

Continuous Linked Settlement

What does Continuous Linked Settlement mean for corporate treasurers? **Julian Hargood**, communication manager at CLS Group, reports.

Since its launch over two years ago, CLS Bank International (CLS Bank) has changed the way the global foreign exchange industry operates, linking fifteen of the world's central banks and approaching 300 of the world's leading financial institutions in a unique global settlement system. This is the first of its kind – a global banking settlement system. It is now at the stage where corporates can start to benefit from direct participation in Continuous Linked Settlement (CLS).

CLS replaces the method of cross-border settlement that had previously been in place for over 300 years. CLS Bank eliminates the 'temporal' (settlement) risk in cross-currency payment instruction settlement, substantially reducing operational risk in the FX markets. Each side of a foreign exchange trade can now be settled simultaneously and irrevocably, in a payment versus payment (PvP) mode that introduces a far higher degree of certainty into the settlement process. If the strict settlement criteria for both the payment instructions received into CLS Bank from the parties are not met, the instructions do not settle and no funds are exchanged, protecting the principal of both parties.

Cross-currency transactions are growing at a remarkable rate – the FX market alone is valued at US\$1.9 trillion per day by the Bank for International Settlements. However, underpinning the stability of the market is an assumption that the system is safe and that parties in a cross border transaction will receive the currency they have bought. Without this basic assumption, the result would be chaos in the international markets.

This network of trust, and ways to maximise its reliability, has been under scrutiny by the regulators and the market for many years. Collapses such as Bankhaus Herstatt, which went into liquidation before submitting required payments to US counterparties in the 1970s, have illustrated the risks involved with cross border transactions.

Concern over these risks led to the Allsopp Report in 1996, and subsequently the creation of CLS Bank by the world's leading foreign exchange trading banks a year later.

In the first two years of providing its settlement service, CLS Bank has shown the industry that it can deliver real added value benefits that more than match the promises in the run up to launch. Two hundred and ninety-six banks, brokers, funds and corporates are now settling through CLS Bank, and on average it is settling over 170,000 payment instructions a day derived from foreign exchange deals submitted by its Members, with a gross value in excess of US\$1.9 trillion.

The background to the continuing volume growth is the value that CLS Bank brings to its participants. We know that they are benefiting from risk reduction, operational efficiency gains, improved reconciliation speed and near elimination of errors.

SPREADING THE NEWS The challenge now is not to merely deliver these benefits, but to communicate them to the wider market. The majority of future growth of CLS volume will come from outside the Bank's core group of Members. Non-member banks, corporations and non-bank financial institutions within the FX market will all potentially benefit from CLS participation. We are pleased with the numbers of third parties who have signed up to the service so far – it is a good foundation on which to build. The majority of third parties using the CLS Bank service today are the correspondent banks of our Members. Our aim is to increase participation beyond this group and to engage with non-bank financial institutions and corporations to communicate what CLS has to offer and ultimately bring them on board.

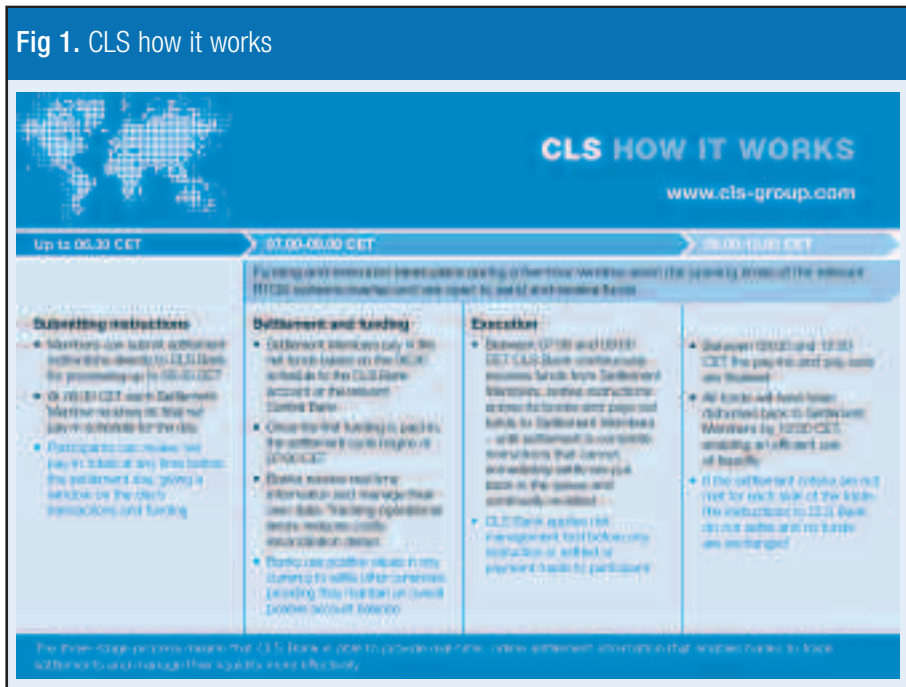
Corporates in particular stand to gain much from CLS participation. Settlement via CLS enables corporates to enhance their operational efficiencies and comply with increased regulatory requirements such as Sarbanes Oxley, while at the same time improving their cash and liquidity management through better forecasting and multilateral netting.

