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Keynote speech Marc Bayle de Jessé to the Central Bank Payments Conference

"The need for a new Public-Private Partnership to address growing FX settlement risk"

15 October 2020 – 14:05-14:35 CET

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Thank you Jean-Michel for that kind introduction, and thank you to Currency Research for the opportunity to speak at the Central Bank Payments Conference this year. Under more normal circumstances, many of us would be seeing each other in Cape Town – an opportunity to meet face-to-face and perhaps see some of the sights before the trip home. I am grateful to be here, albeit virtually, amongst such distinguished guests, friends, and former colleagues, particularly as the central bank community was at the core of CLS's origination and is vital to our success today.

CLS was created in 2002 through an unprecedented partnership between the industry and central bank community. There was a common objective to mitigate a risk, FX settlement risk, that had manifested itself in prominent bank failures - Herstatt, BCCI, and Barings Bank, to name a few - and led to widespread panic in financial markets. Although the launch of CLS reduced the amount of FX settlement risk in the market, there is evidence that FX settlement risk is on the rise and may be reaching levels that threaten global financial stability; particularly if a large market participant were to encounter distress or, in a worst case scenario, fail outright.

I strongly believe that the time to address this growing risk is now. We should not wait for the next large bank failure or market event to take action.

Today I am calling on the industry and regulatory community to create a new public-private partnership, like the one that created CLS almost 20 years ago, to promote the adoption of payment-versus-payment (PvP) settlement and to find a solution for currencies not currently eligible for PvP protection. Before outlining my views on this new partnership, I think it's important to first:

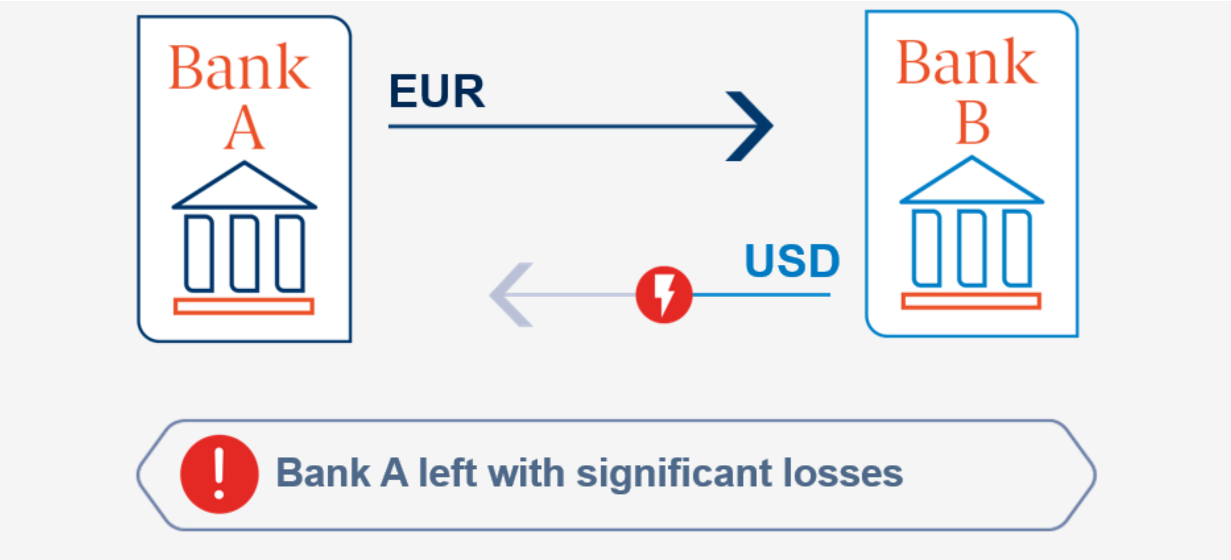
1. Provide a brief history of FX settlement risk and CLS's origins;
2. Explain the new evidence suggesting FX settlement risk is increasing;
3. Outline known obstacles to CLS currency expansion; and
4. Highlight CLS's efforts to promote PvP adoption and its thinking on a solution for non-CLS currencies.

