for automated 'payment v payment' bilateral/multilateral netting mechanisms (e.g. CLS) is keen to promote the increased use of settlement netting for those payments settling outside of established 'payment v payment' systems.

This paper is intended to promote active dialogue between the counterparties to a trade on the benefits of settlement netting and the GFXD welcomes further engagement on this topic.

## 1. Benefits of settlement netting

The 2017 FX Global Code[3] states, in Principle 50:

> *"Market Participants should measure and monitor their Settlement Risk and seek to mitigate that risk when possible… The netting of FX settlements…is encouraged"*

The GFXD believes that settlement netting not only reduces settlement and operational risk but can also promote more efficient funding/capital and balance sheet usage, and reduce the costs attributed to FX settlement. Therefore, the GFXD strongly supports the development and expansion of settlement netting between FX market participants.

## 2. Practical Considerations When Determining the Settlement of FX Transactions

### a. Hierarchy of settlement methods

In order to gain the maximum risk and operational benefits, we recommend the following hierarchy when determining the settlement of FX transactions:

1. Settlement netting is preferable to gross settlement. This includes any of the following netting methods, noting that use of technical solutions enables greater STP[4] and reduces the requirement manual intervention:
    - Automated 'payment v payment' bilateral/multilateral netting mechanisms (e.g.

[3] https://www.globalfxc.org/docs/fx_global.pdf

[4] 'Straight Through Processing' is used to institutions to streamline information through a number of points (e.g. the stages of a trade lifecycle), eliminating the need for paperwork or manual intervention.

CLS)

- Automated netting technologies
- Manual settlement netting processes

2. Consistent settlement practice is preferable to ad hoc arrangements. Operational systems generally require a client to be set up as settling *either* net *or* gross. Switching between gross and net settlement therefore requires an additional manual process which is more likely to result in errors. Consistent use of settlement netting allows for greater automation of operational processing and reduces the risk of incorrect settlement of trades.

### b. Agreeing settlement expectations

It is recommended that both counterparties to the trade should agree (during the mutual onboarding of the relationship) how FX transactions should be expected to settle: net or gross.

As noted above, netting of payments is preferred, with the greatest operational benefit to be gained from consistent netting across trading activity.

Industry documentation exists to memorialise such agreements, such as the ISDA 2002 Master Agreement[5] (in particular, see Section 2c). This states:

> *Netting of Payments. If on any date amounts would otherwise be payable:—*
>
> *(i) in the same currency; and*
>
> *(ii) in respect of the same Transaction,*
>
> *by each party to the other, then, on such date, each party's obligation to make payment of any such amount will be automatically satisfied and discharged and, if the aggregate amount that would otherwise have been payable by one party exceeds the aggregate amount that would otherwise have been payable by the other party, replaced by an obligation upon the party by which the larger aggregate amount would have been payable to pay to the other party the excess of the larger aggregate amount over the smaller aggregate amount.*
>
> *The parties may elect in respect of two or more Transactions that a net amount and payment obligation will be determined in respect of all amounts payable on the same date in the same currency in respect of those Transactions, regardless of whether such amounts are payable in respect of the same Transaction. The election may be made in the Schedule or any Confirmation by specifying that "Multiple Transaction Payment Netting" applies to the Transactions identified as being subject to the election (in which case clause (ii) above will not apply to such Transactions). If Multiple Transaction Payment Netting is applicable to Transactions, it will apply to those Transactions with effect from the starting date specified in the Schedule or such Confirmation, or, if a starting date is not specified in the Schedule or such Confirmation, the starting date otherwise agreed by the parties in writing. This election may be made separately for different groups of Transactions and will apply separately to each pairing of Offices through which the parties make and receive payments or deliveries.*

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However, parties may use a different Master Agreement, or may also agree to a bilateral netting agreement, which is likely to be documented separately. If this is the case, we still recommend that a consistent settlement netting process is agreed.

### c. Setting the operational parameters

It is recommended that those teams performing the net settlement process also mutually agree the operational parameters which are to be consistently applied when agreeing FX settlement nets. Such parameters include, but are not limited to:

- Timing:
  - The time at which the settlement nets will be agreed
  - The common practices regarding currency cut-offs, including time-zone
- Content:
  - What trade populations each settlement net will be expected to contain, e.g. currencies, relationships (e.g. FXPB), entities and type of FX instrument (e.g. FX forwards, FX option premiums)
  - What trades will be excluded from the net and why
  - Whether the net will contain legally confirmed trades only, noting that FX Global Code Principle 50 recommends that *"all initial trades should be confirmed before they are included in a netting calculation"*
- Process:
  - How and where the settlement net will be agreed, and which technical solutions can be employed to facilitate this process
  - Agreement on changes to any existing processes, such as trade confirmation
  - The preferred method for confirming the settlement net (email, manual, electronic)
- Settlement:
  - Whether settlement instructions will remain the same or be confirmed each time an individual net is confirmed prior to settlement

Developing those operational parameters illustrated above, we believe it beneficial to provide examples of netting in practice. These include, but are not limited to:

- Netting across FX instruments: It is likely that a settlement net amount will include similar types of FX instruments. For example, it is unlikely that FX option premiums will be netted with FX spot trades whereas FX spot trades will likely be netted with FX forwards.

- FX Non-deliverable forwards (NDFs): Where technical functionality requires the generation of an offsetting 'fix' trade, the recommendation is that this should be netted with the original trade to generate the settlement amount. It may then be possible to subsequently further net multiple NDF settlement amounts into a single currency for settlement on a specific Value Date.

- Netting across FX accounts: If a client has both a FX prime brokerage and a FX institutional account, it is likely that these two accounts will not be netted together and will require separate settlement.

As part of the agreement of these parameters, both parties should understand that they are each responsible for adherence, in particular for ensuring that the net is agreed prior to the execution of settlement, in accordance with the appropriate currency cut-off time. Any trades entered into after the cut-off time will be treated separately from the agreed net.

Furthermore, we note that some counterparties engage in ad hoc, rather than consistent, netting of FX. As above, we suggest that consistent use of settlement netting is preferred, but in the event of ad hoc netting it will still be important to agree the above parameters at the outset.

### d. Data to be validated during the netting process

When manually agreeing the amounts to be net settled, we recommend a non-exhaustive list of attributes that should be validated:

- Identity of contracting parties;
- Currency to be settled;
- Direction of settlement (are you paying or receiving);
- Amount to be settled;
- Value Date; and
- Reference to settlement instructions.

## Contacts

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