



Mitigating settlement risk:

In a fragmented world

In a global landscape marred by economic uncertainty and increasing geopolitical complexities, market participants are more focused than ever on mitigating risks and optimizing liquidity. As the industry grapples with these challenges, the role of CLS becomes ever more critical.

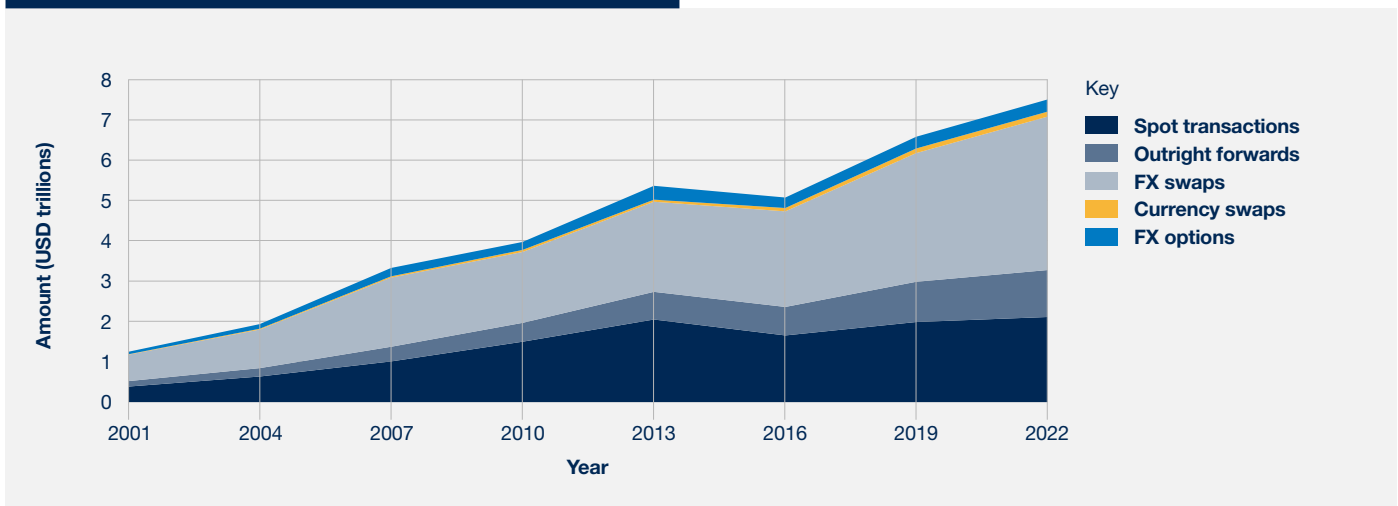
FX payment-versus-payment

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International economic activity depends on the smooth functioning of cross-border payments, which often involve the settlement of an FX transaction. A key risk in FX transactions is settlement risk – the risk that one party delivers the currency it sold but does not receive the currency it bought, resulting in a loss of principal. To mitigate this risk, CLS provides FX payment-versus-payment (PvP) settlement to ensure that the final transfer of a payment in one currency occurs if, and only if, the final transfer of a payment in the counter currency takes place.

Today, CLS’s PvP service, which currently settles over USD6.5 trillion of payment instructions daily across 18 currencies, is considered the de facto market standard for tackling FX settlement risk. PvP’s importance is widely recognized by public and private sector initiatives such as the Basel Committee on Banking Supervision (BCBS), which recommends using PvP settlement where practicable, the G20 Roadmap for enhancing Cross-Border Payments, which inter alia aims to facilitate increased adoption of PvP, and the FX Global Code.

Figure 1: Global FX market turnover by instrument



Emerging market currencies

“Recent [FX market] growth can be increasingly attributed to emerging market currencies.”

Since its establishment in 2002, CLS has helped enable market growth, with FX turnover multiplying fivefold (figure 1). However, recent growth can be increasingly attributed to emerging market (EM) currencies, for which PvP services are largely unavailable. In approximately 20 percent of all FX trades, one or both legs involve an EM currency not supported by CLS’s settlement service. To achieve higher PvP rates for those currencies, progress is needed.

Given its systemic importance, adding new currencies to CLS’s settlement service is an extended effort subject to several requirements, including ongoing support from the relevant central bank and the industry, and the target jurisdiction’s laws and regulations may need to be changed.

CLS has been exploring several ways to expand PvP coverage, including an alternative PvP service for EM currencies. However, progress in this area must overcome regulatory and geopolitical challenges, and it will require public and private sector stakeholders to closely collaborate over multiple years to arrive at an industry solution. For now, CLS is focusing on growing CLSNet, its automated bilateral payment netting calculation service for over 120 currencies.

Emerging market settlement risk

CLSNet helps to mitigate operational risk associated with trading EM currencies. By standardizing and automating the netting calculation process, it facilitates the reduction of the payment obligations exposed to settlement risk while improving operational and liquidity efficiencies. As a result, the flows in CLSNet have increased exponentially, and the service recorded a year-on-year increase of over 400% in average daily volume of net calculations. Crucially, a significant portion of the interbank transaction flow through CLSNet is in the deliverable EM currencies that pose the most settlement risk for CLS settlement members.

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New challenges

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While CLS continues to innovate in the realm of settlement risk, other market developments demand attention. As the US and Canadian securities markets move to T+1, market participants face new challenges, including time constraints that may limit the use of CLS's settlement service. This could increase FX settlement risk and liquidity needs. Recognizing the impact on FX post-trade processes, CLS has engaged with settlement members and industry bodies, forming an advisory group to address these issues. To ensure operational efficiency in this T+1 landscape, CLS offers tools to support the asset manager and fund communities, such as CLSNet and CLSTradeMonitor – a service offering near real-time visibility of all FX payment instructions submitted to CLS's settlement service regardless of custodian or broker, allowing for swift identification and resolution of exceptions.

As it has done for over two decades, CLS stands ready to work with policy makers and support its settlement members and the wider community through the evolution of the FX ecosystem.

Trusted by thousands of counterparties within the global FX ecosystem, CLS makes FX safer, smoother and more cost effective. Trillions of dollars' worth of currency flows through our systems each day.

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