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# FX Global Code July 2021

An overview of the latest revisions to the Global Code, focusing on settlement risk

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# FX Global Code

## Introduction

The FX Global Code is a set of global principles of good practice in the foreign exchange market

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| PUBLIC-PRIVATE SECTOR COLLABORATION | The Global Code was developed by a partnership between central banks and market participants (buy-side, sell-side, infrastructures, trade associations) from 20 jurisdictions. The Global Code is maintained by the Global Foreign Exchange Committee (GFXC) which comprises central bank-sponsored Foreign Exchange Committees and similar structures in various regions. Each member Foreign Exchange Committee designates a central bank and private sector representative for the GFXC |
| VOLUNTARY | The Global Code does not impose legal or regulatory obligations on market participants, but is rather intended to serve as a supplement to local regulations. Almost 1,100 entities have adhered to the Global Code |
| 6 LEADING PRINCIPLES | The Global Code is organised around six main principles: Ethics, Governance, Execution, Information Sharing, Confirmation & Settlement, Risk Management & Compliance. These are specified by 55 detailed principles |
| REVIEW | At least every three years, the GFXC is required to assess the case for, and if appropriate, undertake, a comprehensive review of the Global Code. Separately, from time to time the GFXC will also assess whether particular developments warrant specific revisions. The first iteration of the Global Code was released on 25 May 2017, with an updated version published on 6 August 2018. The GFXC completed the first 3 year review of the Global Code with the publication of the updated Global Code on 15 July 2021 |

# Revised Global Code

## Overview

The July 2021 updates include changes to eleven principles, strengthening the Global Code's guidance on:

- anonymous trading
- algorithmic trading and transaction cost analysis
- disclosures
- settlement risk

The GFXC has also developed disclosure cover sheets and templates for algo due diligence and transaction cost analysis, as well as guidance papers on pre-hedging and last look, to support market participants in applying the relevant principles of the Global Code

The GFXC is encouraging market participants to consider renewing their Statements of Commitment, having regard to the nature and relevance of the updates to their FX market activities. It expects that a timeframe of up to 12 months would be reasonable for market participants affected by the changes to align their practices with the revisions

# Settlement Risk

## Overview

FX settlement risk is the risk that a firm will pay the currency it sold, but fail to receive the currency it bought

— Often referred to as principal risk or Herstatt risk

FX settlement risk remains a systemic concern

— 2019 BIS FX Triennial Survey: close to $9 trillion of payments remain at risk on any given day

Payment-versus-payment (PvP) settlement eliminates FX settlement risk

— Ensures sold currency will be paid if and only if bought currency is received

— The proportion of trades with PvP protection appears to be falling

The revised Global Code places emphasis on the use of PvP settlement mechanisms where they are available and provides more detailed guidance on the management of settlement risk where PvP settlement is not used

New language on the potential systemic consequences of a market participants' failure to meet their payment obligations has been included to specifically discourage 'strategic fails'

# Settlement Risk

## Revised Global Code (Principle 35)

### PRINCIPLE 35: SETTLEMENT RISK

Market Participants should ~~take prudent measures to manage and~~ reduce their Settlement Risks 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, creating incentives for the counterparty to modify its FX settlement methods or taking other appropriate risk mitigation actions.

# Settlement Risk

## Revised Global Code (Principle 50)

**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. When a decision is made to allow a Client to exceed a limit, appropriate approval should be obtained.

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.

# Settlement Risk

## Revised Global Code (Principle 53)

**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 standardised 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.