GFMA Global FX Division

GFXD recommendations for Reducing Settlement Risk

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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\(^\text{1}\), collectively representing the majority of the FX inter-dealer market\(^\text{2}\). 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.

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\(^{1}\) 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 Bank, NatWest Markets, Nomura, Northern Trust, RBC, Standard Chartered Bank, State Street, UBS and Wells Fargo

\(^{2}\) According to Euromoney league tables
Introduction

Settlement Risk, (otherwise known as Principal Risk) remains a key risk within the wholesale FX market. In this paper, the GFXD Operations Committee\(^3\) discusses some of those practices which reduce Settlement Risk.

Settlement Risk is defined in the BCBS FX Supervisory Guidance\(^4\) as:

> The risk of outright loss of the full value of a transaction resulting from the counterparty’s failure to settle. This can arise from paying away the currency being sold, but failing to receive the currency being bought. (Also referred to as “Herstatt Risk”).

Settlement Risk is actively managed through multiple practices, including the use of automated trade confirmations\(^5\) and the use of Payment verses Payment (PvP) settlement, defined in the BCBS FX Supervisory Guidance 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.

Historically, the industry, including supervisors, has looked for opportunities to mitigate FX Settlement Risk. The BCBS Supervisory Guidance, and the principles and guidelines in the FX Global Code\(^6\) for example help to set expectations regarding the management of FX Settlement Risk. CLS Bank International (CLS)\(^7\), established in 2002, enables FX transactions in 18 currencies to be settled on a PvP basis, to help mitigate FX Settlement Risk for its members.

Furthermore, the Financial Stability Board (FSB) work programme for 2020\(^8\) references cross-border payment systems, specifically a desire to develop and deliver a G20 roadmap to enhance cross-border payments. The June 2020 update\(^9\) identified a series of 19 building blocks, where further public and private engagement could help to enhance efficiencies and remove FX Settlement Risk within wholesale FX markets.

To give some idea of scale of Settlement Risk within the global wholesale FX market, the December 2019 BIS Quarterly Review paper contained a section titled ‘FX settlement risk remains significant’\(^10\). The review includes, with reference to the 2019 Triennial survey\(^11\), data suggesting that the daily gross payment obligations for the wholesale FX markets in April 2019 was $18.7 trillion. After bilateral netting, this number was reduced to $15.2 trillion, of which approximately $6.3 trillion was settled on a PvP basis, leaving approximately $8.9 trillion which was not.

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\(^3\) The GFXD Operations Committee comprises senior FX operations professionals from GFXD member banks

\(^4\) https://www.bis.org/publ/bcbs241.htm ("BCBS FX Supervisory Guidance")


\(^6\) https://www.globalfxc.org/fx_global_code.htm

\(^7\) https://www.cls-group.com/

\(^8\) https://www.fsb.org/2019/12/fsb-sets-out-2020-work-programme/

\(^9\) https://www.bis.org/cpmi/publ/d193.htm

\(^10\) https://www.bis.org/publ/qtrpdf/r_qt1912x.htm

There are several ways in which FX transactions can be settled. In the 2021 paper on Settlement Netting\textsuperscript{12}, the GFXD Operations Committee proposed a ‘hierarchy of settlement methods’, as well as recommending that the processes for settling FX transactions between counterparties is agreed during the mutual onboarding of the relationship - this will result in greater efficiency, reduced risk and clarity on any client specific requirements.

The hierarchy of settlement methods is as follows:

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

i) Settlement netting is preferable to gross settlement. This includes any of the following netting methods, noting that use of technical solutions enables greater STP\textsuperscript{13} and reduces the requirement manual intervention:
   - Automated ‘payment v payment’ bilateral/multilateral netting mechanisms (e.g. CLS).
   - Automated netting technologies.

ii) 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 transactions.

Given these points, the GFXD Operations Committee remains focused on and supports the reduction of:

i) Settlement Risk within the market, and
ii) The actual impact once there is an issue with a specific settlement.

This paper therefore focuses on those transactions which do not leverage automated PvP bilateral/multilateral netting mechanisms (e.g. CLS) – typified as having increased Settlement Risk – and discusses ways in which that risk can be reduced. This paper does not focus on the other risks included within the BCBS FX Supervisory Guidance, such as Liquidity or Legal Risk.

