



## **GFMA Global FX Division**

### **GFXD recommendations for FX Settlement Netting**

**Version: July 2021**

## **Background to the Global Foreign Exchange Division**

The Global Financial Markets Associations (GFMA's) 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 23 global foreign exchange (FX) market participants<sup>1</sup>, collectively representing the majority of the FX inter-dealer market<sup>2</sup>. 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.

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<sup>1</sup> Bank of America, 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, Northern Trust, RBC, Standard Chartered Bank, State Street, UBS and Wells Fargo

<sup>2</sup> 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<sup>3</sup>, 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 2021 FX Global Code<sup>4</sup>, which has been drafted to apply to all FX market participants, states, in Principle 50 (emphasis added):

*“Market Participants should properly measure, monitor and control their Settlement Risk equivalently to other counterparty credit exposures of similar size and duration”*

The GFXD believes that settlement netting contributes to:

- Reduced settlement and operational risk, by reducing the overall number of settlements required and the amount at risk during the settlement process<sup>5</sup>;
- More efficient funding/capital and balance sheet usage; and
- A reduction in the costs attributed to FX settlement.

Therefore, the GFXD strongly supports the development and expansion of settlement netting between FX market participants.

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<sup>3</sup> The GFXD Operations Committee comprises senior FX operations professionals from GFXD member banks

<sup>4</sup> [https://www.globalfxc.org/docs/fx\\_global.pdf](https://www.globalfxc.org/docs/fx_global.pdf)

<sup>5</sup> See also the Bank for International Settlements paper ‘Settlement Risk in Foreign Exchange Transactions’, §3.3.2 <https://www.bis.org/cpmi/publ/d17.pdf>

## 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<sup>6</sup> and reduces the requirement manual intervention:
  - Automated ‘payment v payment’ bilateral/multilateral netting mechanisms (e.g. CLS)
  - Automated netting technologies (see section 2e below)
  - 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<sup>7</sup>. In particular, Section 2c 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.*

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<sup>6</sup> ‘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.

<sup>7</sup> Copyright © 2018 by International Swaps and Derivatives Association, Inc.

*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.*

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 (regardless of whether the netting is performed consistently or on an ad hoc basis, noting the preference for a consistent approach). 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

- The trade populations each net will be expected to contain, e.g. currencies, relationships (e.g. FXPB), entities and FX instrument type (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 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 (see section 2d below)
- Agreement on changes to any existing processes, such as trade confirmation
- Whether settlement instructions will remain the same or be confirmed each time an individual net is confirmed prior to 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.

**d. Examples of netting in practice**

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, it is recommended 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 will not be netted together but will require separate settlement.

**e. The benefits of automating the netting process**

As with automated trade confirmation, the GFXD is also strongly in favour of utilising automated solutions to confirm settlement nets. Automation brings additional benefits, such as:

- Reduced operational costs and risks from manual processing errors;
- Better management of credit and liquidity; and
- Fewer settlement fails and an increase in the number of successful net settlements.

Automated netting solutions can be grouped into three types:

Use of a bank’s platform	Use of third-party platform	Direct connectivity to SWIFT <sup>8</sup>
<ul style="list-style-type: none"> <li>• Users view and confirm nets electronically with that bank</li> <li>• Can often be integrated into other services across the FX value chain</li> </ul>	<ul style="list-style-type: none"> <li>• Users view and confirm nets electronically with multiple counterparties</li> <li>• Can often be integrated into other services across the FX value chain</li> </ul>	<ul style="list-style-type: none"> <li>• Users view and confirm nets with multiple counterparties</li> <li>• Can be integrated into other SWIFT message services</li> </ul>

**f. Data to be validated during the netting process**

When manually agreeing nets, we recommend a non-exhaustive list of attributes for validation:

- |   |                                      |
|---|--------------------------------------|
| Identity of contracting parties         | Amount to be settled                 |
| Currency to be settled                  | Value date                           |
| Settlement direction (paying/receiving) | Reference to settlement instructions |

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<sup>8</sup> SWIFT ([www.swift.com](http://www.swift.com)) is a member-owned provider of secure, standardised financial messages