CLS
trusted market solutions

› Managing settlement risk

Global pension industry trends highlight gaps in settlement risk mitigation

For nearly a decade, the sell side has led the way in settlement risk reduction, but a key market area is also making significant progress in terms of mitigating this risk: pensions.

The increased adoption of FX settlement risk mitigation by pension funds is reminiscent of the sell side's response to the Basel Committee on Banking Supervision (BCBS) guidance for managing settlement risk in FX transactions, which was first published in 2000.

Since that time, the FX market has made substantial progress in reducing the risks associated with the settlement of FX transactions and, in 2013, BCBS published new guidelines aimed at the sell side, which expand upon and replace the original BCBS guidelines, with recommended approaches for supervisors and banks on how to manage FX settlement risk (BCBS 241).[1]

Despite many banks' strides toward governance arrangements and the management of risk (including settlement, market, operational and all other FX settlement-related risks), settlement risk remains the most significant risk in the FX market.

The second guideline of BCBS 241 recommends the use of payment-versus-payment (PvP) arrangements, where practicable, to reduce settlement (or principal) risk when settling FX transactions. A PvP settlement system ensures that both sides of an FX trade settle simultaneously, mitigating the risk that would exist if one party to the trade delivers the currency it sold but does not receive the currency it bought from its counterparty.

The creation of CLS in 2002 was during a time of unprecedented collaboration among FX market participants at the behest of the G20 central banks, and it led to a substantial reduction in settlement risk through the introduction of CLSSettlement, a unique PvP multicurrency settlement system.

However, despite the growing adoption of PvP by the market over the years, the most recent Quarterly Review published by the Bank for International Settlements (BIS) suggests that FX settlement risk has increased since 2013 in both relative and absolute terms.[2] It found that the proportion of FX trades with PvP protection appears to have fallen from 50% in 2013 to 40% in 2019. One of the reasons given for the decrease is the growth of trading in currencies not eligible for CLSSettlement. The 2019 BIS Triennial Survey reported that FX markets for the currencies of emerging market economies displayed sharper growth than those for major currencies, rising from 19% to almost 25% of global turnover since 2016.

When viewed alongside the pension industry's substantial growth of market share, the BIS data reinforces the need for all market participants to be aware of their exposure to FX settlement risk, as well as develop strategies to leverage robust services already available to mitigate settlement risk.

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[1] BCBS: Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions (February 2013) https://www.bis.org/publ/bcbs241.pdf

[2] BIS: "BIS Quarterly Review – International banking and financial market developments" (December 2019), specifically Bech and Holden: "FX Settlement Risk Remains Significant" (December 2019) https://www.bis.org/publ/qtrpdf/r_qt1912.pdf

The pension industry's evolution

Pension assets across the largest pensions' markets increased 15% in 2019 over 2018, according to the Global Pensions Assets Study 2020 by Willis Towers Watson,[3] who also concluded that pension assets are the dominant asset owner segment, contributing over 50% of global assets.

Additionally, there was overall growth during the past decade of pension assets accumulated through pension funds, pension insurance contracts and other retirement savings products. According to the Willis Towers Watson report, pension assets globally reached USD46.7 trillion at the end of 2019. This growth can be attributed to an increase in the proportion of working-age people covered by a pension plan, a trend especially strong in countries that have recently implemented mandatory or auto-enrolment programs, such as New Zealand. CLS data supports this, indicating growth in the volume of FX transactions settled in CLSSettlement for pension funds.

As pension funds have secured their status as one of the largest asset owners globally, asset globalization and higher foreign content in domestic portfolios continues to rise. Traditionally, pension funds have invested in bonds and equities, but in recent decades, under increasing pressure to support an aging global population, pension funds have diversified their portfolios both in terms of asset classes and geography.

This trend toward foreign investments is resulting in increased demand for FX transactions and hedging within portfolios.

