

CLS and Liquidity Management: New Challenges; New Tools

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While the advent of CLS should do much to mitigate Settlement Risk and contain capital charges, other risks might become more pronounced. This article focuses on the liquidity issues the industry is facing and the tools emerging to manage the new risks.

The Essential Liquidity Management Problem...

Liquidity is a measure of how well funding commitments can be met at the time they are due. In the CLS process there are two liquidity challenges. The first is to offset long and short positions across all sponsored participants (branches, subsidiaries, and Third Parties). The second is to meet the CLS funding schedule, between 7:00 a.m. and noon Central European Time.

Because CLS Bank accepts only matched trades there is a natural offset of the long and short positions of each trade. However, CLS Nostro Agents that have committed to make payments on behalf of two Settlement Members cannot just pay the net difference if one is long and the other is short. The Nostro agent has to consider each position separately and pay the short position first, as required by the CLS pay-in schedule, regardless of when payouts are received from CLS. This is the root of the problem.

At any point in time on a given day, any requirement to pay out more than has been received via a clearing system has to be covered by central bank overdrafts, which are collateralised (except in the U.S.). As the incoming payments are highly unpredictable, any specific intra-day pay-out requirement raises the amount of the central bank overdraft and therefore the collateral requirement.

...Very Large Pay-Ins

Early analysis of the FX data submitted by CLS Shareholders confirmed that potential spikes in the

net positions will require very large pay-ins. Although in some currencies the liquidity would be available and covered by central banks using available collateral (at a cost), it would be difficult to find available collateral for other currencies.

The problem? With CLS and its specific pay-in schedule, there is a new timing issue. Therefore, shifting part of the net position to a currency settling later in the day may be the solution. The tool to deliver this intra-day movement of positions is the Inside/Outside Swap.

One Solution: The Inside/Outside Swap for an Intra-Day Movement of Positions

The CLS Inside/Outside Swap results in the removal of large net positions from the CLS settlement system and therefore the CLS timeline, which results in moving cash flow requirements to either earlier (AUD and JPY) or later (NA and European currencies). The CLS Inside/Outside Swap is a same-day Swap in which one leg of the Swap settles inside of CLS in order to reduce the net position, and the other leg settles outside of CLS.

FX settling outside of CLS - is this not defeating its purpose? Although the I/O Swap introduces settlement risk back into the process, overall there is still far less risk than in pre-CLS times. Joint estimates by CLS and regulators are that only 2 to 3% of the pre-CLS risk is re-introduced. The I/O Swap is a voluntary arrangement among CLS Settlement Members. The efficiency of the Swap depends on the distribution of the positions among the Settlement Members and the credit lines they are willing to give each other.

Another Solution: Today/Tomorrow Swaps

Not all Settlement Members have bought into the concept of the Inside/Outside Swap. Some would prefer to keep all of their positions inside of CLS,

and will elect to use Today/Tomorrow Swaps in order to manage their position on an inter-day basis.

While the I/O Swap is executed at the same price, the Inter-Day Swap is performed at Swap points reflecting the interest rate differential of the two currencies involved. Depending on the size of the positions being swapped this can be a sizable amount. This explains why the proponents of the I/O Swap are mainly made up of the larger banks, and the supporters of the Today/Tomorrow Swap are mostly smaller and midsize CLS Settlement Members.

Pay-In Calls and Uncertain Liquidity Demands for Settlement Members

Although Swaps are likely to provide some liquidity management relief, they may not always ensure liquidity demands are met in crisis situations that result in high value pay-in calls.

Pay-in calls are a risk management tool provided by CLS Bank which ensure completion of the settlement processes in the event that a Settlement Member is unwilling or unable to meet its commitment in CLS. CLS re-calculates Settlement Members' net positions excluding the trades that have been sponsored by the "tardy" Settlement Member and thus reduces the internal liquidity benefit (netting effect) of the CLS system. This causes CLS Bank to call for incremental pay-ins from Settlement Members on very short notice. These instructions are then passed on to the Nostro Agents¹ who must have the liquidity available to send the funds to CLS Bank in compliance with the pay-in call deadline.

The Underlying Problem

Despite globalisation and the interconnectedness of the financial markets, liquidity is still a very local event. Eventually liquidity will need to be generated in a way that better meets the needs of the integrated markets. A group of financial institutions are examining the new challenges introduced by increasing inter-day liquidity demands and will propose to the central banks, better processes to generate liquidity out of available liquidity in another currency.

The New Buzzword: "Cross Border Collateral Pool"

One concept the banks are considering is the **Cross Border Collateral Pool**. There are two variations of the Cross Border Collateral Pool. The **Common Collateral Pool** would utilise a mechanism by which securities eligible for collateral usage at central banks are moved intra-day from one central bank safe-keeping account to another. Although technically feasible, a lot of central bank goodwill is required to manage each other's collateral.

Another method is the **Common Cash Collateral Pool** which would involve the intraday movement of cash balances in one currency from one central bank to another in order to obtain liquidity in another currency. This method might be an easier one to manage than the Common Collateral Pool.

The following example illustrates how a debit of one currency in one account can be used to credit another currency in another account. It shows how GBP liquidity is generated using USD liquidity.

Scenario

- A Settlement Member needs 1 billion GBP.
- He has the equivalent amount of USD sitting in a Federal Reserve account.

Possible Process


- The USD is moved to the Bank of England's USD account at the Federal Reserve.
- The Bank of England grants the Settlement Member an overdraft of 1 Billion GBP backed by the Cash collateral in USD (after applied hair-cuts).
- The GBP intra-day overdraft is transferred from the Bank of England back to the Fed before the close of business in the UK.
- The USD is released back to the Settlement Member for further use in the USD processing day.

Such a mechanism would use existing central bank channels to provide a quick response to incremental liquidity demands.

How the Various Tools Stack Up

Only experience will tell if these tools are effective enough to manage the liquidity demands introduced by CLS.

In the short term, Swaps seem to be the only feasible solution. Longer term, more innovative solutions, such as The Cross Currency Collateral Pool, may be the answer. The Cross Currency Collateral Pool is a more elegant and general solution to the liquidity issue as its applicability is not restricted just to CLS. However, support is needed by the central banks to move this new tool from concept to reality.

1 The Nostro's obligations with respect to making payments for Settlement Members are subject to the terms and conditions contained in the specific agreement between the Nostro Agent and the Settlement Member 

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