Explanation of FX settlement risk

If you are not part of the foreign exchange ecosystem, you may be wondering: "What is FX settlement risk, and why is its mitigation so crucial for financial stability?" Simply put, FX settlement risk is the risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought. Because many currencies are paid at different times of the day, there could be a big timing gap between the payment of one currency and receipt of the counter-currency.

Here we have an example of a failed bilateral trade (see Figure 1). Bank A pays euros to Bank B and is expecting US dollars in return. However, due to an issue at Bank B – let's say an operational failure – Bank A does not receive the US dollars it is expecting. Further, Bank A already sent an equivalent amount of euros to Bank B. Such missed payments are typically made the following day with appropriate compensation, but what if Bank B collapses and Bank A loses the full amount of the principal?

Figure 1: Failed bilateral settlement



Such a loss of principal may be manageable if the amount is small, but the problem is that today's global FX market is anything but small. Recent estimates from the Bank for International Settlements (BIS) suggest that there is USD18.7 trillion of gross FX payment obligations per day.[1] Worse, a single failure could lead to a domino effect where an institution not receiving funds is unable to make payments to other banks - leading to a chain reaction that spreads losses throughout the financial system.

History of CLS and PvP

FX settlement risk is not a new issue on the regulatory agenda. The central bank community has sought ways to mitigate FX settlement risk to avoid a repeat of the widespread panic, freezing of interbank lending markets, and distrust in inter-bank relations experienced following Bankhaus Herstatt's collapse in June 1974.

During the 1980s and 1990s, the Committee on Payment and Settlement Systems (CPSS), now the Committee on Payments and Market Infrastructures (CPMI), carried out extensive research and analysis on FX settlement risk mitigation. During that same time, several notable bank failures placed urgency on the need for a solution. What many do not realize is that CLS's origins can be traced back to a recommendation outlined in a 1996 CPSS report.[2] The CPSS called on industry groups to develop multi-currency settlement and netting arrangements. Further, the central bank community was to show its support of industry initiatives and cooperate with these groups to ensure timely, market-wide progress.

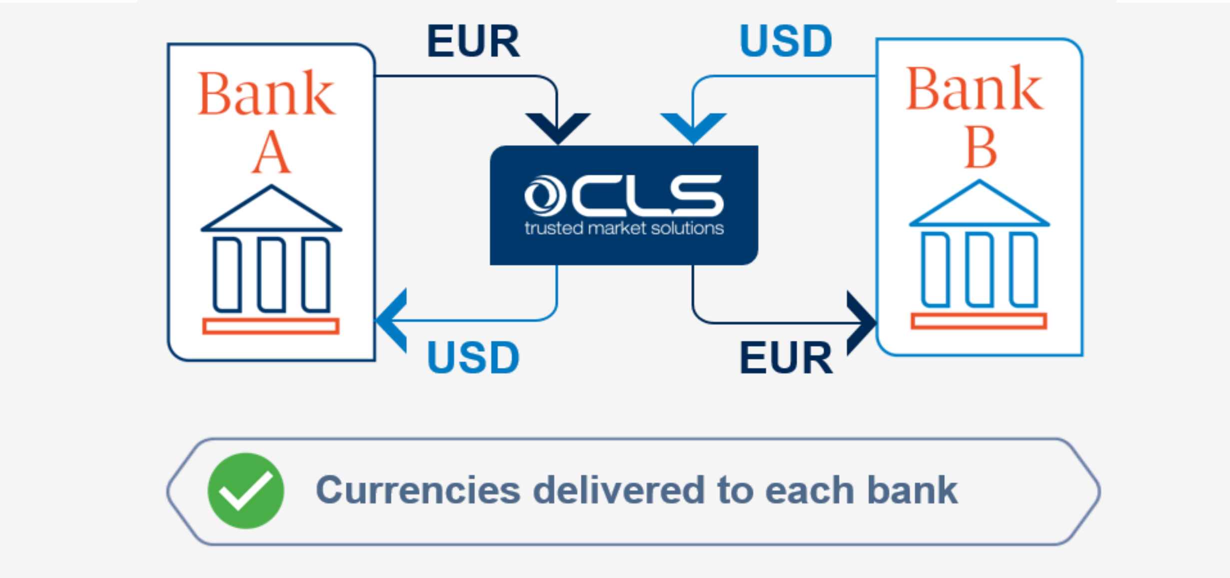
With these recommendations the public-private partnership responsible for CLS's creation was born. Twenty major financial institutions formed a group which, with support from the central bank community, refined the linked settlement concept – or PvP - that remains at the heart of CLS's settlement system today.

