# Global Foreign Exchange Division

## Encouraged Practices for Participants in the FX Prime Broker Ecosystem

## Re: Credit Limit Monitoring and Management

## 16 February 2022

The Global Financial Markets Association's (GFMA) Global Foreign Exchange Division (GFXD) is a financial markets trade association focused on the wholesale foreign exchange (FX) industry. 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), the GFXD's members include 23 global FX market participants.[1] This trade group collectively represents over 75% of the FX inter-dealer market[2]. The GFXD and its members are committed to ensuring a robust, well-functioning, safe and fair FX marketplace.

This document sets out a few practices encouraged for all participants of the FX prime brokerage (FXPB) ecosystem – prime brokers and their clients, executing dealers, platforms and infrastructure providers - by the GFXD related to credit limit monitoring and management. As explained below, the publication of these encouraged practices, some of which have already been adopted or are undergoing implementation by some FXPB participants, aims to promote enhanced capabilities for monitoring and management of credit in FXPB transactions.

The intention behind promoting these practices is to help mitigate any inefficiencies or risk arising from credit limit monitoring and management activities. As well as looking to protect the ongoing efficient, smooth, and safe functioning of the FXPB ecosystem for all market participants.

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## Background

FX prime brokers ("prime brokers") serve an important function within the FX market enabling clients to source FX liquidity from a variety of liquidity providers, such as executing dealers.

The triparty prime brokerage model allows executing dealers and clients to trade bilaterally but to book trades against the prime broker as opposed to each other. Consequently, the credit relationship, collateral exchange and transaction settlement exists between the prime broker and executing dealer as well as between the prime broker and the client. For the client, this enables them to access wider

[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, Nomura, Northern Trust, RBC, Standard Chartered, State Street, UBS, and Wells Fargo.

[2] According to the 2021 Euromoney survey.

liquidity but to consolidate credit, settlement, margin exchange and other operational workflow with the prime broker[3]. For executing dealers, this enables them to trade with a prime broker's clients without establishing a credit relationship for each client.

This framework is governed by a master agreement whereby the prime broker agrees that trades executed between their client and the executing dealer under specified limits, typically an exposure calculation, currencies, tenor and instrument types ("give-up limit"), can be booked against the prime broker ("given-up") instead of being booked bilaterally[4]. In addition, a prime broker will set "platform limits" to limit client activity when trading on FX electronic trading platforms ("e-trading platforms"), e.g. electronic communication networks ("FX ECNs").

Given that FXPB clients may want access to liquidity from numerous executing dealers, platforms and venues,[5] optimizing the ability to monitor and manage all credit limits established in respect of a client's trading activity is critical to ensuring efficiency in the FXPB model. This helps to mitigate risk from overallocation of aggregate FXPB credit to all available liquidity sources.

## Encouraged Practices

### The FX Global Code

**1. All wholesale FX market participants in the FXPB ecosystem should adhere to the FX Global Code[6].**

To ensure ongoing good governance and safety in the functioning of FXPB, all market participants[7] are encouraged to adhere to the FX Global Code (the "Code"). The Code recognizes that prime brokers, in assuming the credit risk of authorized trades executed by their clients, play a unique role in the FX market. Beyond prime brokers and their clients, market participants in the ecosystem contemplated by the Code also include, without limitation, executing dealers, and execution intermediaries such as FX ECNs and other FX electronic trading platforms.[8,]

Several principles and hypotheticals in the FX Global Code are worth highlighting as they refer specifically to expectations of FXPB market participants or relate to limiting and monitoring risk; see

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[3] https://www.newyorkfed.org/medialibrary/microsites/fxc/files/annualreports/ar2005/fxar05PB.pdf

[4] https://www.newyorkfed.org/medialibrary/microsites/fxc/files/annualreports/ar2005/fxar05PB.pdf

[5] FXPB transactions can be executed through direct communication between the FX prime broker's client and executing dealer, in which the identities of both parties are known, 'name disclosed'. However, prime brokers also provide their clients access to trade execution on FX ECNs and electronic broking platforms on an anonymous basis.

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

[7] See FX Global Code at https://www.globalfxc.org/docs/fx_global.pdf, definition of "Market Participant" on p.3.

[8] See FX Global Code "Prime Brokerage Participant" definition on p.75; also see, https://www.newyorkfed.org/medialibrary/microsites/fxc/files/annualreports/ar2005/fxar05PB.pdf

Principles 15, 19, 26, 27, 29 and 41/corresponding hypotheticals. FX market participants in the ecosystem should understand and adhere to these and all other applicable Code principles.

