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**TO:**

Committee on Payments and Markets Infrastructures
By email: cpmi@bis.org

Date: 12 November 2021

**Re: The Committee on Payments and Market Infrastructures (CPMI) call for ideas on solutions to expand PvP settlement**

Dear Sir or Madam,

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) welcomes the opportunity to comment on behalf of its members on the *CPMI call for ideas on solutions to expand PvP settlement*, published on October 7, 2021

The 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[1], collectively representing a significant portion of the FX inter-dealer market. 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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## Introduction

As we have previously noted in our papers *'First Steps Towards 24/7 FX Settlement Capabilities - Expanding Payment versus Payment (PvP) opportunities'*[2] and '*Considerations relevant to initiatives and developments in wholesale*

[1] 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, NatWest Markets, Nomura, Northern Trust, RBC, Standard Chartered Bank, State Street, UBS and Wells Fargo.

[2] https://www.gfma.org/wp-content/uploads/2020/03/expanding-pvp-opportunities-march-2020.pdf

*FX settlements*'[3], the GFXD's Market Architecture Group (MAG) is keen to promote the efficient and safe settlement of wholesale FX transactions, especially noting the importance of settlements to the overall functioning of the FX market.

The FX market is the world's largest financial market, and the effective and efficient exchange of currencies underpins the international financial system. The FX market is also the basis of the global payments system, meaning the volume of transactions is very high and, transactions are often executed by market participants across geographical borders.

Sovereign entities, central banks and other government sponsored entities rely on the FX market to be well-functioning and liquid, and corporations and investors regularly participate in the market for important operational needs, including:

- to reduce risk by hedging currency exposures;
- to pay suppliers and to be paid for services outside their home market;
- to convert their returns from international investments into domestic currencies; and
- to make cross-border investments and raise funding outside home markets.

Payment versus Payment (PvP) is defined in the 2013 BCBS '*Supervisory Guidance for managing risks associated with the settlement of foreign exchange transactions*'[4] as:

> *A settlement mechanism that ensures the final transfer of a payment in one currency if, and only if, a final transfer of a payment in another currency occurs*

The use of PvP therefore enables a market participant to both minimise their risks and gain assurance that they will legally receive the funds they require to meet their operational needs, such as those listed above. PvP remains a critical factor in the successful operation of the global FX market.

Where no PvP mechanism is available, market participants can still affect controlled settlement, but this usually involves one party withholding the release of funds until payment has been received and reconciled. However, this process is operationally intensive, introduces additional risk and is not of benefit to both parties.

Our members fully recognise the systemic benefits of settling FX transactions on a PvP basis, noting the role of CLS Bank International[5] in addressing Principal (Settlement) Risk[6] where possible, but also acknowledging that a population of transactions remain which do not currently settle through CLS., For example this could include transactions with non-CLS participants or in non-CLS currencies and such transactions that are not settled on a PvP basis are the focus of our response.

Whilst we understand that this specific request from the CPMI is on possible and future PvP solutions (mechanisms), our response if more general and is written irrespective of any one particular new

[3] https://www.gfma.org/wp-content/uploads/2019/09/developments-in-wholesale-fx-settlements-september-2019.pdf
[4] https://www.bis.org/publ/bcbs241.htm ("BCBS FX Supervisory Guidance")
[5] https://www.cls-group.com/
[6] https://www.bis.org/publ/bcbs241.htm

mechanism. However, we do note that for any success a suitable legal and operational framework is required.

In the remainder of our response, we will discuss some of the considerations and challenges market participants may face in increasing the number of transactions settled on a PvP basis, as well as what role the private/public sector can play in addressing these.

**Increasing PvP Opportunities**

Feedback from our members suggests that there are several main reasons for transactions to settle on a bilateral (i.e. non PvP) basis. These are:

- commercial sensitivity to the timing of the payment (i.e. funds are required to be moved during the local business day rather than during a specific PvP mechanism operating window);
- a currency or client is not eligible for existing PvP mechanisms; and
- an operational requirement/action causes an eligible transaction to settle bilaterally.

Any new PvP mechanisms, (or developments to existing mechanisms) therefore need to offer opportunities to address these use cases and do so in a flexible manner that meets industry requirements to ensure safe and reliable settlement.

