

The Importance of CLS to Global Corporate Treasury

by Conrad Steinmann, Vice President, Citigroup Global Transaction Services

Why should corporations care about Continuous Linked Settlement (CLS)? The answer is Sarbanes-Oxley. CLS provides a single, transparent FX settlement process for 11 currencies (and is expected to process a total of 15 currencies by the end of 2004). Rather than manage 11 different processes with 11 different banks in a variety of time zones, corporations, as CLS third parties, benefit from using a single CLS provider, a single transparent process, and a single multicurrency account, which is easy to monitor and audit. Corporations should participate in CLS because it facilitates compliance with increased regulatory requirements such as Sarbanes-Oxley while increasing operational efficiencies. Corporations experience other benefits as well – such as improved cash management through more precise multicurrency cash forecasting and reduced funding requirements due to multilateral netting. Before we explore its value to corporations in detail, it is important to understand the basics.

CLS in 2004

Continuous Linked Settlement is the world's first global, multicurrency, real-time gross settlement system; it reduces foreign exchange (FX) settlement risk by settling both legs of a foreign exchange transaction simultaneously and irrevocably on a payment versus payment basis, irrespective of

geographies or time zones. CLS went live in September 2002, and a total of 55 Member banks and their 137 third party customers are now settling over 130,000 payment instructions each day, with a gross value in excess of US\$ 1.4 trillion. On January 20, 2004 (following the public holiday in the U.S. on January 19), CLS Bank International set a new record for the volume and value of payment instructions settled in one day – 262,756 payment instructions with a gross value of US\$ 2.175 trillion.

CLS currency update

Currently, FX transactions involving the Australian dollar, Canadian dollar, euro, Japanese yen, British pound sterling, Swiss franc, United States dollar, Danish krone, Norwegian krone, Swedish krona and Singapore dollar are eligible for settlement in CLS. In addition, the South African rand, Hong Kong dollar, New Zealand dollar and Korean won have been endorsed by the CLS Bank Board, and will, subject to regulatory approval and completion of implementation, become CLS-eligible currencies by the end of 2004. (Note that trading restrictions permit only local corporations to trade in Korean won. Therefore CLS volumes in the Korean won are expected to be low.)

The benefits of CLS

CLS benefits fall into two categories – operational benefits that are typically

viewed by corporations as the primary benefits and 'other' or secondary benefits such as the reduction of risk credit lines.

Increased operational efficiency

CLS offers easy intraday access to real-time settlement information that enables corporations to see and correct errors prior to settlement day. With CLS, participants know early in the process what has and has not matched and can proactively initiate investigations, when necessary. For example, notification of 'alleged trades' that a counterparty enters into CLS lets a corporation know that the counterparty sent a message to CLS and they have to confirm the trade. Alleged trades outstanding for an extended period of time indicate that an investigation is needed. The result is fewer fails and fewer funding issues. A much greater transparency in status reporting and the ability to identify and fix mistakes ahead of settlement day enables timely receipt of expected cash.

Elimination of gross value payments; reduced settlement errors and reliance on daylight overdraft lines

Rather than make multiple gross payments for trades, CLS participants manage one net position per currency (a single debit or credit position) in their funding process with their Settlement Member. In other words, if a corporation settles 100 trades on

a particular day in 11 CLS currencies, it will make/receive only 11 payments (debits or credits) – one for each currency. In this way corporations benefit from the ‘CLS netting effect’ – less chance of payments being misdirected or late, fewer costly FX trade payment investigations to manage, and fewer compensation claims, which reduces settlement overhead. In addition, since only a single end-of-day position is transferred, reliance on daylight overdraft lines is reduced. Corporations can use their daylight overdraft lines for other activities.

Ability to monitor multi-currency activity through a single account and simplify reconciliation

With CLS, corporations can get real-time status information for each trade in 11 different currencies from one place – ideally through their Settlement Member’s browser-based system – rather than from multiple accounts/banks. This means reconciliation is greatly simplified. Corporations receive one fully reconciled account statement showing all the settlement details for both sides of each transaction.

Client service is simplified as well. With CLS, corporations follow up with their Settlement Member’s dedicated client service agent rather than 11 different banks in a variety of different time zones. In fact, with CitiDirect Online Banking, for example, clients can not only initiate their own transactions, but also monitor the entire CLS trading and settlement process end-to-end.

