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

Addressing the key issues in cross-border payments

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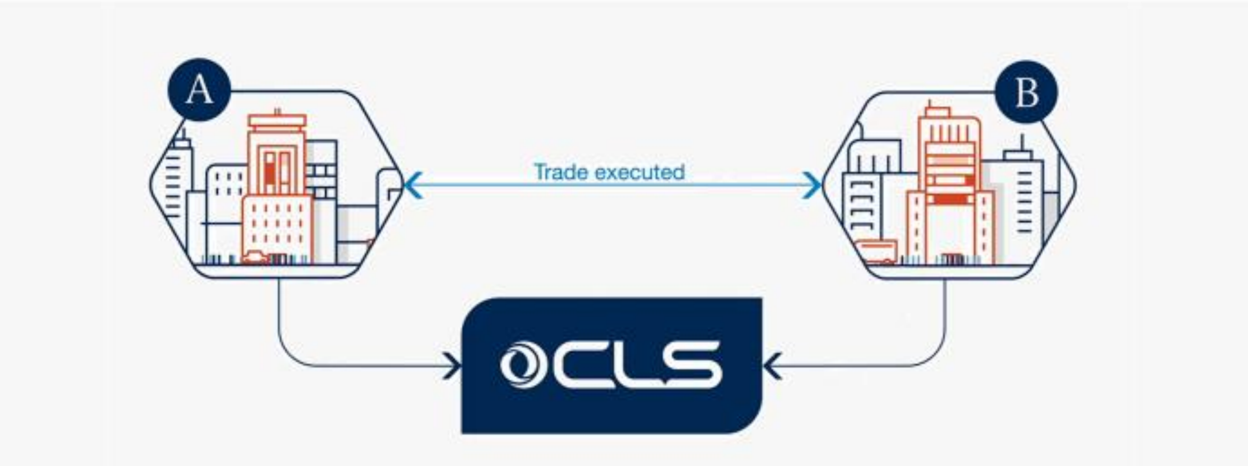
I would like to thank Jean-Michel and Currency Research for the opportunity to talk on the topic of cross-border payments and the mitigation of settlement risk, as well as what CLS is doing to address these issues. Hopefully, in the not too-distant future, we will be able to meet in person again to discuss and debate these issues. But, for now, we must make do with the virtual world.

Public policy initiatives and settlement risk

First, I would like to pick up from Victoria's comprehensive update on the progress the CPMI and FSB have made on the roadmap to enhancing cross-border payments.[1] It's encouraging to see that the majority of milestones for 2021 have been successfully completed or are close to being finalized, and that the overall roadmap remains firmly on track. We, at CLS, applaud the work that has been conducted by participating authorities.

Cross-border payments sit at the heart of international trade and economic activity and, by their very nature, involve the settlement of an FX transaction which requires counterparties to exchange principal in two currencies. But what if one party to the transaction collapses? The result would be a loss of principal. This risk is best mitigated by having an appropriate PvP settlement mechanism in place (see **Figure 1**).

Figure 1: PvP settlement mechanism



Such a loss of principal may be manageable if the amount is small. However, today's global FX market is anything but small – it is the largest financial market in the world with an average daily turnover of USD6.6 trillion.[2] And in recent years, regulators and industry participants alike have become increasingly concerned that FX settlement risk may be reaching levels that threaten global financial stability.

At CLS, we have been particularly focused on building block 9 of the FSB Roadmap, which focuses on facilitating increased adoption of payment-versus-payment, or PvP, settlement mechanisms. The objective of this is to mitigate the settlement risk that occurs during a cross-border payment which typically involves two or more currencies. However, the proportion of FX trades not settled on a PvP basis has increased in recent years, exposing FX market

[1] FSB: "Enhancing Cross-border Payments: Stage 3 Roadmap" (October 2020)
[2] BIS: "Triennial Central Bank Survey of Foreign Exchange and Over-the-counter Derivatives Markets in 2019" (December 2019)

participants to substantial FX settlement risk. I will explain the reasons for this in more detail shortly.

As a result, we are encouraged by the FSB's assertion, in its latest update, that the Committee on Payments and Market Infrastructures (CPMI) "will develop proposals for increased adoption of PvP by encouraging enhancements to existing PvP arrangements and/or (ii) the design of new public sector and/or private-sector solutions for PvP arrangements that currently do not exist by April 2022".[3]

CLS's role is to strengthen resilience and efficiency in the FX ecosystem, and we have long advocated for greater PvP adoption to mitigate FX settlement risk, working closely with both the public and private sectors to highlight its importance. And we fully support the FSB Roadmap's efforts in this area. Our most recent activities have included establishing a working group and industry pilot to explore alternative PvP solutions, as well as speaking at industry events on the topic and presenting at the Global Foreign Exchange Committee and several regional FX committees in order to raise awareness of the issue.