The next visual demonstrates PvP settlement and its risk mitigation benefits (see Figure 2). PvP ensures the final transfer of a payment in one currency occurs if, and only if, the final transfer of

[1] BIS: "BIS Quarterly Review - International banking and financial market developments", specifically Bech and Holden: "FX Settlement Risk Remains Significant" (December 2019).
[2] CPSS: "Settlement Risk in Foreign Exchange Transactions" (March 1996).

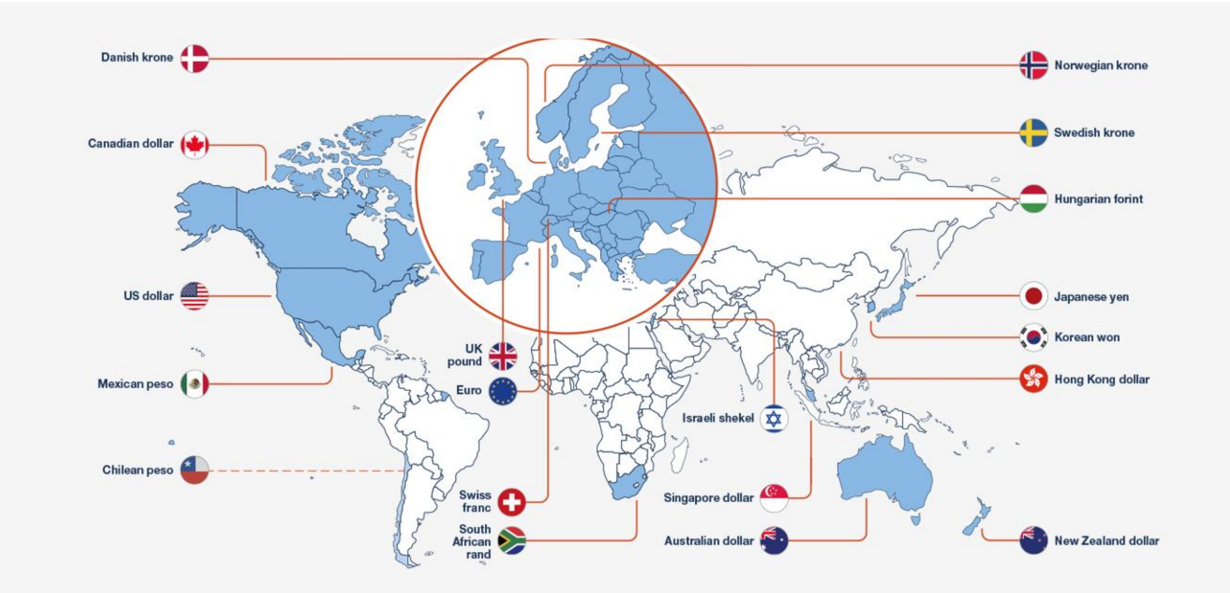
a payment in another currency (or currencies) takes place. With PvP, Bank A does not experience the same loss of principal as in the failed bilateral trade – it knows that its trades will settle in CLS with the significant risk mitigation provided by PvP.