Greater audit control and a streamlined audit process

Without CLS, a corporation’s audit responsibilities and costs expand as they audit different processes for different currencies provided by different banks. CLS concentrates funds

A Conversation with Jonathan Butterfield of CLS Bank International

Jonathan Butterfield, Executive Vice President, Marketing and Communications, CLS Bank International, recently conducted an informal research study, gathering feedback from six U.S. multinational corporations on the real value of CLS to their organizations. Jonathan’s findings are consistent with Citigroup’s findings.

How will U.S. corporations benefit from using CLS?

When speaking with U.S. corporations, we showed them a list of benefits and asked them to rank them. The treasurers we spoke with based their rankings on the CLS benefits that addressed their ‘pain points’ – the need to improve operational effectiveness, comply with Sarbanes-Oxley, and manage cash, liquidity and counterparty risk more effectively. U.S. corporations now tasked with complying with Sarbanes-Oxley clearly value the improved operational oversight and control the CLS process offers, along with related operational efficiencies – efficient trade matching, real-time information on settlement, reduction in payment volumes via netting, and settlement error elimination. Secondary benefits include improved cash management through precise multi-currency cash forecasting, and reduced funding requirements due to multilateral netting. Eliminating counterparty and settlement risks are also viewed as secondary benefits.

Did any benefits surface that CLS Bank and its shareholders had not yet identified?

Some treasurers mentioned that they had never before been able to get any external certification of operational effectiveness on any bank service. Corporations see service records and percentages of fails provided by the banks’ own internal quality departments rather than a certification of operational excellence provided by an external agency. Since CLS Settlement Members are put through live trialing and testing, they feel CLS Bank International has, in effect, certified their operational effectiveness. Some of them mentioned that, for this reason, they will only do business with banks that are CLS Settlement Members.

They also mentioned the benefit of not having to deal with compensation backvalues. Dealing with remote currencies can be tedious and time-consuming due to the lack of standardized compensation rules.

Did corporations surface any concerns?

They understood that if they selected a CLS service for 11 currencies, one bank would be dealing with those currencies and they would be taking operational business from their other banks. They wanted to know if their third party Settlement Member would let them continue to use offshore banks for settlement – many of whom they have local credit relationships with – or if they would be forced into using the Settlement Member’s nostro accounts. We pointed out that, assuming they deal with major banks in major currencies, their settlement banks are likely to be CLS Settlement Members too, which should mitigate any relationship impact. Also some service providers do allow their clients to maintain existing nostro relationships.

into one bank, in the CLS operating account, and brings information on all currencies and transactions into one place. CLS is a single transparent

process that provides treasurers with increased control – complete transparency of real-time information that is easy to audit and approve.

Higher straight-through processing rates, greater operational efficiencies, and reduced costs

A fully automated CLS solution that is integrated into a treasury system enables corporations to rationalize back-office processes, streamline funding and account reconciliation, and achieve higher straight-through processing rates. As a result of increased operational efficiencies, the cost of FX settlement is reduced.

Other benefits

Reduction of risk credit lines

The CLS process reduces settlement risk, and along with it, the need to maintain settlement risk credit lines for FX trading with counterparty banks. This frees up credit that corporations can use for additional trading. Furthermore, bank counterparties are likely to view corporations – even those with credit issues – as less risky counterparties once they become CLS participants.

More certainty about intraday and end-of-day cash positions and increased access to intraday liquidity

CLS features predictable, timed (rather than random) pay-ins and pay-outs. These timed pay-ins and pay-outs provide treasurers with more certainty about their intraday and end-of-day cash positions and improve forecasting. Proceeds can more easily be scheduled to facilitate funding of business activities occurring intraday.

Depending on the Settlement Member, the movement of cash on settlement day can be a highly automated process. For example, Citibank offers a highly automated cross-border sweeping program that leverages real-time gross settlement systems to move net FX settlement automatically, in

Corporations' Most Frequently Asked Questions about CLS

1. How fast can you implement me on CLS?

The time required for implementation depends largely on your treasury and FX settlement system vendors and the changes that must be made to these systems. Changes to some treasury/FX settlement systems are complex and require several months of development. Others take no more than a month or two. Corporations that execute a few trades, fewer than 20 per day, can manually enter trades in their Settlement Member's browser system, such as CitiDirect Online Banking. Corporations with heavier volumes can forego full CLS/treasury integration temporarily and simply upload files so they can begin using CLS and reaping the many benefits sooner.

