

SPEECH

Remarks at the Celebration of the 10th Anniversary of CLS

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Comments at the 10th Anniversary of CLS, New York City

I am honored to be here tonight to speak on the occasion of the 10th anniversary of the founding of CLS.

Today, it's hard to recreate the shock created by Bankhaus Herstatt's failure in 1974 and the revelation that even a relatively small, internationally active bank could pose such substantial financial risk to participants in the foreign exchange market.

Herstatt's failure was just one of several shocks in the early 70s that signaled the end of two plus decades of relatively tranquil recovery and growth after World War II. Another notable shock of those years, of course, was the breakdown of the Bretton Woods foreign exchange arrangements and the introduction of substantial and unfamiliar volatility to the foreign exchange markets.

A saving grace was that the foreign exchange community has had the great good fortune over the decades to be led by participants who recognized the importance of a healthy, resilient and change-friendly marketplace and worked collaboratively to achieve that. Over the years, the foreign exchange community also forged bonds with central banks in major financial centers to promote foreign exchange market health. It has been a great model of public-private cooperation made possible by private-sector leadership.

Despite all that, foreign exchange market participants and central banks in 1974 found Herstatt risk to be an intractable problem. All that was left to banks was to manage it. And so it went for 20 years.

Then, in the mid-1990s, Bill McDonough, president of the New York Fed, identified the continued existence of Herstatt risk as a challenge to be met. As chairman of the Committee on Payments and Settlement Systems of the G-10 Central Bank Governors, he spurred the central bank community to take a fresh look. This time, the combination of new financial analysis and the rapidly expanding availability of raw computing power made the difference.

- In what today still stands as a landmark in analysis of the connection between operational and financial risk, the 1996 Allsopp report demonstrated in a straightforward manner just how much financial risk existed in the bilateral settlement of gross principal amounts of foreign exchange—an analysis that provided the insight into how a settlement facility could reduce that risk, and into understanding how settlement management could improve in the interim.
- Raw computing power was essential for the design and risk management of any proposed new settlement facility. Through scenario analysis and stress testing, CLS's founders could determine the necessary capital and liquidity needs, default handling procedures, and the general benefits of multilateral vs. bilateral netting. The inherently multicurrency nature of foreign exchange settlement of course enhanced the challenge.
- The published Allsopp analysis included a challenge from the major central banks to the major market participants to develop a new settlement mechanism. In short, find a solution or we will find one for you!

I recount this history to highlight the magnitude of the achievement CLS represents. The establishment and growth of CLS is undoubtedly one of the most significant accomplishments in global financial markets in the post-war period and a major breakthrough in managing settlement risk in an over-the-counter market.

- The largest part of the achievement, of course, is the difficult job of making it happen. CLS was actually the third major concept for FX settlement. It succeeded because the industry collectively got firmly behind CLS and because of the hard work of the

many people in the CLS organization, whose commitment and efforts continue to this day.

Let me highlight three dimensions of CLS's success.

First, its growth and its scope. When it went live in 2002, CLS began settling FX transactions in just seven currencies with 39 settlement members. Today it settles in 17 currencies with 63 settlement members and 16,000 third party users.

Volumes and values of transactions settled via CLS have also expanded significantly. Today CLS is settling average daily values of nearly U.S.\$5 trillion and average daily volumes of 1 million transactions. On its peak settlement value day, March 19, 2008, CLS settled over 10 trillion U.S. dollars equivalent.

Second, adaptation to a rapidly changing foreign exchange market.

Today's FX market is very different in its pace, the composition of its participants and its size from the mid-1990s of the Allsopp report. Today's trading reflects more high-frequency, algorithmic trading; a wider range of financial participants, like hedge funds; and higher overall volumes.

In response to those changes, CLS worked diligently with industry and the regulatory community to launch the CLS Aggregation Service (CLSAS), a joint venture between CLS and Traiana, in 2010.

- The service aggregates spot FX trades to support high-volume, low-value transactions, one of the fastest growing segments of the FX market.

And in light of volume growth, CLS has also engaged its stakeholders to help them better understand their own capacity needs and to ensure that both its members and the CLS settlement service are able to manage even further growth as the FX market continues to evolve.

Third, resilience in difficult times.

Following the collapse of Lehman Brothers in September 2008, while market sentiment deteriorated rapidly and money and capital markets were brought to a virtual standstill, the foreign exchange market continued to function effectively. Many have attributed this to the role played by CLS.

And more recently, CLS remained a reliable market infrastructure during and in the wake of Superstorm Sandy. As you know, the Superstorm disrupted this celebration, and my colleague, Sandy Krieger (no relation), who was to deliver these remarks could not make it this evening, but sends her warm regards.

In recognition of the crucial role that CLS serves in the foreign exchange market, CLS was designated as a systemically important financial market utility by the U.S. Financial Stability Oversight Council on July 18, 2012. In my words, we can't imagine the foreign exchange market without CLS.

Let me turn to the future and what it holds for CLS and for us. As is true for all us, the path of the future is determined in part by the momentum of our history and in part by the unknowable that lies ahead. Let me talk to the history.

First, it seems clear that CLS has much more runway ahead in furthering its core mission—the reduction of FX settlement risk—by expanding its settlement service to include additional currencies and settlement sessions, and to increase participation in the system.

- Today, CLS settles 17 currencies. But there are many more currencies to go, some in regions that are just coming fully onstream in the global financial system.
- Today, “same day” foreign exchange activity is not settled in CLS. Can CLS find solutions to help reduce settlement risk in this segment of the market?

- Today, CLS has one discrete settlement session that occurs at a defined time during the day. Is it feasible to imagine a world where CLS is truly Continuous in Linking Settlements on a payment-versus-payment basis at most, if not all times during the global business day?
- And looking ahead, if foreign exchange transactions become centrally cleared, what role can and should CLS play to facilitate the safe settlement of those transactions?
- I'd note, CLS has plenty of strategic choices there, always a good sign.

Second, CLS was created by private sector leadership and financial institutional commitment and industry collaboration is a key part of a successful future.

- CLS cannot do its work alone. What makes CLS successful are members who are proactive in identifying and working with CLS on opportunities to further strengthen the CLS ecosystem, particularly in a market that is rapidly changing.
- That will require not just member support but also member investment.

Third, the birth of CLS and its development exemplifies the productivity of public sector-private sector collaboration. We have different roles, but a common interest in the performance and resiliency of the foreign exchange market. As we play our respective roles, we can make each other more insightful and better performing. We have done that here in foreign exchange settlement—and speaking personally, I would like to see private sector and public sector tackle more opportunities across the financial markets.

Let me end by congratulating CLS and all who are part of it on these first 10 very successful years, thank the wider group here for the collaboration you have developed within the industry, and thank you also for the partnerships you have forged with central banks, most especially, with the Federal Reserve Bank of New York. We wish you another equally successful decade—and look forward to another decade of working successfully together.