**FXPB Limit Allocation, Monitoring and Management**

*Limits used in the FXPB Model*

As mentioned above, the FXPB model requires separate limits being set by a prime broker in respect of the trading activity of its client:

- Prime broker establishes a bilateral overall **trading limit** for its client.
  - The prime broker needs to monitor the trading limit to ensure the client does not breach the overall limit for all trading activity for that prime broker.

- Prime broker establishes a bilateral **give-up limit** for each executing dealer approved to trade with a specific client.
  - This limit is notified in a "designation notice" given by the prime broker to the executing dealer for a specific client. The notice will also list the allowable FX products, maximum tenor, and permitted currencies.
  - The executing dealer can trade with the specified client up to that give-up limit.[9] If a give-up trade breaches this limit, the prime broker reserves the right to reject the trade.
  - Both the executing dealer and prime broker need to monitor the give-up limit to ensure trades given up do not exceed the limit. If the limit is exceeded and a trade is rejected by the prime broker, the executing dealer and client typically have open market risk if the trade is deemed not to have occurred, or will have credit risk to each other if the trade is agreed to be bilaterally executed with each other.

- Prime broker establishes **platform limits** for each FX ECN that the client is authorised to trade on. In addition, the platform will maintain limits for the underlying executing dealer liquidity providers.

**2. (a) Prime brokers should establish trading limits for clients and monitor their usage on a net exposure basis rather than a gross notional limit basis, (b) Executing dealers[10] should monitor give-up limits in respect of their trading with a prime broker's clients, and (c) FX ECNs should support net exposure limits.**

The ability of FX market participants to effectively check their credit exposures against each other is vital to reducing risk in the market. FXPB arrangements require active monitoring against the relevant limits established by the prime broker in the applicable governing legal agreements.

[9] https://www.newyorkfed.org/medialibrary/microsites/fxc/files/annualreports/ar2005/fxar05PB.pdf

[10] Including in respect of client trading direct via voice or electronically via single dealer platforms.

In FXPB transactions, because clients can net down collateral and settlement obligations against a single credit counterparty, it is expected that there will be some offset impact when looking at a client's aggregate net exposure to its FX prime broker at any given time.

Therefore, it makes sense that trading limits, give-up limits and platforms limits are measured, monitored and managed on a net exposure basis as opposed to being based on the gross amounts traded by the client. Whilst prime brokers will have their own risk frameworks and formulas for distributing credit to their clients, not recognizing the effect of netting in monitoring limits exacerbates the ability to manage a client's net risk causing a dislocation between the limit monitoring function and the setting of credit limits. Relying on gross limits does not show a correct view of the true (netted down) exposure. Hence, risk exposure metrics measured solely by examining gross volumes traded are of little value.

Where clients are authorised to trade on FX ECNs, give-up and platform credit limit monitoring is especially complex because prime brokers must supply credit for the client to potentially trade on multiple FX ECNs. This is exacerbated when the methodologies used by the FX ECNs to measure client exposure differs from platform to platform.

A FX ECN that supports only gross notional limit monitoring causes additional risk for prime brokers as it results in them less able to monitor credit limits. Having a standardised risk measure enables prime brokers to optimally manage their and their clients' risk across platforms and venues.

It is important that FX market participants have adequate processes to monitor and manage counterparty credit limits, and it is beneficial when these processes are as consistent as possible. Improved standardization would ensure the continued sound functioning of the FXPB ecosystem and avoid fragmentation of approaches which can introduce systemic risk. The digitization of designation notices would enable realtime updates to limits to take account of client utilization and trading conditions. Furthermore, where it is technically feasible, prime brokers should provide their clients with the ability to monitor their trading limit utilization intraday and notify them once the limit has been reached. This would also be a step in the right direction to support any future development of a universally accepted pre-trade limit check market utility.

**3. Prime brokers should disclose to each of their approved executing dealers, in their master agreements or other governing documents, the specific methodology used by them to monitor give-up limits.**

Master agreements and/or supplemental notices will typically indicate the allowable products, tenors, and specific give-up limits that apply to trades executed by the client that a prime broker will accept from each executing dealer. This enables the executing dealer to ascertain that a trade is within the agreed give-up limit and will be accepted by the prime broker prior to executing the trade with the client.

Consequently, it is important for the specific give-up limit calculation methodology used by the prime broker to be transparent to the executing dealer so that (i) the way in which the prime broker is calculating and monitoring the give-up limit (and thus determining whether to accept or reject the trade on the basis of it being within or outside the give-up limit) is clearly understood, and (ii) it can construct its own give-up limit monitoring methodology to align with the methodology disclosed by the prime broker.