2. What treasury or FX settlement system changes are needed?

Your system or a person must be able to identify CLS-eligible trades by currency, by counterparty, and by trade type. (Tomorrow/next day swaps, forward trades and FX options are allowed; same-day money market trades are not allowed.) You also have to format the confirmation to include your CLS provider as your settlement bank, and CLS bank as the intermediary bank.

3. Do you offer integration with my treasury system?

Yes, but depending on your treasury vendor, system modifications may be required. Certainly the big treasury system providers can easily accommodate CLS integration.

4. Is my principal protected in CLS?

Yes, the CLS process protects principal. As long as there is no rescind of instruction and no cancellation of contract, once the instructions have matched in CLS and settlement has begun, the settlement process proceeds. CLS will not release cash until value is received from the counterparty.

5. Will my FX banks refuse to trade with me if I cannot settle via CLS?

It is probable that your banks will continue to trade with you regardless of whether you participate in CLS. However, it is clear that CLS is a best practice and the optimal settlement method for banks as well as corporations, offering a streamlined process and many benefits including greater transparency and control enabling compliance with Sarbanes-Oxley.

real-time, overnight or intraday. This gives clients more timely access to funds. They can receive funds in the middle of the day in Asia, reducing reliance on daylight overdraft lines for the Asian region. They can also access funds early in the morning, European time, to fund business activity for the day. Since Citibank automates all payments, clients no longer have to generate cross-border sweep instructions.

A greater transparency of information enabling better management of balances

In a non-CLS environment, treasurers typically do not know precisely what their net balance will be at the end of the day. With CLS, a participant sees the projected balance – one position for each currency – a day in advance. For example, in CLS, if a company is long in Swiss francs, and short in euros, they can use a tomorrow/next day swap, to trade Swiss

francs against euro and thereby reduce or eliminate the overdraft in euro and avoid bank charges.

With greater transparency of information available through CLS, a corporation's settlement, trading and treasury units have an opportunity to collectively manage trading and funding in a more optimal way – making adjustments to tomorrow's balances at the end of each business day.

Improved management of capital on a global basis

Since FX trading is more secure, efficient and cost-effective in CLS, corporations might embrace FX trading for cross-border funds movement on a more frequent – weekly or even daily – basis. Corporations may consider using FX trading mechanisms in the CLS environment to fund subsidiaries, to manage capital and liquidity on a regional or global basis, or simply to hedge exposure in certain currencies.

Reaping the full benefits of CLS to gain competitive advantage

CLS brings a wide range of operational efficiencies to corporations. In addition, through the more transparent, more controlled CLS process, corporations can achieve compliance to regulatory initiatives such as

Sarbanes-Oxley. For treasurers challenged with managing their liquidity more effectively on a global basis, CLS offers a new cross-border payments paradigm. Since FX trading in the CLS environment is more secure, they can use FX trading mechanisms more frequently.

For maximum efficiency gains, CLS can and should be seamlessly linked to back-office treasury systems so that trade information is automatically transferred and the potential for errors – and operational risk – further reduced. However, corporations should not forego the benefits of CLS by postponing the transition to CLS until full treasury integration can be accomplished. A better option may be to begin using CLS sooner by simply uploading files.

CLS has already transformed the way financial institutions process FX transactions, and in the future, is likely to transform the way corporations process foreign exchange transactions as well. A few leading corporate treasuries have already begun to implement CLS and their companies will soon be enjoying the full range of operational and strategic benefits CLS offers. Treasurers who understand that the benefits of CLS extend far beyond settlement

risk reduction are the ones that will not only keep pace operationally with their bank partners and counterparties, but also will gain a competitive advantage in an increasingly connected global economy that is now, more than ever, demanding real-time global solutions. ♦

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Citibank has over 40 CLS third party clients and is the number one provider of CLS by volume based on SWIFT T-copy service. Citibank was rated 'Best for CLS in North America' by Global Finance in 2004 and 'Best Approach to CLS' by *AsiaMoney Magazine* in 2003.

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