As of 2018, foreign investments account for roughly a third of pension funds' total assets under management; 34% of total pension investments, compared to 31% in 2014, according to "Beyond their Borders: Evolution of Foreign Investments by Pension Funds," updated and re-published by PwC in 2020. Increasingly, this diversification is seen as necessary for the success of pension funds, as safe-haven investments are less attractive in a trading environment experiencing consistently low interest rates. Pension funds under pressure are increasing foreign investments to gain access to flourishing foreign markets in order to support the growing number of people who rely on their yields.

Settlement risk exposure will likely increase as the pension industry grows and continues to move toward offshore assets, including into the emerging markets.

As their FX exposure increases, pension funds have new factors to consider and generally these considerations span across the front, middle and back office.

Asset owners reviewing the magnitude of currency risk exposure in their investment portfolios are weighing developed versus emerging market currency exposures versus any projected volatility of their home currencies, as well as best execution.

Alongside this review, asset owners need to determine their strategies for currency management, deciding whether to hedge or un-hedge and at what levels, as well as developing an understanding of the associated challenges with implementing currency risk solutions, mainly cost and liquidity.

The potential settlement risk, impact on liquidity management and additional operational burden that comes with hedging a portfolio are also key considerations. For pension funds, this results in continuous conversations with their custodians - and where relevant, their externally appointed managers - around the options available to mitigate FX settlement risk, optimize liquidity and improve operational efficiency. A growing number of funds are looking to mitigate risk through FX solutions which are offered by their custodians, including FX execution, timely reporting, netting as well as settling payments through PvP.

As the industry has evolved, some other trends have emerged.

[3] Willis Towers Watson: "Thinking Ahead Institute Research – Global Pension Assets Study" (February 2020) https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2020/01/Global-Pension-Asset-Study-2020

Insourcing versus outsourcing

One question that often arises is whether it is better to insource or outsource portfolio management across various asset classes, and currently there is a global movement towards insourcing. Bringing portfolio management in-house grants pension funds firmer control over fiduciary duty, costs and performance, and is advantageous when observing certain investment criteria, such as environmental, social and governance (ESG).

For example, AustralianSuper, the country's largest superannuation and pension fund, managing AUD166 billion for 2.2 million members as of 30 June 2019, announced in late 2019 that the fund plans to bring half of its total assets in-house by 2021, citing cost control as the key driver. In 2017-18, AustralianSuper was managing 31% of its portfolio internally, and this increased to 40% for 2018-19. Australian pension funds have traditionally outsourced their assets to external managers, but there has been a recent shift toward insourcing. According to the Global Pension Funds report, the next two largest Australian super funds – Qsuper and First State – have been increasingly insourcing over the past several years because the funds have grown large enough to allow them to afford to hire professional investors, rather than relying on external asset managers.

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Over the past year there have been commitments made by a number of pensions globally to adhere to the FX Global Code's principals.

Operational excellence

The global pension industry's rapid growth and expanding interest in alternative investments have drawn the attention of regulators, which will drive new and increased regulation, governance and transparency. The natural response to this is a focus on operational excellence by reducing costs, improving risk management and enhancing customer experience and delivery of services.

A rising number of pension funds are also adopting industry best practices and aiming to set an example of good behaviour within the market by signing up to the FX Global Code (the Code), a set of 55 principles established through collaboration between central banks and market participants from 16 jurisdictions to promote the highest ethical standards and best practices for the FX market. The Code encourages a robust, fair, liquid, open and appropriately transparent market in which a diverse set of FX market participants, supported by resilient infrastructure, are able to confidently and effectively transact at competitive prices that reflect available market information, and do so in a manner that conforms to acceptable standards of behaviour.

Over the past year, there have been commitments made by a number of pensions globally to adhere to the Code's principles which include Afore XXI Banorte, the largest pension in Mexico; ATP, the largest pension in Denmark; Publica, the largest pension in Switzerland; AustralianSuper, the largest pension in Australia; and VicSuper, which was the first pension in Australia to sign up to the code and is also set to become the second largest pension in Australia after its upcoming merger with First State Super in July 2020.