CLS will be celebrating its 20th anniversary next year, and during my time with you today I would like to discuss:

1) What the industry has achieved in mitigating FX settlement risk
2) The work underway to further mitigate this risk
3) CLS's role in supporting the industry in the future.

However, before I start I think it's important to provide an overview of why settlement risk is increasing.

Settlement risk and why it is on the rise

In our conversations with our settlement member banks, it has become apparent that the increase in settlement risk is being driven primarily by an increase in the turnover of non-PvP settled trades in emerging market currencies. This is supported by the Bank for International Settlements 2019 Triennial Survey, where trades in which a non-CLSSettlement-eligible 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.[4] While US dollar and euro are on one side of the vast majority of these trades, without PvP settlement, both sides carry FX settlement risk for CLS settlement members and other market participants.

These findings have resulted in a heightened focus on overall risk management in cross-border payments, with both the public sector and market participants expressing particular concern about rising FX settlement risk and calling for greater adoption of PvP mechanisms as the optimal solution to mitigate it. In addition to the work being carried out by the FSB and CPMI to tackle settlement risk, there is a second public policy initiative addressing the issue - the three-year review of the FX Global Code undertaken by the Global Foreign Exchange Committee.

Published earlier this year, the updated version of the Code includes amendments to the key principles concerning settlement risk – principles 35 and 50 – placing greater emphasis on the use of PvP settlement mechanisms where available and providing more detailed guidance on the management of settlement risk where PvP settlement is not used (see **Figure 2**). I believe the changes to the Code will encourage FX market participants to explore ways to mitigate risk further and reduce operational costs by adopting a best practice approach to FX settlement risk management and netting.

[3] FSB: "G20 Roadmap for Enhancing Cross-border Payments - First consolidated progress report." (October 2021)
[4] BIS: "Triennial Central Bank Survey of Foreign Exchange and Over-the-counter Derivatives Markets" (2016 and 2019)

Figure 2: FX Global Code – settlement risk principles (35 and 50)

Principle 35

Market Participants should reduce their Settlement Risk by settling FX transactions through services that provide PvP settlement where possible. The use of automated settlement netting systems is encouraged.

Principle 50

Market Participants should properly measure, monitor and control their Settlement Risk where PvP is not available. The recent updates to Principle 50 place a greater emphasis on the confirmation process of bilateral netting and the agreement of predetermined cut-off points.

What the industry has achieved in mitigating FX settlement risk

CLS's unique position at the center of the FX market positions us perfectly to work with both the public and private sector, collaborating widely across the industry, and enabling us to find solutions for challenges the FX industry faces. Therefore, to address the issue of wider PvP adoption and to deliver improvements to cross-border payments, we are encouraged to see collaboration between the public and private sectors. In order to create successful industry solutions, it is essential that policymakers engage with market participants during the early stages of new market infrastructure initiatives to identify and develop optimal models – in this case, an optimal alternative PvP solution. This approach is crucial to ensure that the market's needs are truly understood and that the preferred solution obtains sufficient investment and support from the industry.

CLS itself was established in 2002 as a result of unprecedented cooperation between the industry and central bank community. Twenty major financial institutions combined forces, with support from central banks, and refined the PvP concept that remains at the heart of CLS's settlement system today. Now, nearly 20 years later, we continue to work closely with central banks and regulators and partner with leading commercial banks, global corporations and financial institutions to mitigate systemic risk – and we will continue to do so by developing an alternative PvP solution for the FX industry.

Work underway to further mitigate this risk

So what more is CLS doing to address settlement risk today? Over the last 20 years, CLSSettlement volumes have risen significantly, which is testament to the current value we are providing in mitigating settlement risk in the FX industry. We currently settle on average approximately USD6 trillion[5] each day across 18 currencies[6], accounting for a large proportion of FX trades in the market. We support over 70 of the world's leading financial institutions who, as settlement members, are direct participants in CLS.

[5] CLS settles payment instructions related to underlying FX transactions. It receives payment instructions for both sides of the trades, and both sides are counted in this figure. In the BIS Triennial Survey, the BIS uses the executed trade volume reporting convention (i.e. the bought currency values, or one leg of the trade, to avoid double counting the total amount of trades).

