Foreign Exchange Transaction Processing: Execution to Settlement

Recommendations for Nondealer Participants

The New York Foreign Exchange Committee

October 1999

TABLE OF CONTENTS

Introduction

Once a foreign exchange trade is executed between two institutions, a three-step process unfolds.

- First, each participant's front office system captures the trade.
- Second, the trade is recorded and confirmed.
- Finally, the trade is settled to each participant's satisfaction.

Much effort has been made in the past to regularize and perfect this process among dealer institutions.

Recent statistics from the Bank for International Settlements estimate the average daily volume of transactions in the global foreign exchange market to be valued at $1.5 trillion. If even a small percentage of these trades fail to settle correctly, the economic cost to the affected market participants would be considerable.

The purpose of this paper is to share the experiences of financial institutions (those firms that are most active in the huge foreign exchange market) with nondealer participants (the businesses that may participate in the foreign exchange market on a more occasional basis). We highlight sixteen issues that are meant to heighten risk awareness for nondealers and provide "best practice" options or recommendations.

The bibliography at the end of this paper cites publications that provide additional insight into some of the issues raised in this paper. As the bibliography demonstrates, the Foreign Exchange Committee has on several occasions issued market guidance addressing best practices for trade processing to the industry in general. (Copies of these papers may be viewed on line or downloaded from the Foreign Exchange Committee's web site at www.ny.frb.org/fxc.)

Although the emphasis of this paper is on transactions with nondealer participants, the recommendations are equally applicable to any transactions involving dealer participants. We hope that the implementation of these recommendations by both dealer and nondealer participants alike will work to reduce risk and increase efficiency within the foreign exchange market.

Recommendations

1. Counterparty Identification

Issue: Nondealer participants should aim to clearly identify the legal entity on whose behalf they are making the transaction.

The issue becomes complex when:

- the organization has multiple legal entities (subsidiaries, branches, offices, and affiliates) that are trading in the foreign exchange market;
- employees adopt casual use of marketing nomenclature, for example, in identifying themselves;
- the organization has been subject to recent acquisitions or restructuring that has led to name changes;
- participants are transacting in an agency capacity; or
- trades are allocated to different underlying accounts.

Risks: Failure to properly identify a nondealer participant can lead to:

- incorrect assessment of the credit risk by the dealer counterparty;
- erroneous bookings and/or misdirected settlements, creating potential losses for either counterparty to the transaction; or
- misallocation of collateral.

Recommendation: Each counterparty to a transaction should make sure its organization recognizes the importance of clear identification. All organizations should also understand the expediency of accurately specifying, at the time of transaction, the legal entity on whose behalf it is acting.

2. Capacity/Authority

Issue: A dealer or nondealer may wish to inquire as to whether a counterparty or an individual acting for a counterparty has the capacity and/or authority to enter into a dealing relationship or transaction.

Risks: A dealer or nondealer may feel that there is legal risk and/or potential financial loss associated with dealing, when evidence of a counterparty's capacity to enter into trades or evidence of the authority of a trader acting for a counterparty is absent.

Recommendation: A dealer's or nondealer's standards regarding evidence of capacity and authority should be communicated clearly within a firm so that operations, legal, and compliance staff understand their responsibilities. Staff should know who is to collect any required documentation from a counterparty and who is to review either solicited or unsolicited documentation regarding authority and capacity. All institutions should try to respond to a counterparty's request for proof of capacity and authority.

3. Segregation of Duties

Issue: Nondealer participants should avoid a situation where individuals who transact and confirm trades also perform trade (accounting and general ledger) reconciliation.

Risks: When trading duties are not segregated, the potential for fraud may increase. An individual, for instance, may hide trades and any resultant losses.

Recommendation: Duties of performing trade transactions, confirmations, and general ledger reconciliation should be separated. Firms with small treasury staffs and an overlap in employee responsibilities should set up a system of checks and balances. An example would be to require two-person approval on every transaction.

4. Timely Trade Entry

Issue: Trades should be recorded in a timely manner.

Risks: A delay in recording a trade could disrupt processing, including the communication of transaction information between counterparties, and could result in:

- inaccurate accounting records;
- mismanagement of market risk;
- misdirected or failed settlement; and
- the failure of a trade to be booked at all.

Recommendation: All trades should be booked immediately after a transaction is entered into, and accounting records should be updated as soon as possible.

5. Block-Trade Breakdown

Issue: Block trades transacted by agents should be allocated or "split" to individual obligor accounts on a timely basis.

Risks: The failure to allocate a block trade on a timely basis could result in increased credit, legal, and operational risk. Specifically, a delay in allocation hampers:

- the allocation and management of credit exposure to the underlying client obligors. (If allocated to a previously unidentified account, the delay prohibits credit analysis of the obligor entirely.);

- the linking of counterparties to their respective credit exposures; and
- timely confirmation, which in turn interrupts the settlement process and, in extreme cases, may cause payment failures.

Recommendation: Block trades should be allocated and confirmed to individual obligor accounts as soon as possible. To minimize errors caused by manual intervention, trade allocations should be provided electronically to the counterparty.

