



Adapting to a rapidly changing environment

Changes to payments systems worldwide mean tougher times ahead for financial institutions. Nicholas Downes of Logica outlines the challenges.

Since the introduction of real-time gross settlement (RTGS) by central banks worldwide, liquidity management has become increasingly complex. This year, structural and operational changes planned for payments systems in Germany, the US and the UK will also have a profound impact on the way banks manage intraday liquidity.

The arrival of timed payments under the continuous linked settlement (CLS) model will add to the burden. Complications such as the need to manage multiple euro payment systems and getting liquidity locked up in nostro accounts, rather than passing over payment systems, have been accumulating since the launch of the euro.

Intraday liquidity

Managing liquidity is about to get tougher. Within RTGS systems, financial institutions are usually required to put up collateral to cover their cash positions. Some banks buy a lot of liquidity to enable them to send out payments when it is convenient to them, while others buy a limited amount and use it efficiently by balancing incoming and outward payments.

The industry has gradually moved from the payments netting scenario, where a score would be kept of the incoming and outgoing instructions and the net amounts would be settled at the end of the day. The drawback was that lacking finality, cash could not be relied upon until the end of day. Therefore, the treasurer was never sure whether the money was his until the net settlement had been confirmed.

The payment systems changes which

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are under way create a very different scenario. In the US, intraday finality of payments is being implemented through the clearing house interbank payments system (CHIPS). The CHIPS requirements include periodic funding with specific deadlines, longer operating hours with shorter settlement cycles, and a need for recycling funds between systems and counterparties.

A study by the Intra-day Liquidity Management Task Force of the Payments Risk Committee – *Intraday Liquidity Management in the Evolving Payment System*, published in April 2000 – found that the US dollar liquidity demands of CLS are relatively small in relation to the pool of liquidity available in the US market.

US dollar liquidity is also considered adequate within CHIPS. The problems begin, though, with the distribution of intraday borrowing capacity which is skewed towards the big US money centre banks. The report states: "CLS explicitly links all of the CLS-eligible

currencies, and institutions will need to arrange for committed funding in non-domestic currencies to meet contingency requirements. Since the US dollar accounts for a leg for more than 80% of FX transactions, it will have an important role in the intraday treasury funding used to manage overall CLS currency positions."

CHIPS appeal

In essence, under the new CHIPS model, institutions are required to put in certain amounts of cash liquidity to the central bank, which will then use that in an efficient way and schedule it to coincide with settlement. CHIPS then passes on the information to the beneficiary or receiving bank, which will then know it has finality immediately. But a transaction in CHIPS may remain there all day, looking for a suitable counterbalance.

The interesting aspect of the new CHIPS regime is that it demands a certain amount of cash to be placed into the system, which drags down more of the cash financial institutions are required to pay on a daily basis.

In Germany, the central bank RTGS system is trying a different approach. The RTGS system provides a stream of messages and, within a liquidity efficient service, payments are ordered according to their level of urgency. Those not urgent are assigned a different code. The aim is to have all payments managed, queued and dealt with in the most efficient way.

All these models require treasurers to look at ways of cutting down on how much cash they need to operate. Similar to a float in the till of a shop, how much money you keep in it

depends on the flow of the activity in the shop – too much and you would be wasting resources; too little and you may have to close for the day.

Continuous linked settlement

CLS has made life more difficult in that it has brought timing into the equation. At little notice, financial institutions may have to pay large sums at certain times of the day. But how does a treasury manager cope with this?

One option is to have huge supplies of liquidity available, but that can prove to be very expensive. If a bank spurns this route, then it needs some way of ensuring that it has the right amount of liquidity set aside each day. Another way is to reserve cash within a system that will be used only for critical payments. But if you reserve all the cash you would need for CLS at the start of market, in terms of the ability to make other payments, you are not using that liquidity efficiently. The same applies if you set aside liquidity at the start of day for the first deadline, then set aside spare cash for the second deadline.

Tougher regime

The problem is that managing cash pools is going to become more complicated. Some liquidity is required in CHIPS, some for CLS obligations and, as securities settlement systems move into delivery versus payment, demands at certain times of the day will be made by the settlement clearing house. All of these specialist intraday deadlines require the treasurer to have cash available. And he will also have to rely on counterparties to send in cash promptly.

This complexity in cash pools is having a profound effect on treasury operations. The emerging model combines traditional treasury functions (such as ensuring the bank has enough money) with payments issues (including which payments should be released at what time). Increasingly, payments and treasury processing are being rolled together into an intraday money desk. This ensures that money is in the right place at the right time and that no resources are wasted.

These intraday money desks need certain tools to be able to address intraday liquidity requirements. They must be able to monitor, remember and direct patterns of cashflows. But it

is not restricted to the funds being paid out – financial institutions need to gain a proper understanding of when their counterparties pay them.

The Heathrow Group of banks is currently debating and agreeing 'best practice' arrangements for exchanging settlements in an attempt to address the problem. It recognises that banks need to agree the basic model of operation for using the various alternative payment systems as an imbalance of cashflows results quickly in liquidity gridlock.

