Using technology to overcome the operational challenges of FX settlement netting

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It is widely acknowledged by both industry regulators and market participants that the netting of FX transactions reduces settlement risk and allows intraday funding to be managed more precisely. Yet the percentage of netted transactions is still surprisingly low. What are the operational challenges to the netting process and how can these be overcome?

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Highlighted as a concern by the Bank for International Settlements (BIS) in its 2019 Triennial Survey[1], the issue of FX settlement risk has continued to gain industry momentum. Most recently, in May 2022, the Global Foreign Exchange Division (GFXD) published a paper with recommendations for reducing settlement risk[2], including the increase in netting of transactions over gross settlement. Simply put, netting reduces both the number of payments that a bank needs to make and the cumulative value of those payments, decreasing the impact of a potential settlement default or failure.

Netting has other benefits too: reducing the number of payments being made by the parties to any given transaction in turn reduces the number of manual processes involved and the possibility of error. The cash flows and funding requirements for each of the counterparties are also reduced because they are settling netted volumes rather than each underlying transaction. Nostro accounts can therefore be managed more effectively and the cost of funding managed more precisely.

TO NET OR NOT TO NET?

Why, then, does netting not take place as a matter of course? The answer lies in the pressure that operations and payments teams find themselves under, relying on manual processes and legacy technology and lacking the flexibility to net on a continuous or configurable basis.

In many ways it is simply easier for firms not to net: so long as post-trade systems are effectively integrated, settling gross allows for straight-through processing all the way from the trade matching process through to settlement, whereas netting requires operational input in two or three different ways.

Firstly, the netting calculation process needs to be run in a consistent manner; counterparties need to agree which products and currencies to include. Secondly, they need to agree on when the calculation stops being run – for example on value date, or the day prior to value date. It's vital to have a consistent process, yet processes and preferences can vary between counterparties.

The upshot is that both parties to the netted transactions need to agree the outcome of the netting calculation, i.e. the population of transactions and, therefore, the netted obligations of each party. It is this agreement process in particular that is operationally intensive, requiring a variety of end user computer processes, as well as offline communication. Often, relationships are managed manually and individually.

This operational intensiveness is demanding and time-consuming and can lead to errors. It often also means that the final agreement on what is to be settled is delayed, which can mean that the actual payment is effected hastily - again, creating an opportunity for error.

TECHNOLOGY IS THE ANSWER

In order to focus on the twin issues of settlement risk and efficient funding, firms need to address the operational burden that netting presents. For consistency, it's important for firms to be able to net on a configurable basis – i.e. by product,counterparty and tenor - in a way that meets the requirements of both parties.

The netting population needs to be agreed as effectively as possible. The cleanest way of doing this is to run a common netting calculation based on a single source of data where both parties can have confidence that the values used are correct and therefore there is no need to reconcile the outcomes separately. Payments can, and should, be made very effectively immediately thereafter.Baton Systems' Core-FX™ solution is based around the simultaneous exchange of equal amounts in different currencies to achieve PvP settlement. Core-FX runs on DLT, providing a single source of truth with a single netting calculation.

An alternative is for a firm to know that it is netting in a way that is as consistent as possible with the preferences of its counterparty. If there is a process in place to allow for the automated exchange of information on the netted values and the population of the netting groups, then there should be a very high success rate of matching values and population. Further, if that process of exchanging information and confirming a match is automated, then operations teams will only need to deal with exceptions, leaving them free to concentrate manual resources on those areas where there is a genuine problem.

Baton's Core-Payments™ solution provides for netting on a currency level with the payouts being sequenced and released in an intelligent way according to the settlement risk appetite of a customer against its counterparties. The configured netting process is designed to be consistent with the way the counterparty operates. Baton has streamlined the agreement process by automating the transmission of the calculated values as well as the receipt and interrogation of the response.

In both cases the netting calculations supported by Baton are highly configurable at the counterparty and currency level, including cut-off times and products.

ELIMINATING SETTLEMENT RISK

Settlement risk can be reduced by netting, but what remains of that risk can only be eliminated by settling in a safe and controlled manner, preferably on a PvP basis. This requires a full, straight-through process which takes a transaction from the point of matching, through netting and all the way to the point of safe settlement, with full transparency throughout. Baton offers a configurable and flexible solution by netting on a bilateral, rather than a multilateral, basis and on a currency pair basis. Currency pair netting is the only way to effectively allow bilateral PvP settlement to occur on-demand.

Furthermore, while multilateral netting has proved to be very effective in terms of netting down the values to be settled, it forces a pool of participants to a common process around timing, meaning that both calculations and settlement processes are fixed. Bilateral netting and settlement processes give control back to the participants.

SUPPLYING TECHNOLOGY TO MEET INDUSTRY DEMAND

From the BIS 2019 Triennial Report, through the 2021 amendments to the FX Global Code and, most recently, the GFXD paper, the importance of netting and PvP or safe settlement is constantly being stressed. With the rise of FX volumes and the reluctance by some firms to use limited settlement lines for FX purposes, the industry is more invested than ever in achieving safe settlement.

In the past, multilateral netting by currency has proved an effective way of reducing settlement risk and has become the industry norm. However, firms are now beginning to understand that, by deploying technology to net bilaterally by currency pair, they can go further and eliminate settlement risk with solutions that integrate with PvP.

Technology such as Baton-CORE™ allows counterparties to access a single source of truth with shared workflows around netting and the ability to agree and settle those netted values without resorting to resource-heavy, manual processes which are subject to human error. FX market participants are now beginning to recognise the opportunities for safe settlement which technology has to offer both individual firms and the market as a whole.

1. https://www.bis.org/publ/qtrpdf/r_qt1912x.htm
2. https://www.gfma.org/wp-content/uploads/2022/05/reducing-settlement-risk-may-2022.pdf