FX Settlement Risk

Presentation to the New York Foreign Exchange Committee (FXC)

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Our Foundations

- CLS was established in 2002 by the private sector, in cooperation with a number of central banks to reduce the principal risk arising from settling FX transactions (i.e., settlement risk).
- The Committee on Payment and Settlement Systems (CPSS), which was renamed the Committee on Payments and Market Infrastructures (CPMI) in 2014, defines FX settlement risk as the risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought.
- CLS's settlement service (CLSSettlement) uses a payment-versus-payment (PvP) system to ensure that the final settlement of a payment instruction in one currency occurs if, and only if, settlement of the payment instruction for the currency being exchanged is also final.
- Today CLSSettlement settles payment instructions in 18 currencies for 70 settlement members and over 25,000 third-party customers.[1]

70+
settlement members

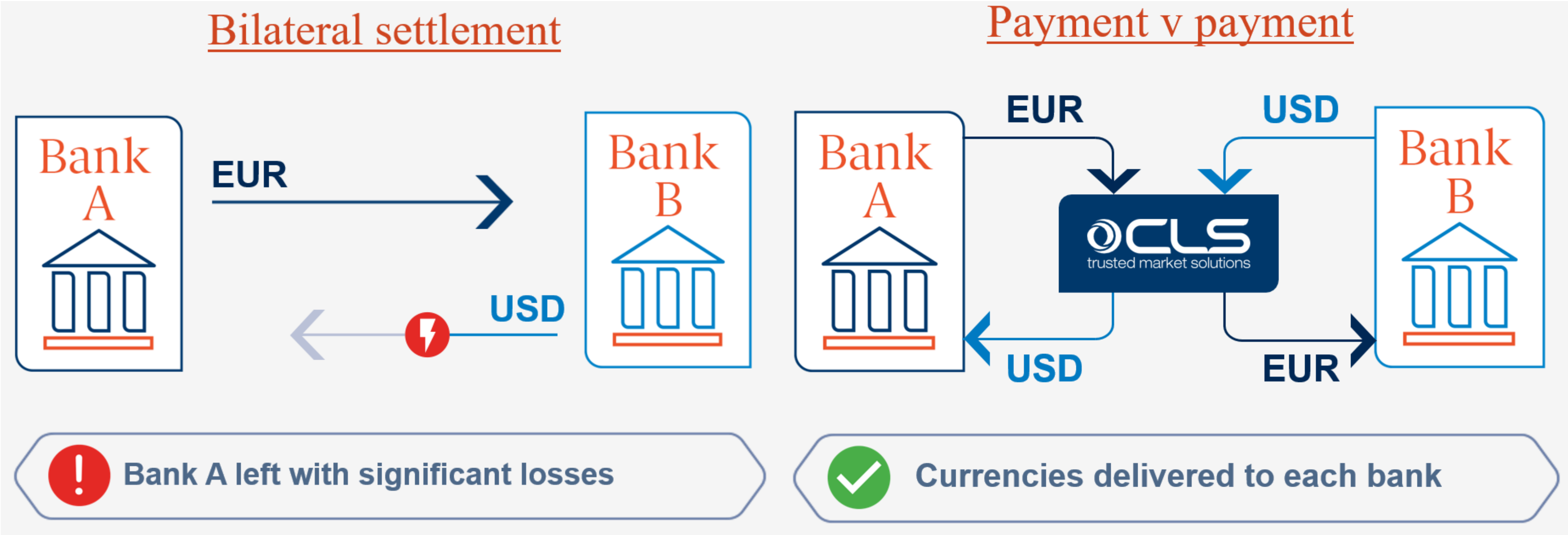
25,000+
participants around the world use our services indirectly through our settlement members

6.0+ USD trillion
average settled each day

18
of the most actively traded currencies globally

[1] 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.

Bilateral Settlement Versus PvP Protection



FX Settlement Risk

- The BIS Quarterly Review (December 2019) concluded that of the $18.7 trillion of daily gross FX payment obligations, $8.9 trillion of payments (approximately half) are at risk.[2]
  - This amount "at risk" had risen sharply since 2013.

- The decline in PvP protection is explained by two main factors: 1) a significant percentage of trades in CLS-eligible currencies are settling without PvP protection; and 2) the growth in currencies not currently eligible for settlement in CLS, which are largely settled without PvP protection.

- These two factors are explored on the following slides.

