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Via email: cpmi@bis.org

Re: Committee on Payments and Market Infrastructures consultative report / facilitating increased adoption of payment versus payment (PvP)

Dear sir/madam,

CLS Bank International ("CLS") welcomes the opportunity to respond to the July 2022 consultative report of the Committee on Payments and Market Infrastructures ("CPMI"), entitled "Facilitating increased adoption of payment versus payment (PvP)" (the "Consultative Report").

A. Background

CLS was established by the private sector, in cooperation with central banks, as a payment versus payment system to reduce the principal risk arising from settling FX transactions. CLS operates the world's largest multicurrency cash settlement system (the "CLS System" or "CLSSettlement"), mitigating settlement risk in respect of FX transactions for CLS's members (each a "Member") and their customers.

CLS is an Edge Act Corporation organized under the laws of the United States of America and is regulated and supervised by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York (collectively the "Federal Reserve"). Additionally, in July 2012, CLS was designated a systemically important financial market utility by the United States Financial Stability Oversight Council and has been specified by HM Treasury as a recognized payment system pursuant to s.184 of the Banking Act 2009. As a systemically important FMI, CLS is subject to the Principles for Financial Market Infrastructures (the "PFMI"), as applicable to payment systems.

B. Response to section 2 (questions 1, 2 and 3)

Question 1: Do you agree with the analysis of the causes of non-PvP settlement?

Informed by extensive Member engagement, CLS believes that, of the 'non-PvP' population, trades involving currencies of emerging market economies ("EME") that are not currently eligible for CLSSettlement represent the greatest degree of settlement risk. CLS is currently collaborating with its Members with the objective of mitigating this risk.[1] CLS continues to observe year-on-year increases in the use of CLSSettlement and estimates that, excluding transactions which are settled between group entities (inter-affiliate or inter-branch) or via a net single currency cashflow or payment via a debit or credit within the bank's ledger, 90% of the eligible traded notional is settled via CLSSettlement.

[1] CLS formed a working group with 12 global Members (the "Working Group"), which engaged in extensive analysis regarding an optimal alternative PvP service design to address settlement risk in EME currencies via a PvP mechanism, and subsequently conducted a pilot. Please refer to CLS's response to Question 4.

In 2020 and 2021, following the high-level findings of the 2019 BIS triannual survey regarding settlement risk, CLS collaborated with three of its largest Members to perform an in-depth analysis of their respective FX trading activity and settlement processes.

The findings from the three exercises were consistent and brought new understanding into the:

- Difference between traded notional and settlement risk notional;
- Range of methods used for settlement; and
- Relative degree of settlement risk associated with each method

CLS's key findings were:

- Nearly 90 percent of total gross traded notional was theoretically eligible for settlement via PvP in CLSSettlement;

- The remaining roughly 10 percent ineligible for settlement via PvP in CLSSettlement, related to EME currencies that are not currently eligible for CLSSettlement (referred to as "Group A"); and

- Of the gross traded notional that was theoretically eligible for settlement via PvP in CLSSettlement, more than 50 percent was settled via CLSSettlement. The vast majority of the remaining amount related to transactions settled between group entities (inter-affiliate or inter-branch) or via a net single currency cashflow or payment via a debit or credit within the bank's ledger. A small residual of six percent remained that was theoretically eligible for CLSSettlement. Within the non-PvP CLSSettlement eligible population, Members consider this six percent to represent the largest category of settlement risk that could still be mitigated via PvP (referred to as "Group B").

CLS agrees that so called "on-us settlement" represents a significant proportion of the 'non-PvP' population. However, CLS's market engagement indicates that Group A and Group B represent a materially higher degree of settlement risk.

CLS can also share that each year it has made progress in bringing on additional entities to address the settlement risk associated with Group B.

Question 2: Do you find that, for your market segments, some causes are more important than others? Please explain.