Figure 2: PvP protection



It was because of this strong public-private partnership that CLS launched in 2002 with 39 settlement members and seven currencies. Fast forward almost twenty years, CLS is now a systemically important financial market infrastructure (FMI) settling on average USD6.0 trillion of payment instructions per day. Funding is determined on a multilateral netted basis, thereby reducing the amount of liquidity required for settlement by approximately 96 percent. Our membership comprises over 70 of the world's largest financial institutions. Approximately 28,000 indirect participants (primarily buy-side institutions) access CLS via our members. We currently settle 18 of the most actively traded currencies, with plans to add the Chilean peso to our settlement system in 2022 (see Figure 3).[3]

Figure 3: CLS eligible currencies



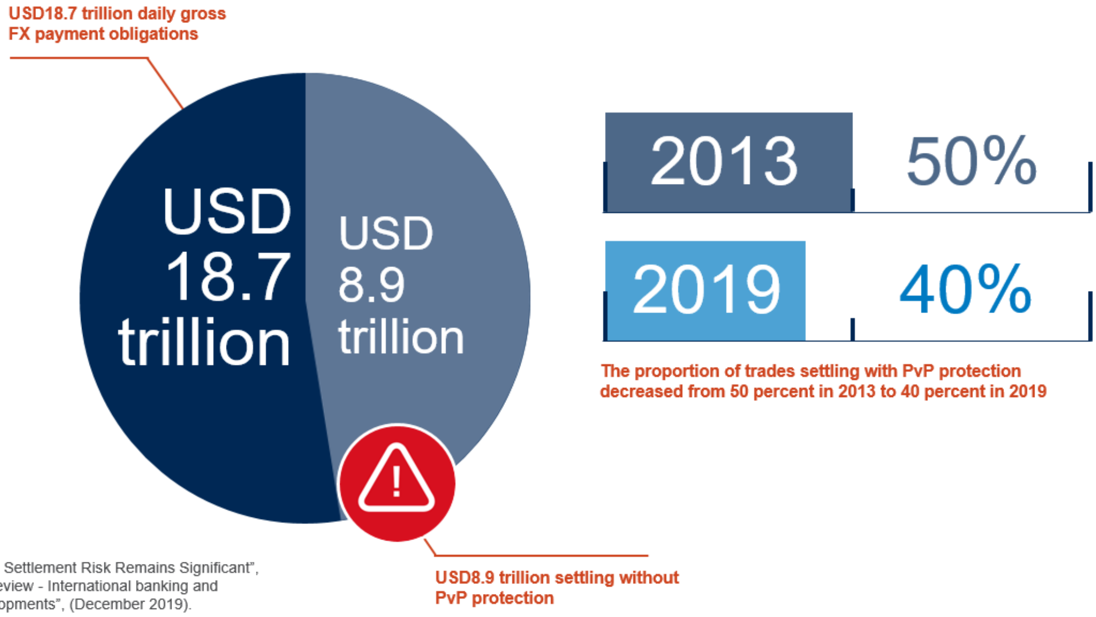
[3] Australian dollar, Canadian dollar, Danish krone, euro, Hong Kong dollar, Hungarian forint, Israeli shekel, Japanese yen, Korean won, Mexican peso, New Zealand dollar, Norwegian krone, Singapore dollar, South African rand, Swedish krona, Swiss franc, UK pound sterling and US dollar.

Further, the 18 central banks whose currencies are settled in CLS, plus five other Eurosystem central banks, have established the CLS Oversight Committee; a formal cooperative oversight arrangement coordinated by the Federal Reserve Bank of New York. 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.

Growing FX settlement risk

You may be thinking “Great! CLS has this FX settlement risk problem solved!” Unfortunately, the solution to FX settlement risk is not that easy. On the contrary, recent data published by the BIS suggests that FX settlement risk is on the rise.[4] Of the USD18.7 trillion of daily gross FX payment obligations, USD8.9 trillion are settling without PvP protection and therefore may be “at risk”. The BIS’s data also suggests that the proportion of trades settled with PvP protection has decreased from 50 percent in 2013 to 40 percent in 2019 (see Figure 4). Further, settlement risk is not only increasing for currencies that are not settling in CLS – these include currencies like the Chinese renminbi, Russian ruble, and Turkish lira – but might be increasing for currencies that are eligible for settlement in CLS.