**Executive Summary**

The GFXD recommends that market organisations are aware of the processes and behaviours that increase Settlement Risk for transactions not settled on a PvP basis and look to mitigate through:

- Adoption of the FX Global Code
- Increased use of automated processes
- Increased education on currency cut-offs and specific procedures across the full trade lifecycle
- Increased use of standardised processes and settlement methods including instructions and netting preferences


\textsuperscript{13}‘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.
Causes of Settlement Risk

An increase in Settlement Risk is usually the result of an action/inaction during the booking of the transaction or during the processes in which the transaction is settled. Given the multiple processes often involved in the lifecycle of a typical FX transaction, including the roles played by external organisations (such as Nostro agents), the nature of the processes surrounding the settlement of transactions carries inherent risk, Settlement Risk.

There are various factors which can influence the effectiveness of managing and reducing Settlement Risk. Examples of these include:

Manual versus automated processes

As noted in the Introduction, it is recommended to use automated payment systems over manual processes. Automation enables scale and improves efficiency but also reduces risk. This not only includes the systems within in which a payment is made, but also associated communication methods, for example the use of electronic SWIFT\(^{14}\) messages versus manual communication methods such as email.

Additionally, if it is agreed that the optimal settlement mechanism is to use an automated PvP system, such as CLS, then every effort should be made to settle all transactions in that system. This means that transactions should be submitted and matched in a timely manner. Any deviance from this may result in manual intervention (i.e. transactions rescinded from the PvP mechanism and settled bilaterally) and will introduce Settlement Risk.

Another common cause of manual intervention occurs when ad-hoc requests are made to previously agreed netting preferences. Ad-hoc and/or frequent changes to settlement processes often result in increased manual interventions and are not recommended.

For example, a transaction is executed and as per the agreed relationship terms and is due to settle within CLS. However, due to the geographical location of one counterparty, operations staff are not available to ensure that the transaction is entered into and matched in CLS in time for value date. This results in the other counterparty rescinding their trade instruction from CLS, pursuing bilateral confirmation and settlement through a series of manual processes, resulting in increased Settlement Risk.

Recommendation: The settlement method (e.g. CLS) should be agreed when the counterparty is onboarded, and ad-hoc processes should be considered on an exceptional basis only. This should include both the settlement mechanism leveraged and also netting preferences.

Payment splitting

There may be times when it is beneficial to split the notional of a transaction into smaller amounts to facilitate a more optimal provision of payment liquidity. Whilst more common in emerging markets, this practice is also leveraged when larger notional transactions are executed. If the recipients are unaware that the payment will be made in several smaller amounts then it is possible they may reject and return the unexpected payment amounts, increasing Settlement Risk.

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\(^{14}\) https://www.swift.com/
As with other cases in this paper, automation can help reduce Settlement Risk in the netting process. Even though there are systems in place to enhance automation, such as CLS Net and SWIFT messages, few market participants, such as custodians support the use of those messages.

**Recommendation:** To enhance automation in the netting process, the market needs an infrastructure which can support automated messages, such as SWIFT. Therefore, it is important that market participants, including custodians can manage those automated tools to support the automation of payment netting as well as splitting.

**Recommendation:** If known, it would be beneficial to agree with the counterparty and ensure that all parties are aware that a transaction will be settled in smaller individual amounts, rather than the full notional of the transaction.

**Currency cut-off times**

A currency cut-off time refers to the time at which a currency-aligned process needs to be actioned.

Typically, these are driven by the operating hours of the payment systems of the Central Bank in which national currency is being settled. Other processes supporting/within the transaction lifecycle will then consider this time within which they must be completed.

However, each organisation will have a number of different internal processes, each with their own currency-aligned cut-off times. A lack of awareness of these times across the full transaction life cycle can result in increased Settlement Risk.

For example, if a counterparty requests to amend a transaction after a previously agreed payment has been released for settlement, then the amount of currency pending settlement could be incorrect and therefore increase Settlement Risk.

**Recommendation:** Internal procedural cut-off times are clearly communicated across all internal stakeholders involved in the life cycle of a transaction, including Counterparty On-boarding, Sales/Trading, Treasury/Funding functions, and Post-Trade functions. This improves transparency and the potential impact of increased Settlement Risk.

**Recommendation:** Consideration should be made for both incoming and outgoing payments when reviewing relative cut-off times as these may vary by currency.

**Recommendation:** The industry evolves to standardised cut-off times based on the operating hours of the central bank in which currency is being settled.

