# GFXC Request for Feedback – April 2021

## Attachment D: FX Settlement Risk

**Background**

The risks associated with FX settlement are potentially very significant, and the management of these risks requires ongoing engagement from Market Participants.

As part of its review of the FX Global Code (Code), the Global Foreign Exchange Committee (GFXC) has identified a need to strengthen the Code's guidance on the management of settlement risk. Specifically, the GFXC wishes to place greater stress on the usage of payment-versus-payment (PVP) settlement mechanisms where they are available, and to discourage 'strategic fails'. In line with these aims, proposed changes to Principles 35, 50 and 53 of the Code are set out below.

The proposed changes have largely been drawn from existing industry guidance (specifically, the Basel Committee on Banking Supervision's *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* (BCBS241)).[1]

**The Code's existing guidance on the risks associated with settlement failure**

The Code's Glossary defines Settlement Risk in terms of principal risk:

> *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. (Settlement Risk is also referred to as "Herstatt Risk.")*

Settlement failures can also give rise to replacement cost risk, which is the risk that the counterparty will default before trade settlement and the Market Participant will have to replace the trade with a different counterparty at altered market prices. Additionally, liquidity risk (the risk that the Market Participant will be left with funding needs in the purchased currency due to a settlement failure) will also be relevant.

The risks associated with the settlement of FX transactions are discussed in several of the Code's principles and there is a degree of overlap between them.

In the *Risk Management and Compliance* chapter of the Code, Principle 29 addresses 'Credit/Counterparty Risk' while Principle 35 provides high-level guidance on 'Settlement Risk'. Both principles advocate the setting of exposure limits, the monitoring of exposures and the usage of netting agreements (close-out and/or bilateral obligation netting).

More detailed guidance is provided in the *Confirmation and Settlement* chapter. Principle 50 encourages netting and PVP settlement, as well as the measuring and monitoring of exposures. Principle 53 discusses liquidity risks, but mostly in terms of Market Participants having the appropriate tools and processes to be aware of their funding needs in each currency.

[1] BCBS241 is available at https://www.bis.org/publ/bcbs241.pdf.

**Proposed changes to the Code**

Principle 35

As Settlement Risk is defined as principal risk in the Code, it is proposed that the guidance on Settlement Risk in the *Risk Management and Compliance* chapter be concerned with the elimination of principal risk (through PVP settlement) or its mitigation through obligation netting.

Consequently, much of the text currently in Principle 50 would be shifted to this high-level principle, including the guidance that the management of each area in a Market Participant's FX operations should have an understanding of the settlement process.

Additional guidance that Market Participants 'should consider' the creation of internal and external incentives to reduce risk have been adapted from BCBS241 (paras 3.7.4 and 3.2.18). As envisaged in BCBS241, internal incentives could include differentiating the costs or capital charges incurred by business units based on the risk profiles of their FX transactions and passing those costs on to the business units.

**Principle 35: Settlement Risk**

***Market Participants should ~~take prudent measures to manage and~~ reduce their Settlement Risk~~s~~ as much as practicable, including by settling FX transactions through services that provide PVP settlement where available~~prompt resolution measures to minimise disruption to trading activities~~.***

~~Settlement fails can expose Market Participants to market and credit risks. Market Participants should have policies and procedures designed to properly monitor and limit settlement exposures to counterparties.~~

~~Where applicable, Market Participants should consider payment netting and bilateral obligation netting to reduce Settlement Risks.~~

Whenever practicable, Market participants should eliminate Settlement Risk by using settlement services that provide payment-versus-payment (PVP) settlement. Where PVP settlement is not used, Market Participants should reduce the size and duration of their Settlement Risk as much as practicable. The netting of FX settlement obligations (including the use of automated settlement netting systems) is encouraged. Where used by Market Participants, a process of settling payments on a net basis should be supported by appropriate documentation. Such obligation netting may be bilateral or multilateral.

The management of each area involved in a participant's FX operations should obtain at least a high-level understanding of the settlement process and the tools that may be used to mitigate Settlement Risk, including, where available, the use of PVP settlement. Market Participants should consider creating internal incentives and mechanisms to reduce risks associated with FX settlement.