Figure 4: Growing FX Settlement Risk



Bech and Holden: “FX Settlement Risk Remains Significant”, BIS: “BIS Quarterly Review - International banking and financial market developments”, (December 2019).

Obstacles to CLSSettlement adoption and currency expansion

Your immediate reaction is probably “Why?”. To elaborate a bit: 1) “Why are CLS-eligible trades not settling in CLS?”; and 2) “Why is there no global solution for key emerging market currencies?”. These are the same questions that CLS, the industry, and regulatory community are now taking steps to answer.

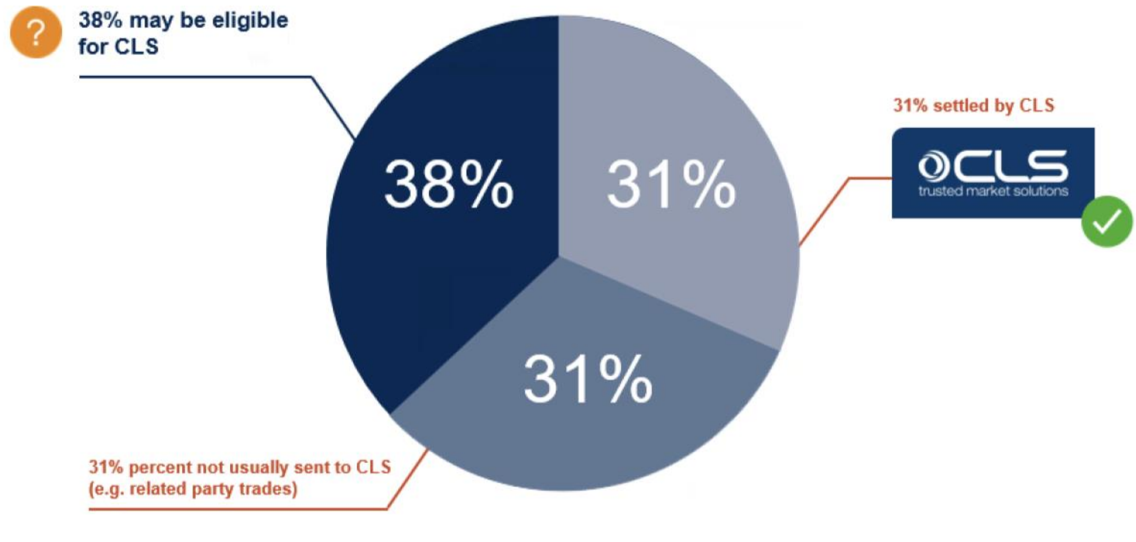
Let’s start with the first question. Although settlement risk is measured by gross payment obligations (i.e., the actual payments that come out of a trade), for comparative purposes, the market looks at traded notionals. All the references provided from this point are based on traded volume, as measured and reported by the BIS and CLS’s own data.

[4] Bech and Holden: “FX Settlement Risk Remains Significant” (December 2019).

CLS conducted its own analysis and concluded that the total daily volume of CLS-eligible currencies equates to USD5.34 trillion (see Figure 5). CLS settles 31 percent of those eligible transactions. This means that 69 percent of transactions in CLS-eligible currencies are not settling in CLS.

Our analysis suggests that approximately 31 of the 69 percent are trades not usually sent to CLS, such as related party trades (or trades between two legal entities of a global bank) and give-up trades of prime brokers. The remaining 38 of the 69 percent may be eligible for CLS settlement, but the BIS data lacks the granularity needed to make an eligibility determination. Such trades could include internalized, low value corporate, retail, and same-day trades.

Figure 5: Settlement of CLS-eligible currencies (USD5.34 trillion total volume)



Source: CLS analysis (2020).