Tackling the issue

The first intraday liquidity task that should be completed is tracking and monitoring incoming and outgoing payments. Different cashflows will, of course, require different strategies. A tool that can take payments out of legacy systems, and apply those strategies to them, will be an important first step on the way to efficient intraday liquidity management.

Over the past four to five months, much interest has been shown in liquidity management tools, particularly among the smaller banks, which cannot set aside large pools of liquidity to cope with CLS timed payments. For example, at Sibos in San Francisco, during September 2000 interest in CLS and its related issues was high as the settlement member banks began to flesh out their offerings and delegates realised the complexity of some CLS issues.

A majority of CLS members, for example, will face an important obligation through their correspondent nostro agents. Some believe that they should work through an agent that can handle the timed payments under a service level agreement guarantee. But

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it is not that simple.

A financial institution can only offload this problem to an agent if it can ensure it has sufficient liquid assets in the account with that agent. For instance, an institution with no access to Japanese Yen clearing will have to balance what it has bought, ensuring the right amount of Yen liquidity so the agent can perform the payment.

Of equal importance is to manage liquidity in nostro accounts as it is in payments accounts. Credits and debits going across these accounts vary dramatically. They could be money market, foreign exchange or securities, and without real-time information the bank will not know how much cash is there. A number of the larger banks, and Swift, are considering delivering real-time access to nostro account information.

Liquidity risk

One important issue which timed payments raises is that of liquidity risk. In tying the movement of liquidity to another movement within CLS, markets are linked globally. Richard Pattinson, Assistant Group Treasurer of Barclays Bank, believes this creates an operational risk, where if a party fails, everyone down the chain is short. If a system runs out of liquidity, the payment system becomes gridlocked and mechanisms to prevent this are becoming a significant need.

Pattinson champions the cause of the inside/outside swap (I/O swap), where CLS settlement members can trade their long or short CLS positions, outside of CLS before CLS settlements begin on a particular day. This enables banks to ease the front-loaded nature of CLS that requires large payments in its first payment tranches. So, for example, a player short in US dollars could find one with a long US dollar position and swap for another currency to borrow the US dollars. The I/O swap is designed to reduce the CLS payment obligation, and turn a time-sensitive transaction into one that more easily matches the normal flow of non-CLS payments in domestic systems. Thus, treasurers will no longer panic about US dollar movements in New York.

Real-time information

Financial institutions must extract more real-time information about cashflows out of their systems. This must begin

with getting to grips with the information they want and how to get hold of it. They must also collate what has happened and what has to happen into a combined management information report for the treasurer. Due to the complexity of real-time reconciliation of payment flows, this is a new concept and few people have been assigned such a task.

Financial institutions are not doing enough to tackle this problem; many are not even aware that one exists because they have not addressed intraday liquidity management at a detailed level. But this not only affects CLS, securities settlement will soon make its own intraday demands, and intraday plans and tools will need to be flexible enough to adapt to each country in which the institution trades.

Relationships with counterparties must also be examined. Managing intraday cashflows depends equally on how much is received as on how much is sent out. It is therefore imperative that some control over counterparties is maintained.

Financial institutions could negotiate with their counterparties to undertake all cashflows at certain times of the day, thus ensuring the treasurer is always aware of when a payment is due.

If the two parties can co-operate on the timing of cashflows, a more efficient system will result. However, both need the ability to control cashflows, and many of the larger banks foresee problems but their counterparties don't have the diagnostics tools to overcome them.

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Again, it must be stressed that it is still very early days. For this reason, a fixed model to manage intraday liquidity is inadvisable. At present, the industry is working to develop flexible solutions and the concept that liquidity is handled by a central system run by the central banks or clearing houses that manage the liquidity themselves has not been well received.

While, objectively, such a model appears to be the most efficient way to address the issue, few banks want to abdicate their control over liquidity. Banks have countered by suggesting that a central system may not be flexible enough or fast enough to adapt to new market models. Plus, a central system does not help with CLS-timed payments, for example, because money still has to be set aside, whether it camps out in the national system or at the centre.

As with large infrastructure programmes, it is difficult to get everyone to agree on what they should be doing. Those financial institutions that can arm themselves with real-time, accu-

rate management information can make whatever banking policy they like. They can set bilateral agreements or impose some controls. But if you do not have metrics to know what is going on, you are not in the game.

Many bank need a range of facilities that they do not have in their legacy payments systems, such as tracking and monitoring of payments timings. Such facilities may be difficult to fit in with existing payments systems, though. And to efficiently manage intraday liquidity, banks need a quick reprogramming tool that can be applied to the payment system during the day.

Slowly does it

Solutions will not appear overnight. They require a lot of consultancy and a debate within each institution as to what it wants and when it wants to get there. CLS will put pressure on banks to solve these problems, but they must not rush in, solutions should be grown gradually as treasurers get to understand each issue.

The benefits to be realised through managing liquidity efficiently, rather than just running payments on an ad hoc basis are great – banks can halve the amount of liquidity they need. Also liquidity is not the only issue here, the consequences of a missed deadline can seriously damage customer relations and dent reputations. ■

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