

BOX VI.1

THE CHILEAN PESO AS AN ELIGIBLE CURRENCY IN THE CLS SYSTEM

The Continuous Linked Settlement (CLS) system is the response of private developers to pressure from regulators in the world's more advanced economies (initially the G10) to reduce the risks implied in cross-border transactions.

The CLS system was created in 2002 and initially encompassed seven jurisdictions (Australia, Canada, Europe, Japan, Switzerland, United Kingdom, and United States). Since then, new currencies have gradually been incorporated, such that the system currently settles 18 currencies.

The CLS system operates through CLS Bank International (a special-purpose financial institution located in New York) and CLS Services (a company located in London that provides technical and technological support services to CLS Bank)^{1/}. The CLS system currently has 79 direct participants or clearing members, which are mostly international banks. The system provides settlement services to over 25,000 institutions or third parties, including banks, institutional investors, investment funds, and nonfinancial companies, settling an average daily value of over US\$5 trillion.

CLS Bank International is located in New York and is thus regulated by the Federal Reserve Bank of New York. Its operations are monitored by an Oversight Committee coordinated by the Fed and composed of the 23 central banks whose currencies are settled in the CLS system^{2/}.

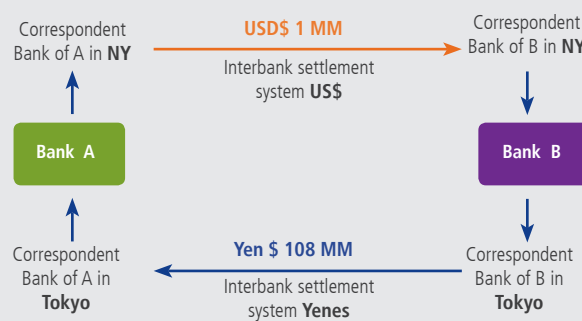
The Central Bank of Chile (CBC) has recently reiterated its interest in incorporating the Chilean peso into the CLS system. This box reviews the Central Bank's main reasons for promoting the inclusion of the Chilean peso in the CLS system and some recent actions undertaken with this objective.

Reduction of counterparty risk

Cross-border foreign exchange (FX) payments are not settled simultaneously, which generates counterparty or settlement risk. This implies that a given counterparty in the transaction delivers the currency being sold, but does not immediately receive the currency being purchased (diagram VI.2). This type of risk is amplified by the different time zones in which financial markets operate, as well as the interaction of multiple operating platforms and different intermediaries, among other factors.

To mitigate settlement risk, the internationally recommended standard is the use of payment-versus-payment (PvP) systems, which ensures that each counterparty simultaneously receives and pays the currency being bought and sold, respectively.

DIAGRAM VI.2
Settlement of cross-border FX transactions



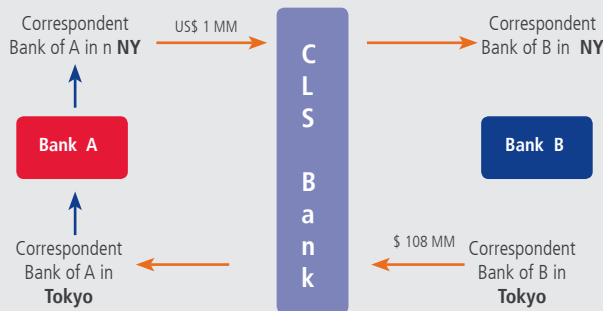
Source: Central Bank of Chile.

The CLS system provides a global payment platform that mitigates or eliminates counterparty risk by establishing a PvP system. In this sense, the CLS system holds a position in between the different correspondent banks through which cross-border transactions are channeled (diagram VI.3).

^{1/} CLS Bank International and CLS Services, part of CLS UK Intermediate Holdings Ltd.

^{2/} The 23 committee members represent 18 eligible currencies, with the exception of the Eurozone which is represented by the ECB and the national central banks of Germany, Belgium, France, Netherlands, and Italy.

DIAGRAM VI.3
Settlement of cross-border FX transactions



Source: Central Bank of Chile.

Counterparty risks in an FX transaction

The reduction of this type of risk was the core motivation for the more advanced countries to develop the CLS system, in an environment of accelerated growth of cross-border transactions and the expansion of the globalization process. In this area, a frequently mentioned example is the German bank *Bankhaus Herstatt*, which became insolvent almost exclusively due to counterparty risk management problems in cross-border transactions^{3/}.

Response capacity in a financial crisis

In periods of financial uncertainty, especially on a global scale, having a channel through which counterparty risk can be attenuated can be crucial.

During such periods, as in the last global financial crisis in 2008, international interbank markets tend to quickly lose liquidity in the face of the uncertainty and the difficulties of assessing the risk associated with their counterparties. This effect, while not eliminated, can be mitigated through the availability of a system that removes settlement risk.

International integration of the payment systems

An important advantage of the CLS system is that it operates via payments in “central bank money.” To achieve this, the CLS system functions by interconnecting the RTGS systems of the different jurisdictions that participate in the system^{4/}.

The possibilities created by this infrastructure include increasing the capacity for interaction between central banks, thereby facilitating, for example, the implementation of inter-jurisdictional liquidity facilities or programs.

Access to the CLS system is a sign of financial strength

To gain access to this system, CLS imposes stringent access requirements on the participating jurisdictions, for example, in terms of country risk levels, legal certainty, the level of development of the internal payment systems, and so forth.

In this sense, pertaining to the CLS system is a signal that the local financial market and payment systems are capable of complying with rigorous international standards.

Greater financial integration favors competition

Finally, greater efficiency and security in the settlement of cross-border transactions would contribute to increasing the number of international participants that are interested in carrying out transactions with local or international counterparties using the Chilean peso. In this sense, incorporation into the CLS system could stimulate a more competitive local financial environment.