For CLS, this remaining 38 percent is our core area of focus, and we are in the process of reviewing the trade data of one of our largest settlement members to better understand what CLS-eligible trades are and are not settling in CLS, and for what reason.

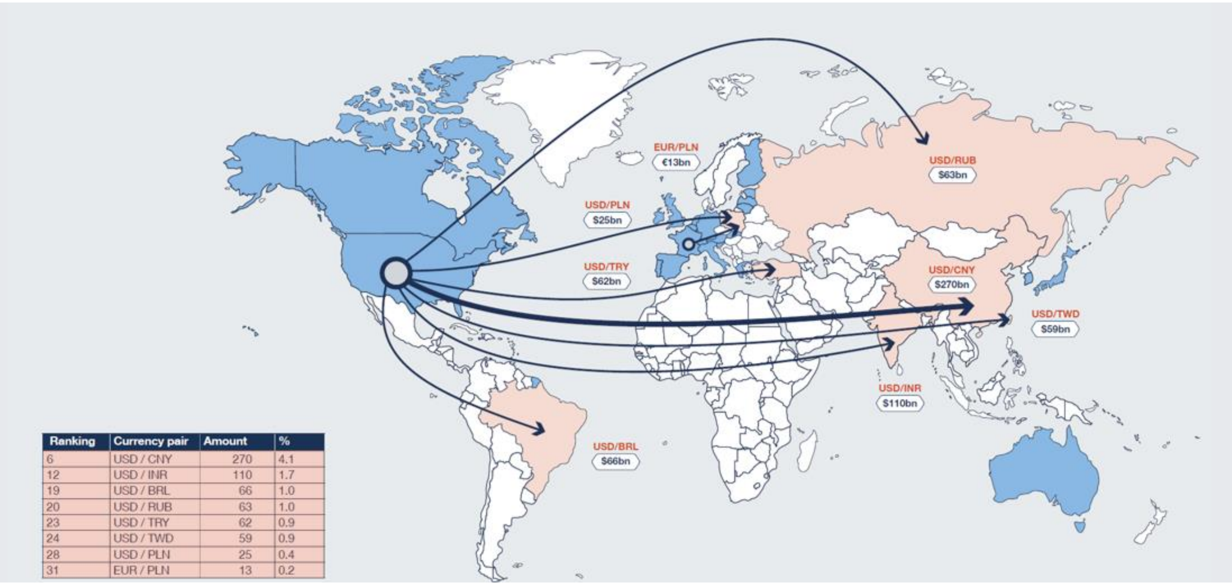
Going back to the second question – “But what about currencies not eligible for settlement in CLS?”. The BIS’s data suggests that emerging market currency volume equated to USD1.25 trillion in 2019 – roughly as large as the entire FX market in 2001 (USD1.2 trillion), just prior to CLS’s launch. Further, growing FX settlement risk should not be a concern to only emerging markets. Central banks of developed markets should take interest in growing settlement risk in non-CLS currencies as these currencies are traded globally with G10 currencies such as the USD and EUR on the other side of the trade. As a result, any failure in these trades could impact the entire financial system. This is visually demonstrated by the following visuals: the top 10 currency pairs (see Figure 6), followed by the top 35 pairs where a non-CLS currency is on at least one side of the trade (see Figure 7).

Figure 6: Top 10 currency pairs (2019 FX Turnover)

Ranking	Currency pair	Amount	%
1	USD / EUR	1,584	24.0
2	USD / JPY	871	13.2
3	USD / GBP	630	9.6
4	USD / AUD	359	5.4
5	USD / CAD	287	4.4
6	USD / CNY	270	4.1
7	USD / CHF	228	3.5
8	USD / HKD	220	3.3
9	EUR / GBP	131	2.0
10	USD / KRW	126	1.9

Data source: BIS: Triennial Central Bank Survey – Foreign exchange turnover in April 2019 (September 2019).