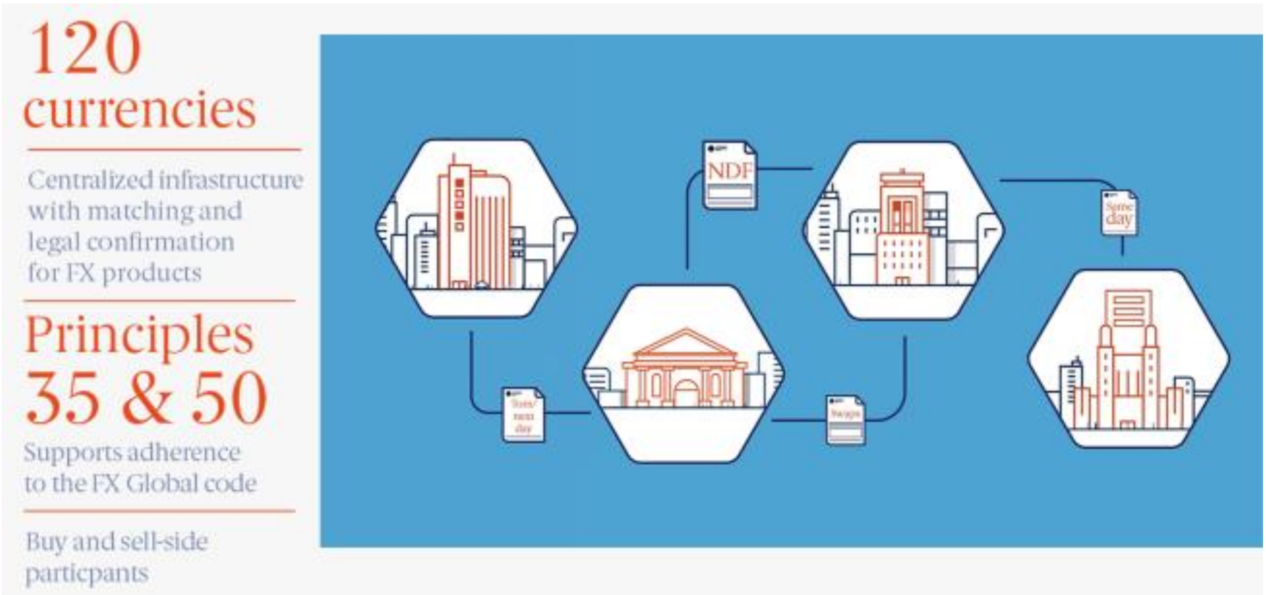
[6] Australian dollar, Canadian dollar, Danish krone, euro, Hong Kong dollar, Hungarian forint, Israeli shekel, Japanese yen, Korean won, Mexican peso, New Zealand dollar, Norwegian krone, Singapore dollar, South African rand, Swedish krona, Swiss franc, UK pound sterling and US dollar.

In addition to global banks, we have more than 28,000 third-party clients around the world accessing our service indirectly through our settlement members. These include banks, funds, non-bank financial institutions and multinational corporations. We are actively engaged with our third-party participants, and activity from this community continues to be a major contributor to growth in CLSSettlement. Over the past year, average daily gross value settled by third parties increased by 18 percent.

The asset manager community has overwhelmingly driven this increased third-party adoption of our PvP settlement system, with much of the growth propelled by FX activity from increased cross-border pension fund investment. Such market participants recognize that they need a strong infrastructure that can mitigate the risk that arises from FX trading, as well as deliver liquidity and cost benefits. Additional growth can be attributed to firms moving to a multi-dealer model and not always trading FX with their custodian bank where settlement risk is eliminated, hence the need for a settlement platform offering risk mitigation and efficiencies. With asset managers taking FX settlement risk more seriously and looking to find cost savings, many are now re-thinking their traditional approaches towards FX settlement. As part of this shift, we are working with custodians to explore ways to expedite the onboarding of new participants. We expect the growth of third-party participants in CLSSettlement to continue.

To provide risk mitigation and operational efficiencies for trades not settling in CLSSettlement, we launched CLSNet in 2018 (see **Figure 3**). Available for over 120 currencies, the service supports the standardization and automation of post-trade matching and netting processes. The CLSNet user community includes major global banks as well as several leading regional banks.

