South African Reserve Bank

National Payment System Department

INFORMATION PAPER – SOUTH AFRICA'S PARTICIPATION IN THE CONTINUOUS LINKED SETTLEMENT SYSTEM

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1.   EXECUTIVE SUMMARY

This document outlines the position of the South African Reserve Bank (the Reserve Bank) with regard to Continuous Linked Settlement (CLS).   The Reserve Bank, in its endeavour to reduce risks in the National Payment System, will support the domestic banking industry's **direct** participation in CLS, and thereby the inclusion of the Rand in CLS as a settlement currency. However, the Reserve Bank, as **principal**, will utilise its agreed correspondent banking arrangements to settle its own foreign currency obligations.

2.   INTRODUCTION

The purpose of this document is to outline the position of the Reserve Bank regarding the South African banking industry's participation in CLS and the inclusion of the South African Rand in CLS.

South Africa is one of the largest emerging economies and acts as a leader in the South African Development Community region.   This and the fact that South Africa needs to be seen as a global market player emphasises the consideration for CLS participation and the inclusion of the Rand.

CLS is a worldwide industry initiative to reduce the risks associated with cross-currency transactions by settling the two legs of a foreign exchange (forex) transaction simultaneously.   Forex settlement risk is the risk that originates once a currency has been irrevocably paid by one party, and thereafter the counterparty fails to meet its obligation in the trade.

3.   BACKGROUND

The mid-1990s were characterised by a concern amongst central banks about the possibility of a systemic risk arising from the settlement of forex

transactions. This is commonly referred to as Herstatt risk, a name derived from the failure of Bankhaus Herstatt in June 1974, a private bank which at that time had a significant exposure in the inter-bank forex market. The collapse of Bankhaus Herstatt highlighted the delay that could occur between the payment of the two legs in a forex transaction and the risks associated with this delay.

When considering that the value of forex deals settled worldwide on a daily basis amounts to approximately US$3 trillion, and that trade is concentrated amongst a handful of major banks, the scale of the potential losses that might arise from Herstatt risk becomes alarmingly clear. What is more important is the fact that the losses resulting from the collapse of one of the major banks might lead to the collapse of other banks. This could endanger the entire global financial system.

The increase in the number of bank failures and political incidents further fuelled concerns to such an extent that, in 1994, the central banks of the G-10 industrial countries endorsed a strategy to investigate foreign-exchange settlement risk.

In 1995, as a result of a G-10 initiative, a group of major global forex trading banks organised an ad-hoc committee, called the Group of 20 (or G-20). Their objective was to consider how the private sector could resolve the problem of forex settlement risk. The study resulted in the CLS concept. CLS facilitates the simultaneous matching of currencies in each forex transaction in the CLS Bank (CLSB), and thereby eliminating settlement risk.

The CLS holding group in the United Kingdom has two operating companies, namely CLS Services (CLSS) and CLSB. CLSS's ownership vests wholly in its 66 shareholders from 17 countries. Though CLSS operates as a private limited-holding company, with its headquarters in London and a representative office in Tokyo, its primary business focus is on CLSB. CLSB, which has its headquarters in New York, is a special-purpose bank, supervised by the Federal Reserve Bank of New York.

In May 2000 the governors of the central banks of the G-10 countries discussed the progress made in terms of the reduction of forex settlement risk. The Bank for International Settlements (BIS), in conjunction with the G-10 central banks, initiated a strategy to achieve a significant reduction of forex settlement risk.

A three-track approach was adopted. The first track entailed action by individual banks to manage and reduce their forex settlement risk. The second track involved action by industry groups to provide risk-reducing multi-currency services, and the third track represented action by central banks. The last track took account of the fact that, although the emphasis of the strategy was on action by the private sector, the public sector should also play a key role. This action by central banks included rapid progress of actively promoting the risk-reduction strategy and the fostering of improvements to national payment systems.

