

Facing The CLS Liquidity Challenge

While the introduction of CLS has done much to mitigate settlement risk, liquidity risk continues to lurk in the industry's collective consciousness as a potential problem—and rear its head as a topic of concern and discussion. The issue, at its simplest, is that CLS providers have to make high-value, timed payments required by CLS Bank throughout the day and may find that they are unable to cover their positions or that they are unable to do so without paying a high cost—in interest or overdraft charges. With so much discussion regarding liquidity one might wonder: Is the industry averting what could be a very real liquidity crisis through the use of tools such as the Inside/Outside Swap, or is all of this talk about liquidity largely much ado about nothing? This article explores the reality of the liquidity issue today, the tools and approaches that are currently available to mitigate liquidity risk and manage liquidity intraday, and the solutions that might be available in the future.

Where We Are Today: The Challenges and Costs of Liquidity in the CLS Environment

Since CLS went live in September 2002, over 170 direct and indirect participants have collectively settled approximately \$115 trillion in CLS as of the end of June 2003, averaging approximately \$4 trillion per week. Except for a systems-related failure at CLS Bank on March 25 that was quickly rectified, CLS has not had a single failed foreign exchange settlement. CLS is not only working extremely efficiently, it is rapidly becoming the standard for foreign exchange settlement within the industry.

Although the industry has not yet witnessed any major events relating to liquidity, there have been instances where CLS Third Party service providers (also referred to as Settlement Members or CLS Agent Banks) have been unable to provide the liquidity required by CLS. Some providers are starting to question whether their Nostro agents can handle the timed payments required by CLS and whether they will always be able to cover their CLS positions.

Settlement Members are recognizing that if they pay out to CLS Bank in Federal Reserve funds and receive return funds from their clients and Nostro agents through CHIPS, they have a problem: The Federal Reserve Bank charges interest on the overdrawn account by the minute. Since CHIPS liquidity does not get converted to Fedwire liquidity until the afternoon, at 5:00 p.m., the interest costs accrued on the overdrawn account can be significant.

Eventually, as volumes on CLS increase, liquidity risks—and the cost of liquidity—will be reduced due to increased netting levels, but the risks and cost will never be entirely eliminated. To protect



themselves and their clients, CLS participants should make sure their CLS Settlement Member has the right service level agreements in place with their Nostro agents.

Mechanisms for Managing Liquidity in the Market

The Inside/Outside Swap has proven to be an effective tool for managing intraday liquidity. Modeled after the EBA/Target Swap, the Inside/Outside Swap is a same-day swap in which one leg settles inside of CLS to reduce the net position, and the other leg settles outside of CLS. The Inside/Outside Swap removes large net positions from the CLS system and reduces liquidity requirements and costs for both Settlement Members and their Nostro agents.

Although the Inside/Outside Swaps have proven to be effective, another possibly even more effective mechanism is on the horizon—namely, a common cash collateral pool that would make the collateral held with the central banks more fungible.

Small-scale cash collateral pools already exist and are serving smaller communities. The Nordic Central Bank, serving Sweden, Norway and Denmark, already has a cash collateral pool in place for the three Nordic currencies. The Bank of England offers, in effect, a cash collateral pool for sterling and the euro; banks can easily get euro in exchange for sterling (and vice versa) in just a few minutes.

The next step is to create a cash collateral pool for the three biggest currencies—euro, US dollar and yen—and ultimately to create a pool with multiple central banks across all the CLS currencies.

Development of an industry-wide cash collateral pool requires the buy-in and support of the central banks, which will need to accept each other's collateral or, at minimum, each other's cash balances. Not all the policy makers of all the central banks are on board with the idea of a cash collateral pool at this time. European countries, through the European Central Bank, have already had to accept each other's collateral as part of the euro conversion and in general recognize the markets are interdependent and interconnected. The central banks of other countries are learning about the cash collateral pool and have expressed various levels of support for the initiative.

The cash collateral pool conforms to central bank policies and requirements for a collateral-based RTGS system, and the underlying mechanisms for creating a cash collateral pool exist. For example, the European Central Bank has an account at the Federal Reserve Bank and vice-versa. With some automation and real-time reporting of information, a cash collateral pool would be fairly easy to create.

such as the real-time Nostro initiative leveraging Cable and Wireless and Gresham technologies enable institutions to capture transaction information earlier and use it to forecast their in- and out-flows much earlier in the day.

CLS: Driving Change and Opportunity

While the Inside/Outside Swap is an effective short-term mechanism for managing intraday liquidity, the cash collateral pool, which recognizes the interconnectedness of the financial markets and meets the needs of an integrated global market, already exists—and works—on a small scale. The next step will be to implement the cash collateral pool on a broader scale. As such, CLS is a true catalyst, driving more change and integration in the global economy than was initially thought.

Opportunities linked to rapidly evolving technologies are also emerging. Financial institutions can leverage the technology initiatives occurring in the industry and within their own organizations to make highly integrated real-time information more readily available. Those that learn how to leverage this real-time information to better manage liquidity intraday are likely to be able to free up capital, improve cash utilization and positively impact the bottom line of their organizations. ■

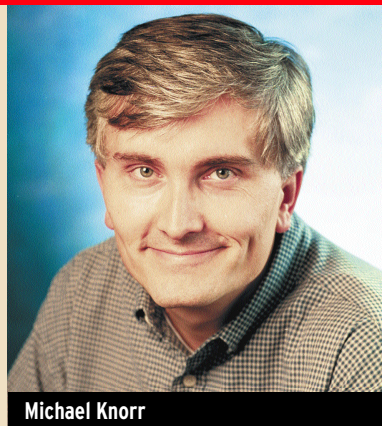
Micromanaging Intraday Liquidity on the Client Side

To manage intraday liquidity effectively, Treasury and Funding need to know when and how long liquidity will be available. They must gain early access to comprehensive, real-time account information and then review their intraday commitments to see where they will be long or short.

SWIFTNet, SWIFT's messaging platform, provides the high-level information integration required, and other enabling technologies

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