One important point to remember is that settlement via CLS is final and irrevocable.

Executive summary

- **CLS Bank International claims to be changing the way that the global foreign exchange industry operates.**
- **Fifteen of the world's central banks and nearly 300 of the world's leading financial institutions are now linked in a global banking settlement system.**
- **Continuous Linked Settlement (CLS) replaces the 300 year-old method of cross-border settlement.**
- **The system is now at a stage in its development when it may be of increasing interest to corporates.**
- **Cross-currency transactions are growing strongly with the FX market valued at US\$1.9 trillion a day.**
- **Underpinning the stability of the market is an assumption that the system is safe and that parties will receive the currency they have bought.**
- **CLS Bank International says that the challenge is not only to deliver the CLS benefits, but also to communicate the potential benefits to a wider market.**
- **CLS benefits that should be of most interest to corporates include:**
 - Finality in PvP settlements
 - Reduction in credit usage and expansion of FX trading
 - Increased operational efficiency and effectiveness
 - Improved cash and liquidity management
 - Lower operational banking costs and
- **CLS Bank in conjunction with the ACT is to create a CLS Roundtable as an educational platform.**

Fig 1. CLS how it works



THE CHALLENGE NOW IS NOT TO MERELY DELIVER THESE BENEFITS, BUT TO COMMUNICATE THEM TO THE WIDER MARKET. THE MAJORITY OF FUTURE GROWTH OF CLS VOLUME WILL COME FROM OUTSIDE THE BANK'S CORE GROUP OF MEMBERS. NON-MEMBER BANKS, CORPORATIONS AND NON-BANK FINANCIAL INSTITUTIONS WITHIN THE FX MARKET WILL ALL POTENTIALLY BENEFIT FROM CLS PARTICIPATION.

Corporates can settle via CLS by using the services of a CLS Member offering a third party participant service – and, by doing so, are protected against loss of the principal in settling an FX trade. By settling through CLS corporates can improve their FX-related settlement management, improve their liquidity management, sharpen their competitive edge and increase profitability.

Benefits of CLS that are of most interest to corporates include:

- **Finality in PVP settlement** – both sides of the trade are settled simultaneously on a PVP basis, eliminating the 'temporal risk' traditionally associated with cross-currency settlement across time zones. All payments to CLS Bank are final;
- **Reduction in credit usage and expansion of FX trading** – as CLS eliminates settlement risk;

there is the opportunity to eliminate settlement risk credit lines for FX with counterparty banks, potentially freeing up credit for additional trading;

- **Increased operational efficiency and effectiveness** – real-time deal matching and settlement information provides significantly enhanced oversight and control of the full settlement cycle;
- **Improved cash and liquidity management** – settlement via CLS enables precise multi-currency cash forecasting. Multilateral netting among all participants can reduce funding requirements by over 90%;
- **Lower operational banking costs** – as a result of error elimination and significant reductions in settlement payment volumes and associated bank charges;
- **Best practices in FX processing** – CLS Settlement Members are required to demonstrate their settlement processing and resiliency

capabilities through a trialing and testing programme to qualify for Settlement Member status. Third party service providers have all completed this qualification process and have proven processing abilities that third party customers can leverage.

At the time of writing around 15 major corporations, including Hewlett Packard, Nike and Volvo are benefiting from CLS settlement. Whilst we are encouraged by this level of participation at a relatively early stage of CLS Bank's existence, we are keen to further increase the numbers of corporates using CLS. To this end it is proposed, in conjunction with the ACT, to create a CLS Roundtable that will be an educational platform to enable those considering CLS participation to better understand the implications and benefits of involvement and will also allow corporate treasurers to share their experiences of CLS. If you are interested in taking part, then please get contact us through the ACT (contact modonovan@treasurers.co.uk).

CLS is rapidly gaining industry standard status, and the benefits are increasingly being recognised by existing users, from all sectors of the FX market. The challenge remains to broaden CLS participation beyond the banking sector into non-banking financial institutions and corporations thereby to further improve the efficiency and effectiveness of operation for all participants.

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Fig 2. Third party relationship