Recent actions by the CBC

Given the importance of the benefits described above, the CBC has recently undertaken concrete actions to promote incorporation in the CLS system.

In July, the CBC received a delegation of representatives from CLS Bank International and CLS Services, who held meetings with key areas of the CBC on the potential implementation of the CLS system. During the visit, the representatives of these institutions had the opportunity to describe the main characteristics and advantages of the CLS system to members of

^{3/} In June 1974, the *Bank (Bankhaus) Herstatt*, after having received payment from its counterparties, was declared bankrupt. As a result, the bank was unable to execute a series of payments to other financial institutions, propagating the effect in the international markets and generating losses of over US\$600 million in the period.

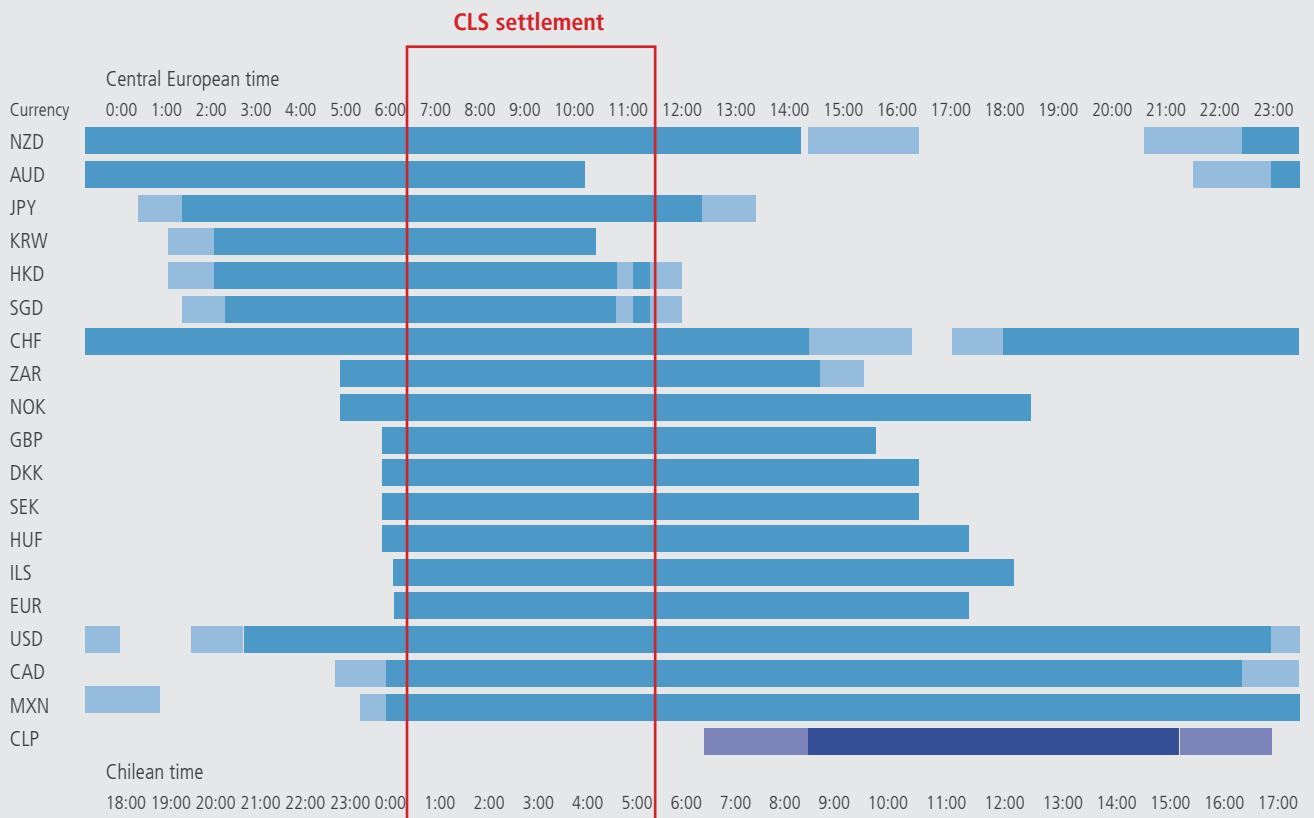
^{4/} Real-time gross settlement (RTGS) systems are, in the majority of cases, operated and managed by central banks for the processing of interbank payments. The monitoring of transactions made through the RTGS system of the CBC is normally presented in Chapter VI of this *Report* in the second half of each year.

the financial market, including banks, pension fund managers, and financial market infrastructures. The representatives also had conversations with financial regulators and supervisors to discuss the benefits and functioning of the system, as well as to learn about the particularities of the local financial sector.

The Central Bank of Chile is studying the adaptation of the RTGS system in accordance with the characteristics of the operations of the CLS system. Given the current high standards of the RTGS system, the main challenge will be operating outside of normal business hours. Due to the time difference with Central Europe, the RTGS system would have to operate in the pre-dawn hours to allow the settlement of payments through the CLS system (diagram VI.4).

Finally, the CBC is implementing an agenda for the modernization and flexibilization of its foreign exchange regulations, which should facilitate the expansion of the number of cross-border transactions that can be carried out with Chilean pesos and, therefore, enable an increase in the participation of nonresidents in the local foreign exchange market (chapter V).

DIAGRAM VI.4
CLS settlement hours versus RTGS system operating hours (*)



(*) The inclusion of the Chilean peso in this table is solely for the purpose of illustration, given that it is not one of the currencies settled in the CLS system. Settlement hours assume daylight saving time in the Northern Hemisphere and standard time in the Southern Hemisphere. The partially shaded areas correspond to settlement hours only during some periods of the year (from the perspective of Central European time).

Source: CLS.