**Settlement instructions**

Given the volume of FX transactions executed and settled globally on a given day, the use of Standardised Settlement Instructions (SSIs) increases the likelihood of settlements being automated and efficiencies to be realised.
An SSI is a consistent settlement instruction defining where a counterparty intends to receive funds. However, these SSIs can be changed to settle a transaction to a non-SSI. Any changes to an SSI require clear and timely communication followed by relevant system updates in order for a payment to be made to the recipients required account details.

For example, if a counterparty updates their SSIs, yet communicates this update to the industry in a manual, non-standardised manner, this could result in a settlement being paid to an incorrect account, therefore increasing Settlement Risk.

Recommendation: SSIs are agreed during the onboarding of the counterparty and settlement to non-standing instructions should be strongly discouraged.

Recommendation: The format when communicating either initial SSIs, changes to SSIs or changes to non-standing instructions should follow standardised industry templates and communicated via industry defined authenticated methods. This will enable automated communication and uploading and avoid manual intervention which can increase Settlement Risk.

Recommendation: The use of third-party settlement instructions (any payment to a counterparty that differs in any way from the name of the entity traded with, including subsidiary and affiliate accounts) should be minimised, and if they are to be used then sufficient evidence (to be agreed between the parties) should be provided to support the purpose of payment.

Recommendation: Even though there is currently inconsistency in the market, the inclusion of SSIs on trade confirmations could help reduce Settlement Risk by enhancing automation. However, to facilitate automation, market participants should be able to amend the standards through ISDA agreements or on the confirmation platforms themselves before the market can achieve a standardised approach on the inclusion of SSIs on trade confirmation.

Recommendation: It is paramount that market participants use authenticated means to communicate settlement instructions between parties and avoid reliance on unauthenticated tools such as emails in order to reduce the risk of fraudulent activities. In line with this objective, we encourage vendor platforms to adopt a standardised approach and share SSIs with their counterparties.

Reducing the impact of Settlement Risk

Deploying the recommendations in the previous section is a very good way of reducing Settlement Risk.

However, there may be instances as a result of processing or systems error which result in payment errors with funds paid to an incorrect recipient or an incorrect amount. Industry processes exist to support the remediation of such situations although they are proprietary in nature and would benefit from harmonisation.

Payment recalls and kickbacks

If a payment is made in error, then an instruction can be issued by the remitter to request the return of those funds – this process is known as a payment recall. The process of a counterparty returning those funds is known as a payment kickback.
Unfortunately, the duration for a payment recall or kickback to process and complete is never immediate (usually taking several days to complete), and organisations could be exposed to increased settlement and credit risk until any funds paid in error are returned.

There are a number of reasons why payment recall, and kickback processing requires an extended period, including but not limited to:

- the time taken to recognise a payment has been made in error,
- the issuance and reconciliation of the payment recall or kickback messages,
- approval processes to agree the return of funds,
- the instruction and settlement of funds back to the remitter.

Whilst these processes are not standardised, and will vary by currency and counterparty, there are still opportunities to reduce the time at which an organisation has exposure.

**Recommendation:** Payment recall and kickback processes should be prioritised and take no longer than 5 days. Funds received in error should be returned as soon as possible.

**Recommendation:** Automated communication methods (e.g. SWIFT) should be leveraged.

**Recommendation:** Any jurisdictional differences for the recall-kick back process should be aligned.

### Good Settlement Practices

**The FX Global Code**

The FX Global Code, updated in July 2021 contains a dedicated section on Confirmation and Settlement principles and provides guidance on recommended settlement processes and the account reconciliation processes together with illustrative examples.

**Recommendation:** Organisations should leverage The FX Global Code as it represents an essential guide to reduce Settlement Risk and facilitate a smooth confirmation process.

### Conclusion

Managing and reducing Settlement Risk remains an inherent part of the global FX market. Whilst automation offers opportunities to reduce Settlement Risk, the global nature of the market, the varied level of sophistication of the organisations using FX and the varied reasons organisations need to trade FX mean that increased standardisation of procedures and increased communication as to the exceptions to these procedures remain key mitigants.

### Contacts

For queries about this document, please contact:

- Andrew Harvey / [aharvey@eu.gfma.org](mailto:aharvey@eu.gfma.org) / +44 (0) 203 828 2694
- Sara Scognamiglio / [sscognamiglio@eu.gfma.org](mailto:sscognamiglio@eu.gfma.org) / +44 (0) 203 828 2711