6. Trade Confirmation

Issue: Transactions need to be confirmed on a timely basis. If transactions are confirmed verbally, written or electronic confirmations should follow.

Risks: Trade discrepancies may go undetected when transactions are not confirmed on a timely basis. In addition, the incidence of error tends to increase when nonautomated confirms, or verbal confirmations, are not followed up with written or electronic confirmation. If a business lacks an independent means of confirmation, the resolution of trade discrepancies can be further hindered. Trade discrepancies can:

- lead to disputes, disrupt the settlement process, and increase processing costs;
- result in failed trades;
- affect any underlying security settlement;
- lead to inaccurate accounting records; and,
- result in the mismanagement of market risk, which can be especially costly during times of increased market volatility.

Recommendation: We make several recommendations regarding trade confirmations:

- All nondealer participants should have their own independent confirmation process.
- Transactions should be confirmed no later than twenty-four hours after the dealing date but preferably on trade date.
- The preferred method of confirmation is electronic. Automated confirmation matches one party's trade details to its counterparty's trade details. It also minimizes manual error and is the most timely and efficient method because it requires no subsequent confirmation or manual check. Automation also reduces the potential for fraud.
- If trades are confirmed verbally, it is highly recommended that the succeeding confirmation be sent electronically or in writing. In some instances, follow-up confirmation may be legally necessary to bind both parties to the trade. With verbal confirmations, most dealers employ recorded telephone lines. Nondealers may want to consider adopting this practice.

- Sending confirmation by fax requires extra diligence to assure receipt by the correct counterparty. It should be noted that fraudulent fax messages can be sent. A faxed confirmation, however, is better than no confirmation.

7. Trade Confirmation of Forward Transactions

Issue: Forward transactions should be confirmed on a timely basis.

Risks: The risks outlined in the preceding section, *6. Trade Confirmations* also apply to forward transactions. In the case of forward transactions, however, the overall level of risk--including market risk--tends to be higher. The longer the term of the forward transaction, the greater the chance that applicable standing instructions may have changed.

Recommendation: In addition to each of the recommendations in the preceding section, we suggest that:

- settlement instructions on forward transactions be reconfirmed two to five days before the settlement date; and,
- amended confirmations be sent promptly when changes in the original confirmation occur.

8. Timely Resolution of Confirmation Discrepancies

Issue: Discrepancies between a confirmation received by a nondealer participant and a dealer's own trade detail record should be brought to the dealer's attention in a timely manner.

Risks: Trade discrepancies not brought to the attention of a counterparty in a timely manner may:

- disrupt the settlement process and increase processing costs;
- result in failed trades;
- affect an underlying security settlement;
- lead to inaccurate accounting records; and,
- result in mismanagement of market risk, especially during times of increased market volatility.

Recommendation: Trade discrepancies should be brought to a counterparty's attention as soon as possible. Automated trade confirmation systems are strongly preferred; these systems can highlight discrepancies and mitigate potential problems.

9. Accurate/Complete Settlement Instructions

Issue: Always provide complete and accurate settlement instructions*.*

Risks: Incomplete or inaccurate settlement instructions may result in:
- a disrupted settlement process, inflated processing and compensation costs;
- failed trade(s);
- disruption of an underlying transaction.

Recommendation: Settlement instructions should clearly reference the following information:
- the recipient's account name, account address, and account number;
- the name of the receiving bank, a SWIFT/ISO address and a branch identifier/short code; and,
- the identity of any intermediary bank used by the recipient.

10. Exchange of Standing Settlement Instructions

Issue: Exchanging settlement instructions on a trade-by-trade basis should be avoided.

Risks: Exchanging settlement instructions solely on a trade-by-trade basis increases the chances for incorrect or incomplete settlement instructions. Even if settlement instructions are delivered correctly and completely, repetitious manual recording is inefficient, increases the cost of trading processing, and invites error. Also, the untimely delivery of settlement instructions delays the trade confirmation process. Incorrect, incomplete, erroneously recorded or untimely settlement instructions have the same impact as the risks listed in *8. Timely Resolution of Confirmation Discrepancies* (page 7).

Recommendation: To ensure that instructions are delivered successfully:
- standing settlement instructions should be exchanged whenever possible;
- an effective date should be included in the transmission of standing (or any settlement) instructions.
- all standing settlement instructions should be delivered electronically if possible and preferably through authenticated media. Electronic delivery minimizes manual error and is the most timely method of delivery. Using authenticated media reduces the potential for fraud. If settlement instructions cannot be delivered electronically, then they should be delivered in writing; and
- even with standard settlement instructions on file, staff should consider calling the counterparty to confirm the accuracy of the settlement information.

11. Third Party Payments

Issue: Third-party payments are extremely risky transactions. In the event that a dealer has agreed to process such a transaction, the nondealer's settlement instructions may direct payment to a third party that is legally unrelated to the nondealer.

