Since September the foreign-exchange market may have become less dangerous

The water closet, patented in 1819, was not a particularly exciting invention, but it certainly proved useful. The same may soon be said of continuous linked settlement. The past few weeks have seen a long-awaited revolution in the foreign-exchange market, the biggest market in the world. Banking customers may not notice the difference, unless—as the water closet sometimes does—it goes wrong. But such a big change has not occurred in international banking since the introduction in 1974 of SWIFT messaging, which gave banks instant and secure worldwide communication with one another.

Like SWIFT, the new system will change the relationship that banks have with their biggest customers and with each other. It will encourage some banks to become dominant “deal factories” through which more and more of the world’s foreign-exchange deals, and perhaps other transactions, are processed. The aim is to reduce risk, by introducing greater trading certainty. But it may, in the view of some, be adding new risk, by concentrating all that certainty in one place.

At the heart of this revolution is CLS Bank, a purpose-built bank in New York that undertakes to settle foreign-exchange trades among the world’s 60-or-so biggest banks, thereby eliminating the risk that only one party to the transaction pays up. This risk is called Herstatt risk, after a German bank that was closed halfway through a trading day in 1974, leaving the dollar side of its foreign-exchange trades unpaid. The bank’s failure caused panic and gridlock in the entire foreign-exchange market, which took weeks to unravel. Regulators have been nervous about a possible repeat performance ever since.

CLS Bank is designed to take details of all trades, and by midnight central European time (CET) to give banks an orderly schedule of when each bank must make payments during the following day to honour them (CLS stands for continuous linked settlement). A single payment of a few million dollars, yen or euros is then enough to a bank’s multiple trades scheduled in that currency for that day, even though their gross value may be hundreds of millions of dollars.

It took many years, and perhaps $1 billion spent by banks, and central banks to adapt their systems, before dealing went live in seven main currencies on September 9th. On November 4th third parties—the settlement banks' customers—were allowed to enter the fray. But only half a dozen did so. It is taking time, and a complete systems overhaul, for the global revolution to spread from bigger to smaller banks. In two months of operations, there have been no major glitches, it is said, apart from linkage problems between CLS and some central banks. On October 29th CLS Bank settled 15,200 transactions, totalling $395 billion, which required only $17 billion of payments between member banks, a 95% reduction. As more banks and more currencies join, the risk reduction should be even greater.

On October 29th CLS Bank settled 15,200 transactions, totalling $395 billion, which required only $17 billion of payments between member banks.

What is so new in all this? First, payments are no longer bunched at the end of each currency's working day—the banks have to make payments according to a schedule set by CLS Bank, usually ending before midday CET. So banks, and their central banks, have to fine-tune their use of liquidity during rather than at the end of each day.

Since there is a value in having intra-day liquidity, interest might soon start to be charged, like some hotel
rooms, by the hour rather than by the day. For example, for the Swiss franc, one of the less liquid currencies, the two big Swiss banks are already talking of charging non-Swiss banks for any intra-day liquidity they provide. Bank treasury departments say they are resisting this trend—nobody wants to be first, although the Federal Reserve already charges for Fed funds by the minute, and the Bank of Japan charges a flat rate every four hours.

Second, the nature of correspondent banking will change. Banks outside the CLS inner circle will favour a relationship with just one CLS settlement member, rather than with many, for administrative reasons. So that single relationship will become more important. Strangely this does not seem to alarm the competition authorities around the world. "CLS is not a closed shop," comments John Gibbons at ABN Amro, a big bank and one of the initial 39 CLS settlement members.

Third, if CLS Bank proves successful it will not be satisfied with settling only big-bank trades in the $1.5 trillion-a-day foreign-exchange market. Joseph de Feo, chief executive of CLS Bank, has already talked of settling money-market trades, and of settling cross-border payments for securities. Cross-border securities transactions are probably the biggest source of cross-border cashflow today.

**In CLS we trust**

Although CLS Bank is a private-sector creation, it has required unprecedented co-operation between central banks. They have linked their real-time payment systems together in a bank supervised by one of them, the Federal Reserve Bank of New York. Now some big banks want the central banks to co-operate even more closely and allow them to swap their liquidity from currency to currency during the business day.

For example, by arrangement with the Fed and the Bank of Japan, a Japanese bank posting collateral with the Bank of Japan would gain access to Federal Reserve dollars in New York. A global multi-currency collateral pool would do the trick, argues a working group of the private New York-based payment risk committee. Other banks think the same could be done via a multi-currency pool within CLS Bank (at present banks must put up collateral in each of the seven currencies, and are helping each other out bilaterally with so-called inside/outside swaps).

Whichever route is chosen, the outcome should be a further reduction of settlement risk. But, as Richard Pattinson, a director of Barclays, points out, risk tends to be squeezed from place to place like air in a balloon, rather than eliminated. CLS Bank decreases Herstatt risk, but it increases banks' exposure to two other risks: liquidity risk (the need to pony up cash several times a day on a strict schedule), and operational risk (the chance that a failure of their system, or of CLS Bank, could cause a mighty hiccup). A CLS Bank hiccup would be global, hitting seven payment systems with one blow. But time and money have been spent to ensure that doesn't happen. In CLS we trust—and hope.