Based on data analysis and market feedback, CLS has concluded that in cases where there is a high degree of settlement risk (Group A and Group B, please see CLS's response to Question 1), the primary cause relates to a lack of a PvP-based settlement service for the relevant EME currencies that meets market needs. Based on its engagement with Members through the Working Group, described in footnote 1 above, CLS believes that a viable PvP service should, at a minimum, have the following features (i) be available to a wide range of financial market participants; (ii) deliver efficient multilateral netting; and (iii) ensure legally enforceable settlement finality. The system must also be soundly designed and operated, and in compliance with the standards set forth in the PFMI.

CLS likewise believes that in order to bring EME currencies into PvP systems, it will require a high degree of regulatory commitment and coordination between relevant authorities in applicable jurisdictions (please see CLS's response to Question 4 below).

Question 3: In which currency pairs or products do you find that non-PvP settlement is increasing?

The most actively traded EME currencies (excluding those already eligible for CLSSettlement) represent the currencies in which non-PvP settlement is rapidly increasing. Most of the trading is against the USD. CNH/USD is the largest of these currency pairs.

C. Response to section 3 (questions 4 and 5)

Question 4: Do you agree with how the proposals for new solutions could increase the adoption of PvP?

CLS has set forth its own proposal, the CLS Alternative PvP Service or "CLSAlt,", reflected in the Consultation Paper, which CLS believes provides a viable solution to expand PvP to this broader range of currencies.[2]

As described above, CLS proactively engaged with a Working Group of 12 Member banks, during a one-year period with the objective of defining/proving an optimal service design for an alternative PvP service for EME currencies, distinct from the existent CLSSettlement service. CLS and the Working Group explored a wide range of potential PvP solutions to address settlement risk and optimize liquidity for currency flows outside CLSSettlement. In Q1 2022, the service design was taken through an internal CLS proof of concept during which CLS's existing settlement technology was proven to be able to support the required functionality. Accordingly, CLS plans to deliver CLSAlt via extension of its CLSNet platform (please see the description of CLSNet below).

CLS believes that CLSAlt can be successful with sufficient support/collaboration between the target currency central banks and other authorities, including a coordinated approach to addressing all legal and regulatory impediments (e.g., meeting the legal basis requirements of the PFMI, including but not limited to settlement finality under the laws of all relevant jurisdictions where currencies and/or participants are located, depending on the specific facts and circumstances).

In addition, based on extensive market engagement and data analysis, CLS believes that careful consideration of the degree of settlement risk relating to the different groupings of non-PvP settlement activity (such as those highlighted in CLS's response to Question 1 above) is essential when assessing potential new solutions.

Many of the potential new solutions listed in Table 4 of the consultation paper exhibit characteristics which, once factoring in practical implications of market operations, were explicitly deemed as unworkable by the Working Group. Of particular note is that PvP requires timed payments; however, the Working Group deemed key attributes that happen to be part of many of the solutions listed in Table 4 as unworkable due to the sheer volume of timed payments required. Additionally, they deemed that achieving liquidity optimization through multilateral netting was mandatory, as was a critical mass of adoption. CLS is encouraged by the industry focus on broader PvP adoption and believes a public-private partnership is a prerequisite to the successful implementation of any new solution.

Since PvP for some of this broader group of EME currencies may be unavailable for an extended period of time, CLS believes that market participants should consider the adoption of other forms of risk mitigation **that are available now**. In particular CLSNet, a standardized, bilateral automated payment netting calculation service (which supports compliance with the settlement risk principles of the FX Global Code) across 120 currencies for buy-side and sell-side

[2] In addition, please see CLS's response to Question 2 above, regarding the features of an alternative PvP service that CLS believes, based on its engagement with the Working Group, will be required to meet the demands of the market.

institutions, has been in production for several years. As a centralized infrastructure, CLSNet provides users with a single common record of their net payment obligations to streamline post-trade matching and netting processes. CLSNet already captures a significant percentage of addressable currency flows - the average daily notional netted in CLSNet was in excess of USD100 billion during August, with the September 2022 IMM (or International Monetary Market) date seeing a daily figure in excess of USD200 billion (please see CLS's response to Question 10 for additional detail).