2. Bech and Holden: "FX Settlement Risk Remains Significant" (December 2019).

FX Settlement Risk – CLS-Settled Currencies

- According to the BIS 2019 Triennial Survey, CLS settles approximately 31 percent of FX transactions in the 18 CLS-settled currencies. The total volume of all CLS-settled currencies equates to USD5.34 trillion. The remaining 69 percent falls into two broad categories:

  1. **Category 1:** Approximately 31 percent of the USD5.34 trillion can be attributed to "related party trades" and "give-up trades of Prime Brokers" – trade types not usually sent to CLS.

  2. **Category 2:** Approximately 38 percent of the USD5.34 trillion are trades that may be eligible for CLSSettlement. The BIS data does not provide sufficient granularity to make an eligibility determination. These trades may include internalized trades, low value corporate trades, some portion of retail, and same-day trades.

- Category 1 and 2 trades have grown significantly (39 percent and 17 percent, respectively), between 2013 and 2019.

FX Settlement Risk – CLS-Settled Currencies (cont.)

- CLS is addressing settlement risk in the CLS-eligible currencies in three ways:
  - undertaking a deep-dive with a Tier-one bank, looking at its data in granular detail in order to understand what flow is not settling PVP and for what reason, as a precursor to further industry outreach;
  - evaluating industry codes to determine whether amendments could further promote PvP as a best practice for market participants; and
  - encouraging awareness of BCBS's "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions" (i.e., BCBS 241).

FX Settlement Risk – Other Currencies

Emerging Market Currencies Not in CLS:

- According to the BIS 2019 Triennial Survey, trades in which a non-CLS currency is on at least one side of the trade equate to approximately USD1.25 trillion – an increase from approximately USD930 billion (or 35 percent) since the BIS 2016 Triennial Survey.
- These currency pairs settle almost entirely without PvP protection. As both sides of these trades carry settlement risk, the risk is relevant not only for the non-CLS currencies, but also the counter-currencies: USD or EUR are on one side of roughly 90 percent of EM trades.[3]
- While the addition of currencies to CLSSettlement is a way to further mitigate FX settlement risk, CLS's ability to add more currencies is currently limited – few remaining currencies can meet the currency eligibility criteria, which have been developed to ensure compliance with the *Principles for Financial Market Infrastructures* and other applicable regulations.

3. The BIS 2019 Triennial Survey provides the USD percentage against all EM currencies. The EUR percentage is only given against certain EM currencies and has been extrapolated.

FX Settlement Risk – Other Currencies (cont.)

- If settlement risk in these currencies is to be mitigated, a fundamental consideration is whether a model that provides a form of PvP protection is better than the outright risk that is taken today in trading these currency pairs.

- If so, trade-offs and choices in the design of elements, which will be different to CLSSettlement, will have to be considered in order to achieve a model that can be implemented and can maximize broad-based risk mitigation.

- CLS assumes that PVP (in the sense of simultaneous settlement of the two currencies) would be part of the base-line proposition, but other parameters to be considered for striking the optimal balance between good risk design and achievability/adoption would include:

  - the form of finality;
  - socio-political requirements in the context of "rule of law";
  - gross settlement versus bilateral netting;
  - central bank versus commercial bank money; and
  - uniform requirements versus connectivity between different local systems.