4. CONTINUOUS LINKED SETTLEMENT

CLS is a worldwide industry initiative that is designed to affect the market in three primary ways. Firstly, settlement risk in cross-currency transactions will be significantly reduced; secondly, new real-time facilities will supply previously unavailable continuous settlement information; and lastly, the management of liquidity and cash will be greatly improved globally.

CLSB provides a solution to forex settlement risk-reduction via payment-versus-payment (PvP) settlement across real-time gross settlement (RTGS) systems in eligible currencies. The principal feature is that either both sides of the settlement instruction will be settled simultaneously or neither side will be settled.

There are two legs in a foreign currency transaction, namely the payment instruction and the flow of funds. The payment instruction is initiated one or two days before settlement, with settlement taking place on the predetermined settlement date. This foreign currency settlement may be extended to a T + 5

period, or longer, if there are weekends and public holidays over the relevant period.

CLSB requires a settlement account within each RTGS system for the currency in which it settles. An RTGS system is a gross settlement system in which each transaction is processed and settled in real-time.

The settlement process is effected continuously during a five-hour settlement window. The settlement window for CLS-related transactions starts at 07:00 and ends at 12:00 Central European Time (CET).

Settlement members pay funds to, and receive funds from CLSB via their local RTGS payment systems. The use of settlement accounts and RTGS payment systems ensure the security and finality of inward funding and outward payments.

The currencies in which CLS-related transactions are initially settled are, the Australian Dollar, the Canadian Dollar, the Euro, the Japanese Yen, the Pound Sterling, the Swiss Franc and the United States Dollar.

5. ISSUES TO BE RESOLVED

The Reserve Bank believes that the South African domestic market is sufficiently liquid and robust to accommodate CLS requirements. However, the following issues concerning South Africa's participation in CLS have been identified:

5.1 Compliance with current square-off parameters: South Africa's RTGS system (the SAMOS system) does not currently comply with the stipulated square-off parameters. Steps have already been taken to address this situation.

5.2 The legal framework: The legal issues required to accommodate the CLSB will be addressed in the revised NPS Act.

5.3 Cost Implications: a US$5 million capital investment is required from each of the two domestic settlement banks in order to become shareholders in the CLSB. Set-up infrastructure costs also apply to the settlement members. It is the Reserve Bank's understanding that these costs could be substantial. In addition, substantial annual costs might be incurred for developments in infrastructure and information technology in order to keep up with additional functions. However, the domestic settlement members could address infrastructure costs by the sharing of infrastructure.

5.4 Initial discussion revealed that no major exchange control restrictions exist.

6. CONCLUSION

The Reserve Bank has taken the position that the South African Rand should be included as a CLS currency in the future, for the following reasons:

- CLS is an important development in terms of forex settlement risk. If the South African Rand becomes a CLS currency, it would be extremely advantageous to South Africa as an emerging economy.

- Other emerging economies have joined CLS. If South Africa is not aligned with international practices and on par with other competing emerging economies, foreign direct investment could be negatively affected.

- If the Rand is not included, and if the South African banking industry does not participate directly in CLS, domestic banks could incur additional transaction costs, and there could be limited forex market acceptance. It is

possible that a two-tier pricing structure could develop in terms of correspondent-banking arrangements for non-CLS transactions.

The inclusion of the Rand in CLS would not only reduce forex settlement risk, but would also provide valuable real-time settlement information that could improve the management of settlements.

7.   ACKNOWLEDGEMENT OF RECEIPT

Two additional copies of this position paper are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to the National Payment System Department at the SARB at the earliest convenience of the aforementioned signatories.

D C Mitchell
Head: National Payment System Department

<u>ACKNOWLEDGEMENT OF RECEIPT</u>

I acknowledge receipt of Position Paper 02/2002. Copies have been handed to the undermentioned auditors of this institution:

NAME OF AUDITOR   **AUDITOR'S SIGNATURE**

1. ....

2. ....

DATE.................................   ....………..

                                                    CHIEF EXECUTIVE OFFICER

NAME OF BANK

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PLEASE RETURN TO:

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