Question 5: Do you find that these new solutions, together, if launched successfully, can mitigate FX settlement risk? Please explain.

Please see CLS's responses to Questions 2 and 4.

D. Response to section 4 (questions 6, 7, 8, 9 and 10)

Question 6: Do you agree with the analysis of the barriers to increased adoption of PvP?

CLS agrees with the analysis regarding many of the barriers outlined in the Consultative Report. However, Members have not highlighted RTGS operational hours as a barrier to extending PvP. By contrast, Members expressed the view that RTGS hours could become relevant in the future, but only if they are considered alongside extended hours for local money markets in addition to extended cut-off times for nostro agents. CLS agrees with this point, which is supported by CLS's own analysis.

From an efficiency perspective, CLS observes that market participants and RTGS operators already have large investments to make to cover the cost of RTGS renewals and ISO20022 implementations. Accordingly, the market would need to be comfortable that any further investments in new functionality, such as interoperability, would be cost-effective.

Question 7: Which barriers do you find most significant, and do you observe any additional barriers that are not identified in the report? Please explain with specific reference to individual barriers.

Please see CLS's response to Question 4 above. As noted, CLS considers that a prerequisite to any PvP solution is the implementation of necessary legal and regulatory amendments to ensure that the legal basis requirements of the PFMI will be met. Based upon CLS's engagement with its Members, CLS does not believe that there is any appetite for "finality light" and the resulting risks that participants will face in any system that adopts this approach. If any new PvP solution is to be robust and resilient, it will require substantial cross jurisdictional effort and the creation of a rulebook which underpins finality.

CLS believes that broad-based adoption of any new PvP solution is only possible with sufficient support from, and collaboration between, central banks and other authorities as well as local market nostro agents from within the jurisdictions of the primary target currencies and/or participants. This workstream should acknowledge and give due consideration to the reality that not all central banks and other relevant authorities may be supportive of their own currency being included in PvP solutions, and therefore may not seek to address barriers to inclusion related to their currencies and/or participants.

Question 8: Do you agree with the possible roles for private and public sector stakeholders in addressing the barriers?

With respect to the private sector, CLS does not believe that the items identified would have a material impact in increasing the adoption of PvP.

With respect to the public sector, CLS believes that support from, and collaboration between, public sector actors is a mandatory component of any new PvP solution.

Question 9: Do you find that the private sector could take on other roles in facilitating increased adoption of PvP? Please explain.

CLS considers that the private sector would need to closely collaborate with the public sector in order to deliver a soundly designed and operated new PvP solution, including robust finality protections, and in line with the standards set out in the PFMI.

Question 10: How could the public and private sectors work together to take this forward? Please explain and suggest any practical actions that could be taken by existing industry bodies.

CLS supports certain of the suggestions set forth in Section 4.2.1 of the Consultative Report, such as global adoption of the BCBS Guidance.

In addition, CLS cannot overstate the importance of strong collaboration between applicable authorities and service providers in order to implement PvP for a given currency pair. However, CLS also acknowledges that for certain currencies this degree of collaboration may not be possible for various reasons. As noted above, in instances where PvP will not be possible for an extended period of time, CLS supports the adoption of other forms of risk mitigation such as standardized, automated netting (as set forth in the FX Global Code settlement risk principles). CLSNet provides a netting calculation service that supports such automated netting, which is growing fast in terms of adoption and currently processes more than USD100 billion in daily notional.

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CLS greatly appreciates the opportunity to submit these responses.

Sincerely,

Dino Kos

Cc:
Marc Bayle de Jessé, Chief Executive Officer
Keith Tippell, Chief Product Officer
Kerry Denerstein, Public Policy Lead