Figure 7: Non-CLS settled currencies - Top 35 currency pairs (2019 FX turnover)



Ranking	Currency pair	Amount	%
6	USD / CNY	270	4.1
12	USD / INR	110	1.7
19	USD / BRL	66	1.0
20	USD / RUB	63	1.0
23	USD / TRY	62	0.9
24	USD / TWD	59	0.9
28	USD / PLN	25	0.4
31	EUR / PLN	13	0.2

Data source: Source: BIS: Triennial Central Bank Survey – Foreign exchange turnover in April 2019 (September 2019).

The harsh reality is that many countries seeking PvP protection may not be able to obtain it under the current regulatory regimes applied to FMIs offering such services. For example, few remaining currencies can meet CLS's currency onboarding standards, which (as a systemically important FMI) derive from the *Principles for Financial Market Infrastructures* (PFMI), other applicable regulations, and CLS's own standards. Principle 1, legal basis, and Principle 8, settlement finality, have presented the largest obstacles to onboarding new currencies to CLS's settlement system.

In the case of the Chilean peso, CLS resumed talks with the Banco Central de Chile upon the passage of Chile's settlement finality legislation. Passing new legislation to pave the way for CLS onboarding is not an easy task, and not all jurisdictions will be able to, or have the political will to, enact such changes. The central bank of Chile should be applauded for its efforts and commitment to join the CLS ecosystem.

CLS's efforts to promote PvP adoption

So, where does this leave us, the industry and regulatory community, in solving this growing risk to financial stability? Since the publication of the BIS Quarterly Review in December 2019, CLS has taken several steps to promote awareness of growing FX settlement risk and to support further PvP adoption. Our strategy has three short-term objectives: 1) educate key stakeholders about growing FX settlement risk; 2) strengthen the FX Global Code; and 3) advocate for better, high-quality data collection via the semi-annual turnover surveys of regional Foreign Exchange Committees (FXCs). I am pleased to say that a number of central banks, as well as CLS's Oversight Committee, have expressed support for these efforts to date.

Specific to our first objective, education, we recently published a white paper on our website titled *"Unsettling: the increase of foreign exchange without settlement risk mitigation."*[5] The paper is a great primer, as we wrote it assuming much of the industry and regulatory community may not know about: 1) FX settlement risk or its growth in recent years; 2) CLS and its systemically important PvP settlement system; or 3) the obstacles CLS faces with respect to currency expansion. Additionally, CLS has been invited to present to the Global Foreign Exchange Committee (GFXC) and several regional FXCs on the topic. We hope to build new relationships with emerging market local FXCs and other central banks whose currencies do not settle in CLS. For those listening today, please feel free to reach out to me or perhaps the Currency Research team after the conference, who can make the connection. We very much welcome your engagement.

Shifting to objectives two, strengthening the FX Global Code, and three, improved data collection, we are encouraged by the GFXC's leadership in these areas. We believe that Principles 35 and 50, the settlement risk principles of the Code, should be strengthened to better promote the use of PvP settlement mechanisms. Should PvP not be available, risk management practices and controls, for example binding settlement risk limits, should be in place to mitigate remaining FX settlement risk. The GFXC also stated it would engage its member FXCs to consider ways to leverage the semi-annual turnover surveys to obtain a better understanding of trends in settlement activity. Any new solution that mitigates FX settlement risk will greatly benefit from efforts to obtain an improved picture of current FX settlement practices.

Solutions for non-CLS currencies

CLS has started to formalize its views around a solution for non-CLS currencies. At a foundational level, we believe a degree of agile or flexible thinking is required – the solution may take a much different shape to what CLS is today. A new, different solution does not necessarily equate to throwing security or proper risk management practices out the window. Instead, any new solution should be viewed as an opportunity to remove FX settlement risk from global financial markets.

Here are just a few key questions that require further debate by the industry and regulatory community:

What is the optimal model type?

