Asset managers and custodians look to manage FX settlement risks with CLSSettlement

In a recent webinar held by Global Custodian and CLS, a panel of asset management and custody experts discussed current FX settlement risk mitigation practices and how buy-side firms can gain increased efficiencies through CLSSettlement.

Amid the recent geopolitical volatility together with the ongoing uncertainty arising from COVID-19, market participants – including asset managers – are doing their utmost to mitigate risk across their businesses and portfolios. In particular, a growing number of asset managers are looking to reduce their FX (foreign exchange) settlement risk exposures. At the same time, many firms now acknowledge that efficient FX execution processes can yield significant cost savings. This is prompting fund houses to rethink their historic approaches towards managing FX. As a result, more asset managers and asset owners are now turning to FX settlement services – such as CLSSettlement – to help support them with their FX requirements.

Challenges around FX settlement

According to research by the Bank for International Settlements (BIS), the number of FX transactions leveraging PvP (Payment versus Payment) protection – a safeguard wherein payments on both sides of an FX trade are settled simultaneously – has steadily fallen from 50% in 2013 to just 40% in 2019. This decline in PvP rates has corresponded with growing levels of cross-border investment, often in currencies which are outside of CLSSettlement's PvP scope. Absent of any PvP settlement systems, FX trading counterparties rely on non-PvP bilateral gross and net settlement arrangements, which leads to added counter-party credit risk.

Lia Oyman, senior manager, trade services operations at Franklin Templeton Investments, says counterparty credit risk is something that asset managers need to be cognisant of when settling FX transactions outside of PvP mechanisms. "With all the volatility happening in the market right now, you do need to watch out for credit rating downgrades at counter-parties," she adds. Others concur that managers are taking FX settlement risk more seriously. "The events in March and April of 2020 have served as a wake-up call for asset managers," notes Christopher Gothard, global head of FX new business development and head of FX for Europe and Asia at Brown Brothers Harriman (BBH).

Many aspects of the FX settlement process are still manually intensive, which creates further costs for asset managers. These added overheads come at a sensitive time for active managers, especially as many firms are facing growing cost pressures as a result of rising operational spending, increasing regulations and mounting fee compression from investors. Moreover, a lot of active managers are also being challenged by low-cost passive providers such as ETFs (exchange traded funds). With asset managers feeling the squeeze on so many levels, firms are looking to optimise their costs. Obtaining efficiencies in FX settlement through automation is one way in which active managers could etch out some decent savings. "Increasingly, more attention is being paid to the full life cycle of the asset managers' operating model. Custodians are increasingly providing solutions to bridge the gap between post-trade and OMS (order

management systems), and FX is a part of that. Some of these solutions and shifts towards automation are helping to optimise transaction costs and reduce FX risks," says Gothard.

Regulators hone in on FX settlement

Global regulators are taking a proactive position on FX settlement risk too, conscious of the serious systemic implications FX failures can have. The Basel Committee on Banking Supervision (BCBS) and the Committee on Payments and Market Infrastructures (CPMI) recently urged national regulators to incorporate its 2013 Supervisory Guidance on Managing FX Settlement Risk together with Principles 35 and 50 of the FX Global Code into their supervisory frameworks. Principles 35 and 50 of the FX Global Code advise that market participants have measures in place to manage and monitor settlement risks. Some regulators including Hong Kong and Singapore have since implemented elements of the FX Global Code, whereas Japan has adopted it in full.

The BCSB guidance also recommends that PvP settlement be used so as to eliminate principal risk – namely when one counterparty to a trade sends a currency payment to the other before receiving the other currency. In instances where PvP is not possible, the guidance urges banks to minimise the size and duration of their principal risk and to conduct timely reconciliations of payments received. Lisa Danino-Lewis, global head of sales at CLS, notes that CLS is in regular dialogue with global regulators and is working very closely with custodians and asset managers in educating the wider market about FX settlement risks.

The shift towards CLSSettlement

The increasing scrutiny on FX settlement risk is prompting growing interest in CLSSettlement, owing to the fact that it provides PvP. The multilateral netting benefits this entails are also significant. Andrew Smith-Plenderleith, global head of cash and FX for securities services at JP Morgan, says the netting benefits allow for settlement risk to be considerably reduced.

Aside from insulating users from FX settlement risk, the solution also provides customers with counter-party risk benefits. "Another reason for the increase in adoption of CLSSettlement is the heightened market awareness of the benefits of counterparty diversification when looking at both counterparty risk and the pursuit of best execution. Settlements outside of CLS often require manual processes tailored to each counterparty bank for each settlement per bank and per value date. Using CLSSettlement enables a participant to employ a broad counterparty roster with far greater ease," reads a CLS article.

Multilateral netting together with automation are generating huge efficiencies for clients too. For instance, multilateral netting can shrink funding requirements by up to 96% on average allowing for better capital optimisation and liquidity advantages. "Netting helps us reduce counterparty risk, but also enables us to free up funds to settle intraday. Once transactions are matched at CLS, the settlement is guaranteed," says Oyman. Others concur. "CLSSettlement confers a number of operational efficiencies for users. It allows asset managers to effectively outsource much of the post trade process for FX settlement, and focus their resources on other parts of their businesses. In the case of smaller asset managers – where FX may not be a prominent part of their overall business – this has been cited as a real value-add," adds Danino-Lewis. By utilising industry solutions to manage operational aspects such as FX settlement, BBH's Gothard concurs that asset managers can focus more on identifying alpha opportunities and demonstrating value to their underlying customers.

An expanding business

CLSSettlement continues to undergo exponential growth, expanding its market share in jurisdictions where it historically had a limited presence. "Having launched in 2002 and settled its first fund FX transaction in 2004, 75% of the top 250 asset managers by AUM (assets under management) are now using CLSSettlement, and over 500 asset managers globally. In regions such as Asia, we have seen growth of more than 30% since 2018. Take Japan, for example. In 2018, there were no Japanese funds settling in CLSSettlement, but now we have over 40. Similarly, we are seeing strong adoption in Australia where 75% of the country's superannuation funds are using the service. In order to grow further, we are continuing to educate market participants about FX settlement risk and how CLS can help them mitigate it. We are also working with custodians to explore ways to expedite the onboarding of new participants," says Danino-Lewis.

With market participants taking FX settlement risk more seriously and asset managers looking to identify cost efficiencies, many are now rethinking their traditional approaches towards FX settlement.