Consolidation

Rising regulatory scrutiny tends to lead to consolidation, as smaller market participants struggling to comply and control costs may buckle under the pressure of competing with larger funds that benefit from economies of scale. There is evidence of this cause and effect right now in the Asia Pacific banking industry. "New regulations aim for higher efficiency, stronger risk management, better choices for customers, and capital controls. This can have an indirect impact on consolidation, as the new regulations pose special challenges for smaller, less-efficient banks," according to a July 2019 McKinsey report titled "Bracing for consolidation in Asia Pacific banking: The quest for scale."[4]

Regulators and investors both require greater transparency, and increasingly, in Australia, regulators are implementing new rules demanding more transparency and disclosure of fees and costs. Heightened compliance, regulation and technology costs will drive out profits across the region and indirectly lead to consolidation.

Although the McKinsey report focuses on banks, the pensions industry is not immune to the effects of this, as evidenced earlier in the upcoming merger of First State Super and VicSuper. According to PwC's "Beyond Their Borders" report, the UK pension fund industry is also under increasing pressure to consolidate under regulations and growing demands for improved transparency and governance. Additionally, there is evidence of this consolidation in the Dutch pensions industry as the number of funds has been divided by three over the past decade, a trend that is expected to continue.

Heightened compliance regulation, and technology costs will drive out profits across the region and indirectly lead to consolidation.

[4] McKinsey & Company: "Asia-Pacific Banking Review 2019 – Bracing for consolidation: The Quest for Scale" (July 2019) https://www.mckinsey.com/industries/financial-services/our-insights/bracing-for-consolidation-in-asia-pacific-banking-the-quest-for-scale

Spotlight on Australia

As Australia's superannuation fund industry continues to grow and evolve rapidly, it presents an interesting lens through which to view these and other global pension funds trends.

Australia is the second largest pension market in the Asia Pacific region after Japan, according to the Global Pensions Assets Study 2020 by Willis Towers Watson. In alignment with the global trends of industry growth combined with increased pressure from its members to expand investments globally, Australian superannuation funds are increasing asset allocation to foreign investments, especially smaller firms.

A central theme emerging from the 2019 National Australia Bank's (NAB) 9th annual biennial Superannuation FX Hedging Survey[5] was that funds are not only increasing their investments offshore, but they plan to continue the trend in pursuit of further diversification and bigger returns.

On average, superannuation funds had 41% of their assets offshore as of June 2019, and 72% of respondents indicated that over the next two years, they plan to expand their share of investments in international assets. Specifically, the NAB survey found that funds are likely to increase allocation to alternative international investments, such as private debt, infrastructure and real estate.

Consistent with the trend in pensions diversifying their investments and increasing their allocation to offshore assets, Australian superannuation funds settling through CLS have expanded the currencies they trade by more than 10% over the past three years.

As funds in Australia and globally increase their investments overseas, they hold more foreign currency in their portfolios, and therefore would potentially hedge those exposures through FX trading. Against the backdrop of an ever-changing regulatory landscape and heightened pressure to reduce cost and fees, it is important to ensure that FX trading and settlement is executed to the best standard.

About three quarters of Australia's 20 largest superannuation funds already use CLSSettlement to settle their FX trades.

[5] NAB: "Superannuation FX Hedging Survey 2019" (August 2019) https://business.nab.com.au/nab-superannuation-fx-hedging-survey-2019-summary-36299/

The power of PvP

This exploration into current global pension trends provides a deeper understanding of existing and emerging risks in pension portfolios. There is an increased desire by the pensions community to ensure it is managing risk effectively, specifically related to settlement risk resulting from increasing FX activity.

This is supported by CLS, which holds the largest repository of FX data in the market. Analysis of CLS data suggests significant growth in the value of FX transactions settled on behalf of pension funds globally, an increase of approximately 40% and over 75% in the Asia Pacific region.