Risks: Third party payments contain an extremely high degree of legal risk. Such payments impose additional obligations and potential legal liability on the party making the payment. If the third-party payment is directed to an incorrect beneficiary, the payment may be delayed or even lost.

Recommendation: Parties should avoid third-party payments whenever possible. In case a dealer agrees to process a third-party payment, the nondealer should provide as much information as possible (for example, the third-party account's name, address, account number) to satisfy the dealer making the payment. Also, third-party payment instructions should be provided electronically or in writing, and they should be verified prior to settlement.

12. Netting

Issue: Transaction payments should be netted when possible and gross transaction settlements should be avoided.

Risks: Settlement on a gross basis not only increases the actual number of settlements that are necessary but also raises settlement risk and the likelihood of error. A netting agreement has the benefit of entitling parties to reduce the number and size of payments.

Netting should be implemented with the legal protection of a netting agreement. Without a full netting agreement, a party contemplating closeout netting may be at risk if the other party approaches insolvency. The insolvency of a party could result in the counterparty's loss of its entire gross payment amount.

Recommendation: It is strongly recommended that parties engage in netting by:

- entering into standard netting agreements that are legally enforceable in the event of insolvency or bankruptcy; and
- encouraging counterparties to automate the actual netting calculation so that errors introduced by manual calculation are reduced.

13. Confirmation of Bilateral Amounts

Issue: When counterparties have entered into a netting agreement, they should be certain the transactions can be netted.

Risks: Parties that do not correctly identify and confirm contracts that can be netted may risk:

- exchanging incorrect settlement payments, which could boost processing and compensation costs;
- excluding contracts that could be netted, thereby missing the opportunity to reduce settlement risk. Such exclusion might inflate settlement exposure and could restrict business between the parties given applicable settlement limits; and
- including contracts that may not be netted, resulting in incorrect settlement calculations, and in some cases, artificially reduce settlement exposure.

Recommendation: Netted trades should be confirmed individually on the date of the trade, and net settlement amounts should be confirmed no later than one day prior to settlement. Parties should establish cut-off times for confirming bilateral netted amounts. Such deadlines will ensure agreement between parties as to which transactions are included in the net amounts.

14. Timely Account Reconciliation

Issue: Account reconciliation--the process of comparing expected and actual cash movements--should be performed in a timely manner.

Risks: Failure to reconcile expected and actual cash movements could result in an inability to recognize an underfunding of transactions and/or an overdraft to the cash account. On the one hand, when cash is used to overfund a position, opportunity costs for the counterparty rise because cash cannot be invested. On the other hand, overdraft charges may be imposed unknowingly on the counterparty when positions are underfunded.

Recommendation: Expected cash flows should be reconciled against actual cash flows at the earliest possible date (in most cases no later than one day after settlement date).

15. Reporting Payment Failures

Issue: Parties that do not receive payments should report the nonreceipt to their counterparty in a timely manner.

Risks: Parties that do not report nonreceipt of payment in a reasonable amount of time may prevent their institution from claiming full compensation from the counterparty.

Recommendation: All instances of nonreceipt of payment should be reported immediately to a counterparty's operations and/or trading units.

16. Compensation Claims

Issue: Parties that have failed to make a payment on a settlement date should arrange for proper value to be applied and pay compensation costs.

Risks: The counterparty that has not received payment may risk covering the costs associated with nonpayment, including obtaining alternative funding on the settlement date (for example, interest costs associated with overdraft lines) and taking on the added expenses of processing and administering payment.

Recommendation: Compensation claims for nonreceipt, or late receipt of payment, should be made expeditiously. Parties may want to consider using the U.S. Council on International Banking's Interbank Compensation rules as a guide for approximate costs. Under these rules, compensation is calculated based on the dollar amount of payment multiplied by the number of days plus a $200 administrative fee. The administrative fee is meant to compensate a bank for its costs in adjusting value on a payment.

Bibliography

The Foreign Exchange Committee. "Standardizing the Confirmation Process." 1995.

The Emerging Markets Traders Association, the Foreign Exchange Committee, the International Swaps and Derivatives Association, the New York Clearing House Association, the Public Securities Association, and the Securities Industry Association. "Principles and Practices of Wholesale Financial Market Transactions." 1995.

The Foreign Exchange Committee. "Guidelines for Foreign Exchange Trading Activities." 1996.

The Foreign Exchange Committee. "Management of Operational Risks in Foreign Exchange." 1996.

The Foreign Exchange Committee. "Managing Operational Risk in Collateralized Foreign Exchange." 1997.

The Foreign Exchange Committee. "Guidelines for Foreign Exchange Settlement Netting." 1997.

The Foreign Exchange Committee and the Financial Market Lawyers' Group, "Guide for Transactions Involving Intermediaries." 1998.

Acknowledgments

The Operations Managers' Working Group prepared this Foreign Exchange Committee report. The majority of the work was done by:

Charles LeBrun	Bank One
Philip Scott	Bank of New York
Kathryn Wheadon	Bank of America

Special thanks to Steve Archer, Bank of New York, who provided invaluable editorial assistance.