Figure 3: CLSNet overview



In addition to existing CLS settlement members, CLSNet can be used directly by non-CLS banks and the buy side, enabling a wider group of market participants to benefit from the reduction in operational costs and mitigation of risk the service delivers. To further support broad-based adoption of CLSNet within this community, we are collaborating with other FX ecosystem service providers to expand connectivity options and evolve the functionality of the service.

CLS's role in supporting the industry in the future.

CLS Working Group and industry pilot

CLSNet was a great addition to our suite of risk mitigation solutions, but it is clear that the industry now requires an alternative PvP mechanism for currencies that are not currently eligible for CLSSettlement. With this in mind, late last year, we established a working group of 12 settlement members with global operations to evaluate market demand and explore alternative PvP solutions.

Initial feedback from our working group shows a strong interest in an alternative PvP mechanism and, as a result, an industry pilot is underway which will evaluate the liquidity and settlement risk of potential models. This work is being planned with the FSB Roadmap's timelines in mind to ensure we are well placed to provide input as it progresses. Expanding the availability of PvP to a wider range of currencies will not only further mitigate FX settlement risk, but also facilitate liquidity optimization in the FX market.

In addition to the working group initiative, we are also working with our global settlement members to analyze their settlement activity to better understand settlement risk for currencies that are not currently eligible for CLSSettlement and how FX trades are settled in those currencies. It is expected that the results will provide further transparency into settlement behavior in the FX market and enable us to contribute useful findings and conclusions to some of the policy initiatives discussed earlier.

We believe that an alternative PvP mechanism is the most effective way to address settlement risk, given that the majority of risk now lies with currencies not eligible for CLSSettlement. As a systemically important financial market infrastructure (FMI) subject to the Principles for Market Infrastructures (the PFMI), our ability to expand PvP protection to new currencies and improve direct access to CLSSettlement is therefore defined by these standards.[7] To be successful, any alternative PvP solution should respect the standards that have served FMIs well and ensure those standards are not a barrier to risk mitigation.

We will continue to engage with countries that can meet the necessary standards and aim to bring those currencies into CLSSettlement. We have been working with Chile, which enacted key legislative amendments in recent years, and are aiming to bring the Chilean peso into CLSSettlement – our first currency in South America.

On the question of non-bank participants, we believe that an FX settlement system should permit fair and open access while also balancing the protection of its members and the integrity of the system itself. So a wide range of requirements such as contingency plans, capital ratios and minimum long-term credit ratings should be in place. Certain low-risk, non-bank participants should have the ability to participate directly in such payment systems. This includes supranational institutions, multilateral development banks, foreign systemically important institutions and their operators, and sovereign wealth funds.

Lastly, the industry must continue to develop standards, particularly ISO2022, that will enable cross-border payments to advance effectively and make interoperability between payment systems possible.

The future – an alternative PvP model

While our initiative to develop an alternative PvP mechanism has considerable industry support and momentum, any new solution must prioritize safety, stability, and scalability. For any alternative PvP solution to be successful, due consideration must be given to certain factors such as account structure, legal framework, and local market practices and regulations, and ample time will be required for appropriate implementation. Further, for any FMI to deliver an optimal solution to public policy and industry challenges such as wider settlement risk mitigation, it must invest heavily in its products, risk management and controls, and respective

[7] PFMI

underlying technology on an ongoing basis. For CLS, this means investing in our resilience posture, cybersecurity and three lines of defense to uphold the highest operational standards and ensure the high quality expected of CLS. Earlier this year, we successfully completed a significant phase in our multi-year technology investment program – migrating our PvP settlement service to a state-of-the-art technology platform. We are now focusing on upgrading the hardware and data centers that support CLSSettlement to ensure we continue to deliver the effective and resilient service our clients have come to rely on. With the investments we have made and are continuing to make, we now have one of the most sophisticated, resilient, scalable, and flexible post-trade technology platforms across global FMIs, which will help us to adapt our PvP offering more easily to the requirements of the FX market.

The implementation of best practices related to settlement risk mitigation and post-trade efficiency in the FX market is a high priority for market participants, policymakers and regulators. As a systemically important FMI that operates a settlement system for FX transactions (CLSSettlement), we support the industry objectives regarding mitigating settlement risk, and are committed to raising awareness of PvP adoption more broadly.

In order to develop the optimal model to solve these industry challenges, policymakers and the private sector should, and are, engaging with market participants on an ongoing basis. This approach is crucial to ensuring the market's needs are truly understood and that the preferred solution obtains sufficient industry investment and support. In short, a strong public-private partnership – similar to the one that created CLS in 2002 – is required to build a successful cross-border solution to remove FX settlement risk from global financial markets.

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