

## CLS HAS THE FX MARKET SEWN UP

*In October 2007, CLS celebrated its 5<sup>th</sup> anniversary of live operations. CLS (Continuous Linked Settlements) was conceived and brought live with the hope of capturing an average of 45,000 FX trades per day in seven currencies. In March 2008, CLS processed nearly 600,000 trades in a single day with a gross value in excess of USD 10 trillion.*

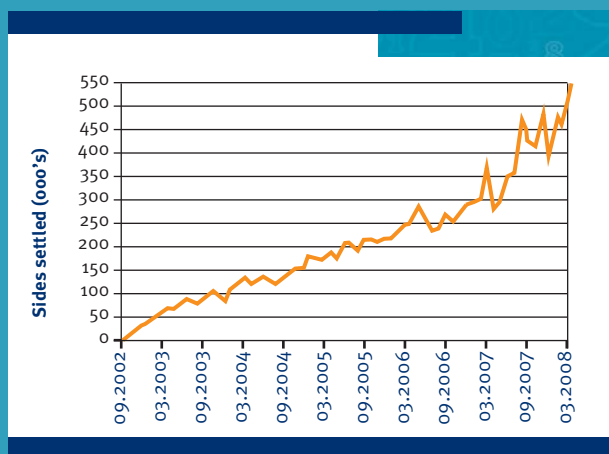
There are 15 currencies now live and two more – the Mexican Peso and the Israeli Shekel – are planned for the second quarter of 2008. There 70 shareholders, three of which are Swiss (UBS, CS and ZKB). As direct settlement members or as CLS third parties and more than 2,000 banks, brokers, funds and corporate customers use CLS daily to settle their FX trades. CLS has captured approximately 55% of total FX daily settlement volume, which itself has grown significantly. By any measure, this can be deemed a success.

The original concern at UBS was the efficient handling of the intraday credit needs of its major bank customers, which were increasing with their global expansions. Larger and larger transactions led to higher credit needs. If these could be netted down, the whole system could run more smoothly. Other banks realized they had similar concerns and around the same time, central banks also began to take an interest in taming Settlement or Herstatt Risk. With the publication of the CPSS (Committee on Payment and Settlement Systems) report on settlement risk in the FX markets in 1996, there was clear market interest to act.

### STREAMLINING PROCESSES AND STANDARDIZATION

Taking CLS live took another six years and was no easy feat. In order to work effectively, it had to have a large percentage of the FX transactions. This meant garnering support from the largest commercial banks as well as central banks. To bring the former on board, CLS also had to bring certain efficiencies to the market. This required agreement on standards and market practices. Once these agreements began to emerge and banks settled upon the operational elements, CLS gathered momentum. CLS had the potential to transform settlements through operational efficiency. Through streamlined handling of confirmations, payments, reconciliations and claims handling, CLS has established an efficient and highly scalable model, which is easily leveraged for non-members through third party offerings. The resulting streamlining in processes attracted the commercial interest of the participants and continues to appeal.

Sources: CLS



### THE QUEST FOR MARKET EFFICIENCY

CLS has adapted with times to become the leader it is today. The basic concept of CLS was presented by Dr. Hubert Huschke (then a senior executive with UBS) at Sibos in Boston, USA in 1994.

While CLS has substantially reduced the cost of settling FX trades when compared to gross settlement over Nostros, many CLS users focus primarily on the cash-out cost per trade. Others have recognized that the benefits go well beyond this. Some alternatives to CLS settlement exist, including pre-settlement netting schemes. While on the surface, these appear to offer lower transaction costs, the presumed savings are actually lower due to the following reasons:

- *New or separate processes or variations in standards will inevitably lead to new inefficiencies*
- *Fully automated confirmation matching and reconciliations are not assured with other services*
- *Claims handling for fails could be more complicated and will be more costly*
- *A solid global and standard legal basis may be required and will lead to set up and recurring costs*
- *The very high levels of resilience which CLS has will be expensive to replicate*
- *The well-orchestrated and robust crisis management procedures which CLS have created would need to be re-created*

## COSTS REMAIN THE KEY ISSUE

Also, CLS is a scalable utility: volume increases do not lead to direct increases in cost. Similarly, volume decreases would still leave fixed costs to be paid. If volume is reduced, the cost per trade will go up. Still, given the focus on pure transaction cost, and the general interest to manage costs, CLS will also have to make sure its cost base is rigorously managed and trending in the right direction to stay fit and competitive – especially in light of nimble competitors who will try to cherry pick through low transaction prices. To counter this, CLS may well envisage using its fixed cost base to its advantage

and consider introducing a more utility-oriented pricing scheme to allow its users to lock in scale effects. In order to keep serving the banking community and live out its role in risk mitigation, CLS has also expanded its settlement capabilities selectively. New currencies have been added on a regular basis. Though the gross volume to be settled in each successive new currency is generally smaller, the value of bringing settlement standards and a certain reliability to these markets should not be under-estimated. Trading interest can grow significantly when settlement issues are removed and this can have far-reaching macro-economic benefits. Mexico and Israel, for example, should benefit enormously from CLS, by bringing the use of global standards into common use (in and outside of CLS). In 2007, CLS also added non-deliverable forwards to their settlement palette and has proved a natural multi-currency settlement partner for the DTCC's DerviServ initiative. For the near future, CLS will also look at new currencies (possibly Thailand and Turkey) as well as the feasibility of introducing additional regional settlement cycles. As shown in the most recent CPSS follow-up study (<http://www.bis.org/publ/cpss83.pdf?noframes=1>), CLS has massively reduced settlement risk in foreign exchange (roughly 55% by value). In addition, it has brought operational savings. These two points together have helped support the huge growth in FX volumes over the past years. Through its dedication to the market it serves, it has clearly earned a place in the cash settlement landscape. Still, challenges loom in cost management, market-wide understanding of the full, end-to-end benefits, and competition which may appear cheaper. ■

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Source: CLS

	2002	2007	2008
Capacity	45k / 90k	500k / 1,000k	Building capacity of 1m / 2m
Currencies	7	15	17
Products	FX	FX & live with NDFs, credit derivatives	FX, NDFs & credit derivatives. FX option premiums to be launched.
Av. FX price	Ramp-up £1.37 – £2.37	£ 0,80	£ 0,69