As mentioned earlier, CLS's multilateral, strictly standardized, and centralized settlement finality model is not attainable for many currencies. Where multilateral netting cannot be achieved, a bilateral netting solution with PvP settlement would still provide a degree of liquidity benefit and be hugely valuable in mitigating FX settlement risk. To that end, CLS has created a bilateral netting service for these currencies, called CLSNet, that may be a starting point for a solution that includes PvP settlement. Should CLSNet serve as the initial building block, you could have

[5] CLS: "Unsettling: the increase of foreign exchange without settlement risk mitigation." (July 2020)

a series of tailored PvP settlement systems with groups of two or three countries with strong currency and economic ties. Such an approach would increase PvP adoption in parts of the world that currently do not have access to it.

What is the appropriate account type?

CLS has accounts with each of the 18 central banks, soon 19 with the Chilean peso, whose currencies are part of our system. Our settlement members pay and receive funds via these central bank accounts. Many emerging market countries recognize CLS as a foreign entity, and as a result CLS would need to leverage third-party banks in these countries to enable any transfer of funds. Our accounts could be identified in the book of the central bank, but the account would not be in CLS's name. If such an arrangement is not possible, CLS would need to utilize a commercial bank to hold and secure funding.

What are the structures that will achieve acceptable finality?

I find that discussions of settlement finality often invoke a feeling of fear and dread, particularly with central bankers. A centralized means of achieving finality, which is equally recognized by all participating jurisdictions, is necessary for a multilateral and systemically important FMI like CLS. Any country wishing to join CLS, as noted earlier with Chile, would need to adjust their domestic rules or legislation to align with CLS's standards. However, outside of CLS, finality exists in most countries' payment systems and may provide a basis to achieve finality in each currency without resorting to a centralized standard. For example, if a new, bilateral PvP solution is created between the US dollar and a non-CLS currency, you could rely on the rules of those two countries independently, provided a degree of simultaneous settlement could be achieved. Should there be simultaneous settlement and adequate legal certainty, you could then align to the existing laws of those jurisdictions rather than wait for a change in domestic rules or legislation.

What type of standards would apply to a new solution(s)?

Existing standards, such as the PFMI, applied to PvP settlement mechanisms like CLS are appropriate for the systemically important role these firms play in global financial markets. Any new solution for non-CLS currencies may not rise to the same level of systemic importance as CLS, at least not initially, but will need to be mindful of a potential future state where the solution may breach systemically important thresholds. Consideration should be given to what standards should apply: the existing standards that apply to systemically important FMIs (i.e., the PFMI); new standards; or an adaptation of the PFMI. The guiding principle is not to dilute standards that have served FMIs well, but to ensure standards are not an absolute barrier to the mitigation of risk. The key question, and a question that would need to be asked repeatedly over time as the market's use of any such solution evolves, is what risk management practices are required given the scope, nature, and size of the activity performed.

These are just some of the many questions that will require an agile and flexible approach when developing a new solution for non-CLS currencies. While a lot of attention in this space has been given to the potential of private stablecoins or central bank digital currencies, these are simply a way of delivering payments. These options do not detract from the fact that a comprehensive payment solution covering the elements I just outlined needs to be considered as a matter of policy. CLS welcomes further discussion on these issues.

The need for a new Public-Private Partnership

To conclude, we must decide, and decide quickly, if a new, different type of model is the preferred path forward over no solution at all. Right now, we are at a pivotal crossroads – we can choose to actively pursue a solution for this threat to financial stability or stand by and do nothing.

The choice is clear to me. I am calling on the industry and regulatory community to form a new public-private partnership, similar to the one that created CLS in 2002. This partnership should build upon the GFXC's efforts to promote PvP adoption and, importantly, agree to a solution, or solutions, for non-CLS currencies.

The path forward is not a smooth one. Complex questions require answers, and compromises need to be made. A successful cross-border solution will be wholly dependent on strong global cooperation. Partisanship and politics must be avoided. The key question is: "Are we up to the challenge?". Given what is at stake, we must be ready, and I know we are ready. CLS and its operations today are evidence that when the industry and regulatory community work together, the financial market's toughest challenges can be solved.