40%

Approximately 40% growth in PvP settlement by pension funds **globally**

75%

Over 75% growth in PvP settlement by pension funds in **Asia Pacific**

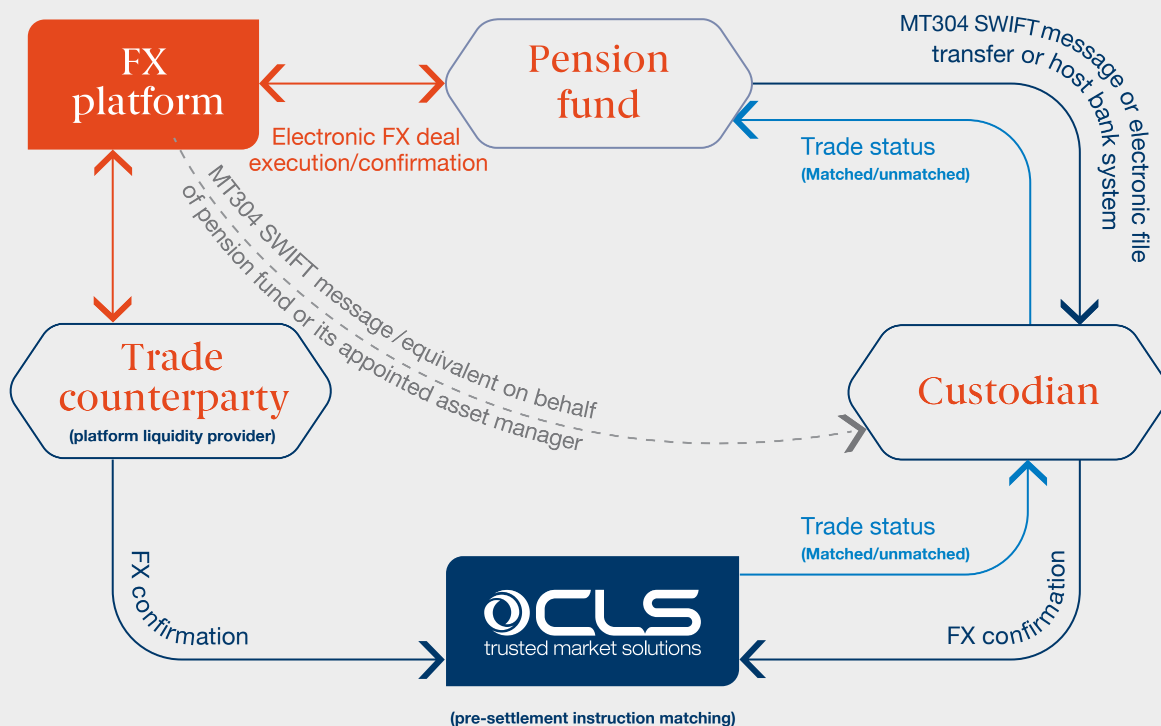
90%

Nearly 90% growth in PvP settlement by pension funds in **Australia**

CLS settles payments in 18 of the world's most actively traded currencies.[6]

When a CLSSettlement-eligible FX trade is executed by a pension, or their externally appointed manager, CLS receives an electronic payment instruction for each leg of the trade through the pension fund's custodian, a CLS settlement member.

CLS's PvP system authenticates and matches the trade information, holding the trade until the agreed settlement date. On each settlement date, CLS simultaneously settles each pair of matched instructions during a two-hour window in the European morning when all the real-time gross settlement systems (RTGSs) of all the currencies are open simultaneously. The matched and settled trades are reported back to the pension fund or their asset manager through the custodian.



[6] Australian dollar, Canadian dollar, Danish krone, euro, Hong Kong dollar, Hungarian forint,Israeli shekel, Japanese yen, Korean won, Mexican peso, New Zealand dollar, Norwegian krone, Singapore dollar, South African rand, Swedish krona, Swiss franc, UK pound sterling and US dollar.

In a growing market such as the pensions industry, where the global trends indicate an increase in exposure to foreign assets and insourcing of portfolio management activities, understanding and mitigating FX settlement risk is essential for ensuring stability of the FX market and reducing risk globally.

In addition to settlement risk mitigation, different functions within a pension fund or an asset manager derive different benefits from using CLSSettlement. The front office benefits from business growth opportunities through enhanced credit efficiency, an expanded range of counterparties and increased trading opportunities.

