

Facing The CLS Liquidity Challenge

While the introduction of CLS has done much to mitigate Herstatt or 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 Members 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 problems that have surfaced in the market, 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 60 direct and indirect participants have collectively settled over US\$36 trillion

"... if the provider has a client that does, for example, two trades a day - each for a half a million dollars - the provider will need to look at the returns on the credit lines because they will not be making adequate returns on the fee side..."

in CLS without a single failed foreign exchange settlement. In terms of FX settlement, CLS is working.

Although the industry has not yet witnessed any major events relating to liquidity, there have been instances where CLS Settlement Members have been unable to provide the liquidity necessary to meet the pay-in requirements of CLS. Some Settlement Members are starting to question whether their Nostro agents can handle the timed payments required by CLS and whether they will always have access to the funds they require to cover their CLS positions.

Settlement Members are recognising 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 a fee 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 cost accrued on the overdrawn account can be significant.

Eventually, as volumes on CLS increase, liquidity risks - and the cost of liquidity - will be reduced, but the risks and cost will never be entirely eliminated. Although Settlement Members are charging for CLS Nostro services, they are not charging Third Party clients for liquidity because of competitive pressures. If a CLS Settlement Member has a Third Party client with high transaction volumes and high liquidity needs, the transaction fees should cover the cost of liquidity. But if the provider has a client that does, for example, two trades a day - each for a half a million dollars - the provider will need to look at the returns on the credit lines because they will not be making adequate returns on the fee side.

To protect themselves and their clients, CLS Settlement Members that do not have a direct relationship with the local Real-Time Gross Settlement (RTGS) system for a particular CLS currency should make certain that they have the right service level agreements in place with their Nostro agents. In addition, to avoid unforeseen liquidity needs - and associated costs - Settlement Members should gather detailed information from their clients.



Michael Knorr

At Citibank we have collected an extensive body of knowledge on each client. We know if they have access to the RTGS systems or if they have increased their collateral. We know their net positions, their counterparties, and how they move funds. With such exhaustive information, we are better able to estimate liquidity needs.

Mechanisms for Managing Liquidity in the Market

Although some CLS Settlement Members are being challenged to meet liquidity requirements on an individual basis, Inside/Outside Swaps have proven to be an effective tool for managing intraday liquidity within the market. The Inside/Outside Swap removes large net positions from the CLS system. It also 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. The idea is to make the collateral held with the Central Banks more fungible via a common cash collateral pool.

Small-scale cash collateral pools already exist and are serving small communities. The Nordic Central Bank, serving Sweden, Norway, and Denmark already as 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 Euro; banks can very quickly and 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, U.S. Dollar and Yen - and ultimately to create a pool with multiple central banks, across the seven or more 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 systems, 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

"... 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..."

Central Bank, have already had to accept each other's collateral as part of the euro conversion, and in general recognise the markets are interdependent and interconnected. The Central Banks of other countries are observing and 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.

Micromanaging Intraday Liquidity on the Client Side

To manage intraday liquidity effectively, Treasury and Funding need to know when liquidity is available. Treasury and Funding must gain early access to more comprehensive, real-time (cash, securities, foreign exchange and other) information impacting accounts and then review the bank's intraday commitments to see where they will be long or short. SWIFTNet, SWIFT's messaging platform, provides the high-level information integration required. Other technology initiatives such as the real-time Nostro initiative leveraging Cable and Wireless and Gresham tech-

nologies enable banks to capture transaction information earlier and use it for short-term forecasting. Internally, new messaging technologies enable clients to capture SWIFT traffic before it even gets through a transaction processor, which also helps them forecast their in and out flows much earlier in the day.

CLS: Driving Change and Opportunity

Although some CLS Settlement Members have encountered preliminary challenges in the area of liquidity, or major liquidity events have occurred in the market. The Inside/Outside Swap has proven to be an effective short-term mechanism for managing intraday liquidity but a more promising solution is now on the horizon. The cash collateral pool, which recognises 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 broaderscale. As such we may one day be able to view CLS as 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. Corporations cannot justify spending millions of dollars on their infrastructure to support intraday liquidity management. However, they can leverage the technology initiatives occurring in the industry and within their own organisations to make highly integrated real-time information more readily available. Corporations 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 utilisation, and positively impact the bottom line of their organisations.

• CLS and CLS Bank are trademarks of CLS UK Intermediate Holdings Ltd.

• SWIFT and SWIFTNet are registered trademarks of S.W.I.F.T. SCRL

Michael Knorr

Vice President, Citigroup

Michael Knorr, is the Global Product Manager of Citibank "CLSTM Settlement Services. In previous assignments, Michael was the EMU Business Project Manager for Global Cash Management and has developed electronic banking systems, receivables and EDI solutions.

www.cashtradetresury.citibank.com