Such a common understanding will reduce disputes between prime brokers and executing dealers as to why a give-up trade may be rejected. This benefits not just the prime broker, but also the executing dealers and clients. Rejected trades must be managed by the executing dealer and client, which may require compensation, or unwinding of the transaction resulting in unwanted market risk and/or credit risk exposure.

**4. When monitoring give-up limits established for trades which will be accepted by a prime broker, executing dealers should aim to match the methodology used by the prime broker as indicated in the relevant master agreement or other governing document.**

As mentioned above, reducing differentiation in approaches taken to give-up limit measurement will mean fewer discrepancies or surprises as to the acceptability of give-up trades.

When signing master agreements or other governing documents with a prime broker, the executing dealer should take note of the give-up limit calculation methodology used by the FX prime broker and aim to replicate this methodology in establishing its own mechanisms for measuring and monitoring the relevant give-up limit.

However, there may be occasion when a prime broker and executing dealer may put in place different methodologies in their limit monitoring for specific products, e.g., non-linear trades, or exotic FX products.

## E-Trading Platforms - Limit Monitoring Services and Enhancements

**5. Where suitable and possible, FX ECNs and other e-trading platforms, including single dealer platforms, should offer real-time application programming interface (API) connectivity for prime brokers, executing dealers, and vendors to enable optimal credit limit management, improve capabilities for real-time credit limit monitoring and, thereby, mitigate the possibility of systemic risk.**

APIs that allow real-time adjustment of trading limits should be implemented throughout the FXPB ecosystem. This would benefit prime brokers, executing dealers, as well as other market participants because the improved dynamic monitoring of limits results in a better functioning, more effective and resilient FX market.

Notably, Principle 41 of the Code provides that "Prime Brokerage Participants should strive to monitor and control trading permissions and credit provision in Real Time at all stages of transactions in a manner consistent with the profile of their activity in the market to reduce risk to all parties."

Furthermore, Guideline 3.2.6 of the BCBS 2013 Supervisory guidance for managing risks associated with the settlement of FX transactions ("BCBS FX Guidance")[11] provides that '. . . Where a bank is acting as a prime broker, it should have ex-ante processes in place to prevent client trades from creating exposures that would exceed the limit. . .. [and] use an ex-ante process that updates and reports exposure on a timely basis, preferably as each trade is executed. . .'.

Real-time monitoring of credit capability utilization in FXPB is also referred to in Guideline 5 of the BCBS FX Guidance.

It can be challenging for a prime broker to optimally monitor and manage credit limits when the client is trading across multiple platforms and venues, especially on a pre-trade basis. This is especially true for high frequency trading where clients can add risk very quickly.

Although certain technologies do exist to assist with FXPB credit monitoring, a significant portion of credit monitoring and management in respect of prime broker client trading on FX e-trading platforms is currently conducted on a post-trade basis, which means there is potential for risk accumulation in instances where overall limits have already breached.

To enable better optimized and more accurate credit monitoring in FXPB, e-trading platforms should support mechanisms that can help enable real-time credit limit monitoring. This will decrease reliance on credit 'over-allocation' by prime brokers and its associated risks. Indeed, real-time trading limit management enhances the value that is realized in monitoring positions and limits.[12]

**6. Where suitable and possible, FX ECNs and other e-trading platforms, including single dealer platforms, should connect to external services that can help reduce the risk of limit breaches, for example (though not limited to): electronic communication/transfer of information tools, document management tools, pre-trade limit checking, kill switches and dynamic limit adjustment mechanisms.**

Vendors active in the FXPB space have developed various tools and functionality which can help firms with their management of credit and trading limits. Where it makes sense, and depending on their participants and activity, trading platforms and venues should consider making those third-party credit risk management tools available to FXPB market participants. This will reduce the risk inherent in credit overallocation when prime brokers must reduce credit limits quickly on ECNs and e-trading platforms but lack the sophisticated tools to do so efficiently.

[11] https://www.bis.org/publ/bcbs241.pdf

[12] https://www.newyorkfed.org/medialibrary/microsites/fxc/files/annualreports/ar2005/fxar05PB.pdf

## Industry Discussion

To promote further exploration and development of industry solutions that might further help alleviate challenges and mitigate risks that exist today in credit limit monitoring and management, we welcome discussion amongst the broader FXPB community on these 'Encouraged Practices for Participants in the FX Prime Broker Ecosystem'.

Given the importance of the FXPB services to so many FX market participants, optimization of credit limit management is an important goal, not just for prime brokers, but for all FXPB market participants. The focus of all parties should remain the continued safe and sound functioning of the FXPB model and broader industry.

FXPB market participants must collectively adopt and implement industry capabilities to reduce the potential of systemic risk in the global FX market.