Potential Next Steps

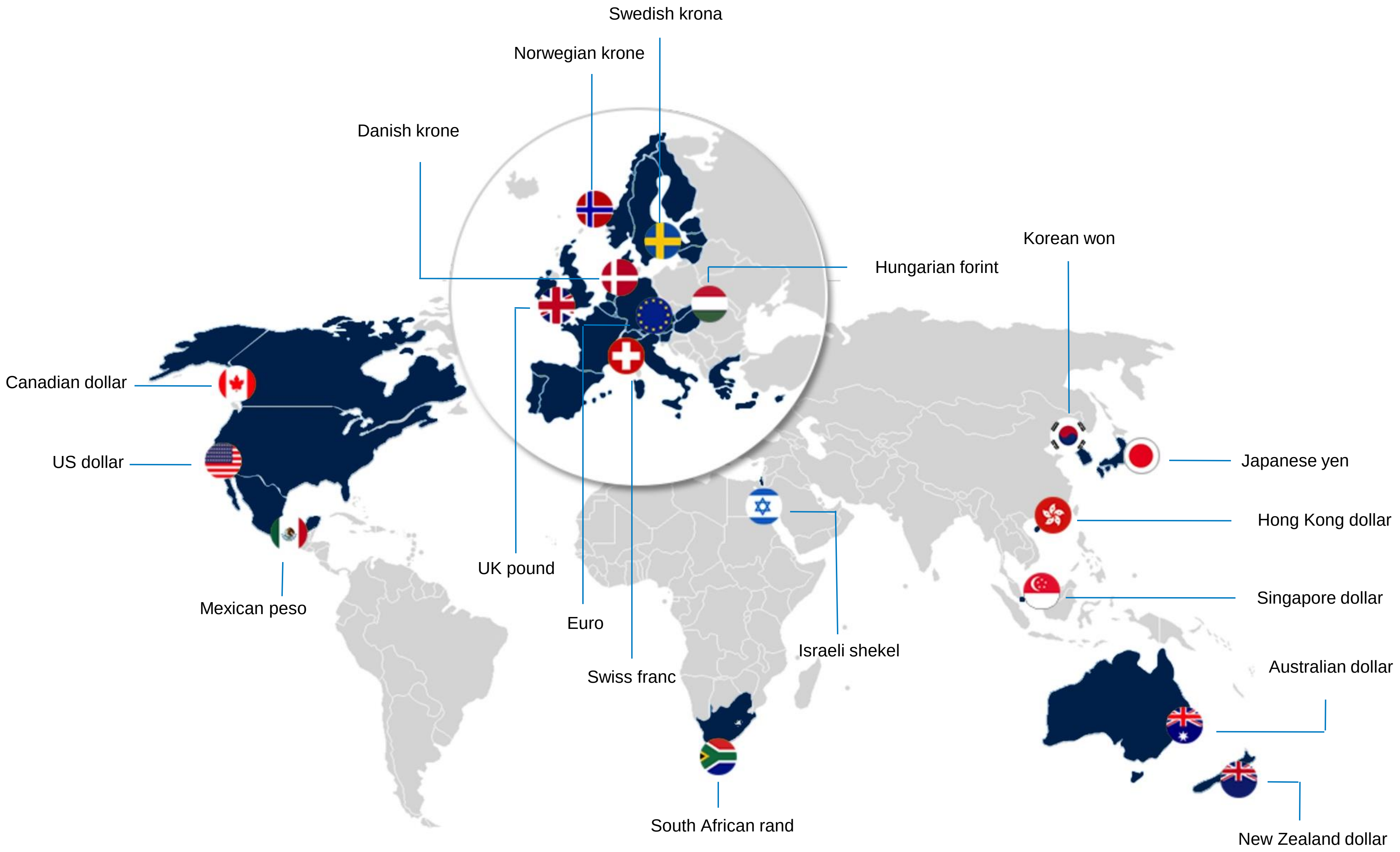
- While there are many important topics on the agenda of global regulators and the industry, CLS believes that with the need for further risk mitigation being highlighted by the BIS data and Quarterly Review, the current Covid-19 crisis, and the stressed credit environment into which the market is certainly heading, this is an important time for global regulators and the industry to consider these questions.

Potential industry actions:

