CRÉDIT AGRICOLE
CORPORATE & INVESTMENT BANK

FX SETTLEMENT RISK

CA-CIB

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1 Introduction

FX Settlement Risk

Definition & key facts

✓ **FX settlement risk is the risk that one party in a foreign exchange trade pays out the currency it sold but does not receive the currency it bought**

- Counterparty credit risk raised when one party fails to fulfill its obligations due to default.
- Financial Losses can be triggered because of currency fluctuations between trade execution and settlement.
- Fails can lead to reputational damages and deteriorate trust and relationships with counterparties.
- Large settlement failures can disrupt financial markets as failed payments (for operational issues) can result in significant losses for market participants, and sometimes with systemic consequence

✓ **Over the past two decades, market participants have made significant progress in reducing FX settlement risk but FX settlement Risk remains because of a few factors**

- Higher trading activity with higher nominal values
- More and more structured products and Taylor made processes
- Volatility of rates (which increases fx settlement risk but as well number of claims - for instance in CA-CIB, number of FX Claims have been multiplied by 7 over last 2 years, and amounts in stake have « exploded »
- All market participants should reinforce their controls and improve their process

✓ **Accelerating securities settlement to T+1 raises Fx settlement risk**

- Transaction funding dependent on Fx settlement may not occur in time – prefunding can be necessary
- Closer coordination of the timing and settlement for both the security and FX trade is needed to ensure there is adequate time available for the settlement and payment of Fx trade for T+1 security transaction
- May have impact on CLS settlement if CLS cut-off is not extended

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FX Global Code

FX Global code

FX global code stronly reminds most of these principles

The FX Global Code July 2021 (Global Code) is a set of global principles of good practice in the foreign exchange market, developed to provide a common set of guidelines to promote the integrity and effective functioning of the wholesale foreign exchange market. It was developed by a partnership between central banks and Market Participants from 20 jurisdictions around the globe.

File Download (globalfxc.org)

Principle 35

Market Participants should take prudent measures to manage and reduce their Settlement Risks, including 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.

Principle 50

Market Participants should measure and monitor their Settlement Risk and seek to mitigate that risk when possible.
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.
The 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 utilized whenever practicable.

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How to mitigate FX settlement risk?

The mechanisms to mitigate (1/2)

✓ **Reinforce awareness**

- Firms should estimate accurately their FX settlement exposures, with proper limits and measuring the full duration of their exposures
- Firms should better control their bilateral FX settlement exposures, and not underestimate the risk
- Banks should reinforce their governance around fx settlement risk and make sure ops are involved
- Through FX settlement survey, banks are pushed to assess progress in reducing FX Settlement risk

✓ **Management of failed trades**

- Banks should better manage and identify failed trades , in order to take appropriate actions. Effective monitoring of failed transactions is crucial, as unexpected failures cause exposures to be higher than expected.. A failed trade represents continued exposure for the full principal value of the operation until necessary actions have been taken. Type of counterparty risk associated with default risk should be taken into consideration

✓ **Regulatory Framework.**

- Financial institutions should adhere to the regulatory measures aimed at mitigating FX settlement risk, such as the Basel III framework

✓ **Internal incentives to reduce the risk**

- Banks should define effective incentives to reduce the risks associated with FX settlement, by for instance differentiating and passing on the costs to business units depending of the risk profiles of their transactions, or by allocating penalties and financial costs from settlement incidents to the initiating business units.
- Banks could consider decreasing their exposure limit if the trade counterparty used a settlement method that prevents banks from reducing their fx settlement risk in order for them to incentivize the counterparty to modify its FX settlement methods. In addition, where trades are settled in PvP, banks may lower their internal risk charges.

The mechanisms to mitigate (2/2)

✓ **PVP settlement**

- CLS provides FX payment-versus-payment (PvP) settlement to ensure that the final transfer of a payment in one currency occurs if, and only if, the final transfer of a payment in the counter currency takes place.

✓ **Netting**

- Market participants can bilaterally offset their payment obligations to reduce the amounts that need to be settled

✓ **Use market solutions to simplify/automate agreement process**

- Some providers (ex CLsNet, Osttra) offer some solution to simplify the netting agreement process between both parties

✓ **Payment Shaping**

- Needs to provide a series of best practices/guidance to explain why payment are shaped and help the industry normalize and reduce Settlement Risk

✓ **Same day (real time nostro reconciliation)**

- There is a strong need to determine settlement finality in a shorter/accelerated timeframe, and therefore obtain a timestamp of when finality occur, indeed Status of funds will be required to enable decisions on providing liquidity or amending trades during
- Same day reconciliation would allow to get a more secure and safe funding process

✓ **Automation and streamlining of settlement processes to minimize operational risks**.

- Advancements in technology, such as blockchain, may offer innovative solutions for FX settlement risk

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What are the limitations?

Some limitations to the mitigation

✓ **Netting**

- Netting agreements consider both buys & sells, but netting several sells will increase the size & the risk
- Netting process remains most of the time manual as there is systematic requests to get a bilateral agreement before releasing payment

✓ **PVP settlement**

- Many firms do not use PVP settlement methods even when available for a variety of reasons, including:
  - Initial or ongoing costs
  - Counterparties using PvP while others do not
  - Lack of awareness or internal incentives to reduce FX settlement risk
- All currencies are not eligible to PvP settlement and then numbers can be complicate to improve

✓ **Payment Shaping**

- Payment shaping is currently unstructured across the industry, with firms taking an individual approach, often leading to reconciliation issues and funds being returned
- Shaping is done at BO level, triggering heavy workload. Ticketing at FO level sounds complicate as raising some clients' concerns

✓ **Same day reconciliation**

- Not extended within the industry need to learn from any experience and educate and make linkage with some other processes like funding or claim issuing
- Large IT enhancements may be requested to reach this target

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T+1 settlement impacts

Shorten settlement cycles will increase fx settlement risk

US securities settlement has moved from T+2 to T+1 effective **28th May 2024.** This highlights the question of moving to settlement in T+1 in Europe

- T+1 should allow to **improve** efficiency in the clearing and settlement process, **reduce** risk exposure and margin **and get aligned** between all markets
- Nevertheless accelerating the securities settlement cycle raises the risk that transaction funding dependent on FX transaction may not occur in time, involving **potential settlement and operational risks and costs consideration.** Market participants need to implement robust risk management practices to mitigate these risks effectively.
  - Not only the amount of time available to remediate any trade failure is shortened but operational teams have less time to perform pre & post-trades tasks (account opening, KYC checks, SSI management / allocation, matching, confirmation & payments)
  - T+1 settlement introduces additional operational complexities and challenges. There may be delays or errors in processing transactions, reconciling accounts, or coordinating payments across different time zones. These could lead to more settlement failures.
  - T+1 settlement requires participants to have sufficient liquidity to fulfill their settlement obligations. If liquidity conditions change or if there are disruptions in the financial markets, it may become more difficult for parties to access the necessary funds, leading once again to settlement delays or failures.
  - Because of the different time zones, we may expect that the move to T+1 can create some difficulty, especially from Asia.
  - The securities lending market could be strongly disturbed
  - Cash funding and FX processes have to be reviewed (ex: CLS cut-off)

The question raised is should we move quicker Europe on the same model considering that the infrastructure is more complex (more CCP, more CSD, more currencies), and that European market has already achieved important milestones to improve market infrastructure efficiency and stability, through rigorous regulations (CSDR, settlement discipline fees, application of penalties in case of settlement fails,).

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