If a counterparty's chosen method of settlement prevents a Market Participant from reducing its Settlement Risk (for example, a counterparty does not participate in PVP arrangements or does not agree to use obligation netting), then the Market Participant should consider decreasing its exposure limit to the counterparty or creating incentives for the counterparty to modify its FX settlement methods.

Principle 50

With much of the existing content shifted to Principle 35, it is proposed that more nuanced guidance on the measurement of Settlement Risk be introduced into Principle 50. The additional paragraph at the end of the principle has been adapted from BCBS241 (paras 3.2.9 and 3.2.12).

**Principle 50**

***Market Participants should properly measure, ~~and~~ monitor and control their Settlement Risk ~~and seek to mitigate that risk when possible~~equivalently to other counterparty credit exposures of similar size and duration.***

~~Market Participants should develop timely and accurate methods of quantifying their FX Settlement Risk. The management of each area involved in a participant's FX operations should obtain at least a high-level understanding of the settlement process and the tools that may be used to mitigate Settlement Risk.~~

~~The netting of FX settlements (including the use of automated settlement netting systems) is encouraged. Where used by Market Participants, a process of settling payments on a net basis should be supported by appropriate bilateral documentation. Such netting may be bilateral or multilateral.~~

Where PVP settlement is not used, Settlement Risk should be properly measured, monitored and controlled. Market Participants should set binding ex ante limits and use controls equivalent to other credit exposures of similar size and duration to the same counterparty.

Where settlement amounts are to be netted, t~~T~~he initial confirmation of trades to be netted should be performed as it would be for any other FX transaction. All initial trades should be confirmed before they are included in a netting calculation. In the case of bilateral netting, processes for netting settlement values used by Market Participants should also include a procedure for confirming the bilateral net amounts in each currency at a predetermined cut-off point that has been agreed upon with the relevant counterparty. ~~More broadly, settlement services that reduce Settlement Risk—including the use of payment-versus-payment settlement mechanisms—should be utilised whenever practicable.~~

To avoid underestimating the size and duration of exposures, Market Participants should recognize that Settlement Risk exposure to their counterparty begins when a payment order on the currency it sold can no longer be recalled or cancelled with certainty, which may be before the settlement date. Market Participants should also recognize that funds might not have been received until it is confirmed that the trade has settled with finality during the reconciliation process.

Principle 53

To ensure that a Market Participant's funding requirements are met, Principle 53 focusses on the need to have adequate systems and procedures in place to make sure there are no inadvertent failures.

Nevertheless, as in the case of 'strategic fails', there can be some discretion in meeting funding requirements. To discourage such activity, it is proposed to add a new paragraph at the start of Principle 53, stressing the importance of 'appropriately' managing funding needs (and the potential systemic implications of failing to do so). The additional text is adapted from para 3.4.1 of BCBS241.

**Principle 53**

***Market Participants should have adequate systems in place to allow them to project, monitor, and manage their intraday and end-of-day funding requirements to reduce potential complications during the settlement process.***

Market Participants should appropriately manage their funding needs and ensure that they are able to meet their FX payment obligations on time. A Market Participant's failure to meet its FX payment obligations in a timely manner may impair the ability of one, or more, counterparties to complete their own settlement, and may lead to liquidity dislocations and disruptions in the payment and settlement systems.

Market Participants should have clear procedures outlining how each of their accounts used for the settlement of FX transactions is to be funded. Whenever possible, those Market Participants with nostro accounts should be projecting the balance of these accounts on a Real-Time basis, including all trades, cancellations, and amendments for each tenor (value date) so that they can diminish the overdraft risk from the nostro account.

Market Participants should send payment instructions as soon as practicable, taking into consideration time zone differences as well as instruction receipt cut-off times imposed by their correspondents. Market Participants should communicate expected receipts (via standardized message types, when possible) to allow nostro banks to identify and correct payment errors on a timely basis and aid in the formulation of escalation procedures.

Market Participants should communicate with their nostro banks to process the cancellations and amendments of payment instructions. Market Participants should understand when they can unilaterally cancel or amend payment instructions and should negotiate with their nostro banks to make these cut-off times as close as possible to the start of the settlement cycle in the relevant currencies.

**Questions**

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| **D1** | **Do you agree with the proposed changes to the Code's guidance on the management of settlement risk?** |