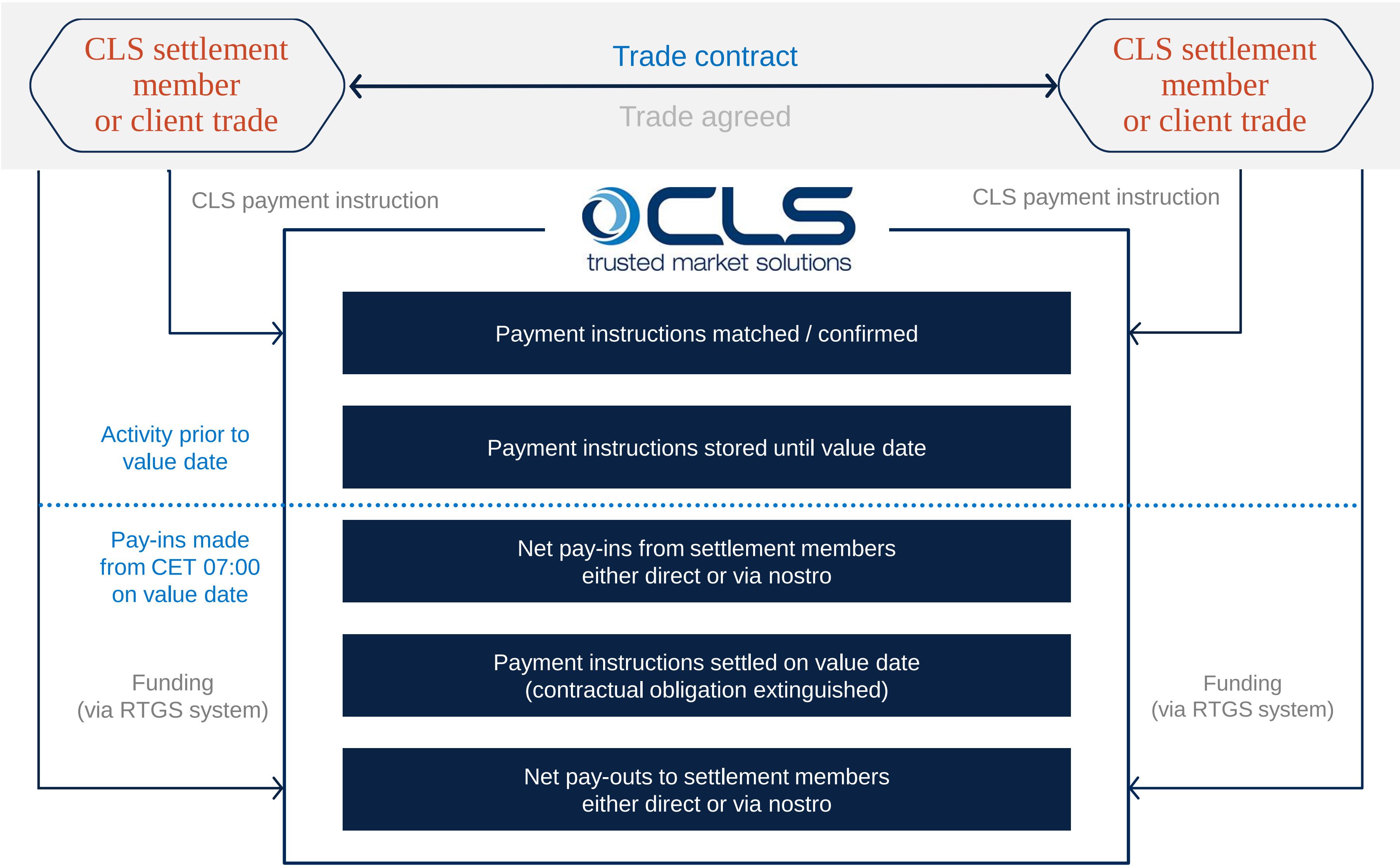
- A review of and possible strengthening of the current principles in the FX Global Code relating to the management and reduction of FX settlement risk (i.e., principles 35 and 50);
- Collecting data relating to FX settlement risk via the semi-annual FXC survey; and
- Coordinated work by the industry, policymakers, and CLS to advance the agenda of mitigating settlement risk.

Appendix

18 Currencies Eligible for CLSSettlement



How CLSSettlement Works within the FX Trade Lifecycle



Regulatory Supervision and Oversight

- CLS is regulated and supervised by the Board of Governors of the Federal Reserve System (Board of Governors) and the Federal Reserve Bank of New York (FRBNY).
- CLS Bank (i.e., the operator of CLSSettlement) was designated as a systemically important financial market utility (SIFMU) in 2012 by the U.S. Financial Stability Oversight Council (FSOC).
- Due to this designation, CLS Bank must adhere to enhanced standards for risk management, recovery, and wind-down outlined in the Federal Reserve Board's Regulation HH.[4]

[4] Regulation HH implements provisions of sections 805(a) and 806(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which outlines risk-management standards for FMUs that are designated as systemically important by FSOC and standards for determining when a designated FMU is required to provide advance notice of proposed changes to its rules, procedures, or operations that could materially affect the nature or level of risks presented by the designated FMU.

Regulatory Supervision and Oversight (cont.)

- FRBNY coordinates the CLS Oversight Committee (OC), which is a formal cooperative oversight arrangement established by central banks whose currencies (18) are settled in CLS plus five other Eurosystem central banks.[5]
- The OC is utilized to: 1) avoid duplication of effort by the central banks; 2) foster consistent, transparent communication between the central banks and CLS; and 3) enhance transparency regarding applicable regulatory policies in CLS jurisdictions.

Bank of Canada
Bank of England
Bank of France
Bank of Israel
Bank of Italy
Bank of Japan
Bank of Korea
Bank of Mexico
Bank of Norway
Central Bank of Hungary
Danmarks Nationalbank
Deutsche Bundesbank

European Central Bank
Hong Kong Monetary Authority
Federal Reserve Board and FRBNY (chair)
Monetary Authority of Singapore
National Bank of Belgium
Netherlands Bank
Reserve Bank of Australia
Reserve Bank of New Zealand
South African Reserve Bank
Sveriges Riksbank
Swiss National Bank

[5] The Eurosystem central banks include representation from Belgium, France, Germany, Italy, and the Netherlands.