*Commercial sensitivity to the timing of a payment*

As noted in the Introduction, wholesale FX transactions are often executed to fund other commercial activities, most of which will be time dependent and dependent on provision of liquidity in the local market. PvP mechanisms should consider this need and be available throughout the local market operating windows of both currencies, allowing an overlap of central bank operating hours and facilitating safe settlement.

*A currency or client is not eligible for existing PvP mechanisms*

It is clear that any new PvP mechanisms, (or developments to existing mechanisms) will need to include the currencies which at present settle on a physical basis, this includes G20 and non-G20 currencies. Such an approach will attract a wide network of market participants, itself resulting in greater cost and liquidity management efficiencies.

Whilst the focus of those individuals developing mechanisms may naturally fall to certain types of currencies, e.g. emerging markets, it is also worth noting that there are considerable opportunities to settle the more commonly traded currency pairs on a PvP basis too. We do not believe that there are greater needs in any currency pair versus another. We recommend that the due to benefits of scale, any PvP mechanisms should consider a wide range of currencies, complementing the CLS main settlement session.

Regarding the market participants themselves, any developed/new mechanisms should be open to as many participants as possible. This is key to success and a participant's decision to use a PvP mechanism will invariably have a cost consideration. The global FX market is typified by its vast number of participants, all with very varied levels of technical sophistication. In order to promote adoption, any new PvP mechanism should be open/available to as many of these market participants as possible in a cost effective and technology agnostic manner.

*An operational requirement/action causes an eligible transaction to settle bilaterally*

There are many reasons which cause eligible transactions to settle on a bilateral basis.

Feedback suggests that mismatches in the details of transactions submitted to settle on a PvP basis often result in bilateral settlement. Such mismatches could be caused by booking differences in the transaction details, or simply due to timing issues when transactions are inputted into the system (e.g. a transaction may be entered after a procedural cut-off).

Whilst there is an educational element here (i.e. those involved in the full front-to-back transaction lifecycle may not be aware of all procedural deadlines), there is also a need to consider the strategic evolution of the FX market (i.e. trends towards the use of new technologies that are able to facilitate faster settlement), and the ability for market participants to actually use such technologies.

To account for these developments, any new PvP mechanisms, (or developments to existing mechanisms) should allow for longer operating hours and greater flexibility on when transactions can be settled on a PvP basis.

Drivers to enable longer operating hours of PvP mechanisms include:

*Central bank operating hours* – Central banks will need to ensure that their payment systems are available for longer periods during any given operating day, potentially up to and including 24/6 or 24/7. Longer operating hours for example can be assumed to lead to greater overlap in the real time gross settlement (RTGS) operating hours of either central bank, leading to greater flexibility and will facilitate greater opportunities for PvP settlement.

*Settlement Date* – Given that the wholesale FX market is global in nature and operates across borders and time-zones, it may be necessary to reconsider the concept of a Settlement Date (namely the date the transaction settles and any applicable payment is made by one party to the other party) for certain transactions, potentially even aligning with the concept of a 'Global Trading Date' which is used in trading.

Currently the Settlement Date is applied to the local business day of each currency within the transaction and the flow of liquidity is therefore driven by the operating hours of the local market. This is especially relevant when considering increased opportunities for PvP settlement, particularly when the central bank RTGS systems of the two currencies involved in the transaction may not overlap.

A PvP mechanism should enable both currencies to settle across a longer time-window, breaking down the local market operating hours construct (especially when considering payments for commercial purposes) and create more opportunities for PvP settlement, without requiring pre-funding.

For example, considering a transaction in AUDUSD settling on a bilateral basis on the 1 December, the AUD will settle on the 1 December in Australia, whilst the USD will settle on the 1 December in the United States. Due to the time-zone differences settlement will actually occur on the next business day (i.e. 2 December) in Australia. The question remains on how a AUDUSD transaction could be settled at 6pm NY on a PvP basis – a revised Settlement Date concept could provide a suitable answer.

Given that FX is often used to fund other financial activities, including the purchase/sale of foreign securities, it is critical to consider any potential changes to Settlement Date in light of the wider financial ecosystem, as well as considering how any changes would impact transactions which are settled using current Settlement Date conventions.