The pension fund or its appointed asset manager also potentially enjoy reduced funding requirements and better liquidity management oversight for their middle office operations if their custodian passes on the netting benefits derived from CLSSettlement, while the back office experiences operational risk efficiencies as a result of enhanced straight-through processing and minimizing operational errors and associated costs.

For pension funds and asset managers, risk mitigation and risk management through efficient post-trade processing has a direct impact on the performance of their investment portfolios, as every marginal opportunity for savings delivers to the bottom line. Asset owners, especially pension funds, are focused on returns and in the current environment, where it is not easy to differentiate performance and returns, asset owners or their appointed managers are even more fixated on operational efficiency and cost savings.

In addition to fund performance and cost reduction, pensions – partly as a result of the evolving regulatory environment – are increasingly focused on principles such as governance and controls, protection of member interests and safeguarding of assets. This means that when a pension can provide evidence that these principles are being adhered to — through excellence in operations and risk management, such as the adoption of a PvP settlement service to mitigate FX settlement risk — it satisfies the requirements of its members as well as relevant regulatory obligations.

In addition to settlement risk mitigation, CLSSettlement also enables pensions to benefit from:

Front office:
- Best execution
- Competitive FX pricing opportunities
- Liquidity savings – enabling funds to stay invested in markets

Middle office:
- Reduced funding requirements

Back office:
- More streamlined operations
- Reduction in payment instructions
- Elimination of overdrafts and fail trades

Still work to do

While there is a growing awareness of FX risks both globally and within Asia Pacific, there remains a pool of funds just starting to invest offshore that may be unaware of settlement risk.

Their settlement risk exposure will likely increase as the pension industry grows and continues to move toward offshore assets, including into the emerging markets. Despite an increasing number of pension funds settling their FX payments through a PvP mechanism such as CLSSettlement, there are still many funds with fewer middle office resources that have yet to adopt a solution to mitigate their FX settlement risk exposure.

Historically, it was often the case that the decision to settle FX payments through CLSSettlement was made by the asset manager appointed by the pension fund, rather than the pension fund itself. As a consequence, many pensions did not know about CLS or were unaware that some of their managers use CLSSettlement while others who also traded FX did not. The result of this was inconsistent protection against settlement risk across the accounts of the pension fund.

However, more recently we are seeing an increasing number of pensions – particularly some of the larger funds – proactively reviewing their asset manager appointments and custody accounts, to ensure all accounts across all asset managers are set up to settle in CLSSettlement. This trend is the result of an increased awareness amongst pension funds around settlement risk and the availability and benefits of a PvP option.

There are robust options available for pension funds aiming to mitigate their FX settlement risk.

Next steps for pensions considering how to mitigate their exposure to settlement risk

1. Identify all your accounts or mandates that are outsourced to external asset managers which execute FX
2. Understand who is executing the FX – whether it is the custodian, the asset manager or internal teams executing directly with a select panel of counterparties
3. If the FX is executed outside the custodian against a panel of counterparties, identify how the FX-related payments are settled
4. Determine if a PvP solution can help to mitigate settlement risk and understand the overall benefits of PvP settlement to the front, middle and back office relating to best execution, liquidity savings and operational efficiencies
5. Ask your custodian(s) about the FX settlement risk mitigation solutions they offer including a PvP solution through CLSSettlement
6. Discuss this approach with your appointed asset manager where relevant
7. Contact CLS directly with any further questions

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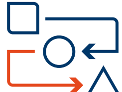
Settlement



Processing

Data

FX Global Code
Using CLS products and services plays an integral part in helping you comply with the FX Global Code. Find out more at cls-group.com

CLS helps clients navigate the changing FX marketplace – reducing risk and creating efficiencies. Our extensive network and deep market intelligence enable CLS specialists to lead the development of standardized solutions to real market problems. Our innovative, forward-looking products make the trading process faster, easier, safer and more cost-effective – empowering our clients' success.

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