*Regulatory oversight* – Given the desire to include as many physically settling currencies as possible within a PvP mechanism, it is very likely that any regulatory oversight will include central banks and national regulators from different jurisdictions. Clear and harmonised supervision of the mechanism/participants will encourage wider participation, therefore supporting greater scale and efficiencies. Consideration should also be made to existing regulatory obligations, such as regional trade reporting requirements, and how these may be impacted.

*Nostro Account Statements* – Settlement finality is typically deemed to have occurred once the statements from Nostro providers showing daily activity are reconciled. The statements are usually sent towards the end of Settlement Date and reconciled accordingly to identify any payments which have not been made or received. The point of reconciliation allows the movement of Central Bank monies to be evidenced, enabling the account holder to deem that settlement finality has occurred. Technological advancements are expected to enable this process to accelerate towards real-time reconciliation of the movement of central bank monies.

This ultimately builds to the determination of real-time (instant) settlement finality based on a single, referenceable universal timestamp, which will ensure legal certainty of money ownership amongst participants in various value chains who may be rapidly transferring goods, service and monies to each other.

*Flexibility* – Feedback from our members suggests that to meet the needs of their clients, it may be preferable to PvP settle transactions on either a netted (multilateral/bilateral) or gross basis. As such any new mechanisms should enable their participants to choose how best to settle their transactions. Such flexibility will promote the beneficial recycling of liquidity and enable participants to manage their funds, ensuring they are available in the right place, at the right time as required.

**Opportunities for the Public Sector**

We continue to support the engagement of the Financial Stability Board (FSB) through the CPMI in developing practices to improve cross-border payments. As noted above, there are opportunities to increase the number of payments made on a PvP basis, but they will first require significant support from central banks and the wider supervisory community, both at the G20 level and from countries outside of the G20, and we strongly support the need for collaboration between private and public sectors.

There are several overriding themes which will help foster an environment to support the creation of new PvP mechanisms, these are:

- Coordinating Central Bank activity to:
  - Identify and develop opportunities to increase the overlap of RTGS operating hours, noting that this may be through earlier opening or later closing times
  - Lead discussions on the concept of Settlement Date which could impact other asset classes
  - Ensure that non-G20 countries are engaged in any developments, especially considering the global nature of the FX markets
- Where possible, supervisory guidelines promoting the management of FX Settlement Risk (e.g. the BCBS FX Supervisory Guidance and the Global Code[7]) should consider the technical evolution of the wider market and help promote interoperability. For example, do

[7] https://www.globalfxc.org/fx_global_code.htm

the supervisory guidelines have flexibility to accommodate developments in technologies or are some supervisory guidelines at risk of quickly becoming out-dated?

- A focus on activity-based regulation/supervision to ensure that standards are maintained for new and existing market participants. This will help promote security and confidence within any new PvP mechanisms.
- Form public/private sector forums to discuss the reasons why transactions do not settle on a PvP basis today, and what changes will result in increased PvP settlement using today's mechanisms.
- Promote the engagement of local as well as global banks in any discussions. Both have important roles in driving change and local banks will have essential jurisdictional specific expertise.
- Consider that market factors could result in new pricing models for currencies which are able to trade and PvP settle on a near real-time basis.
- Promote standards for nostro providers to enable the widest possible availability of PvP mechanisms to market participants. Whilst the central bank community may make changes to their operating hours, success will also be determined by such extensions being made available through the nostro agent network, especially noting that technical advancements are expected to enable the real-time reconciliation of Nostro Account statements, and thus the real-time reconciliation of the movement of central bank monies.

**Conclusion**

The use of CLS and other PvP mechanisms are instrumental in managing the systemic Settlement Risk within todays wholesale FX market. The development of these mechanisms has been driven through partnerships between the private and public sector.

Whilst risks have been greatly reduced there still remain opportunities for developments to complement existing CLS or other PvP mechanisms. More than ever, the use of cheaper and more powerful technologies can result in increased cost and time efficiencies, the further reduction of risks and create an environment to increase the number of active participants. Whilst the private sector can provide some of the answers, there remains a considerable role for the public sector and we look forward to engaging further.

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We greatly appreciate you giving us the opportunity to share our views. Please do not hesitate to contact Andrew Harvey on+44 203 828 2694, email aharvey@eu.gfma.org should you wish to discuss the above.

Yours sincerely,

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