Follow the leaders

ANDREW GREENWOOD SETS OUT WHY CORPORATES SHOULD USE CLS.

Since its launch in 2002, CLS (Continuous Linked Settlement) has expanded considerably, both in the number of currencies covered and the volume of payment instructions settled. The initial seven currencies have risen to 15, and in June 2006 CLS Bank settled a record daily average of 291,087 payment instructions with a gross value exceeding $2.7 trillion.

There are two kinds of CLS participants: settlement members and third parties. A settlement member settles its own transactions and those of its customers (that is, third parties to whom it has sold the service). Currently, the service is used by 56 settlement members and 738 third parties. The number of corporate third parties used to be rather low, but there is an increasing number of major corporate clients, including GlaxoSmithKline Finance, Hewlett-Packard, Nike, Renault Finance, Unilever and Volvo.

A PRAGMATIC ASSESSMENT But for which corporates is the CLS concept suitable? What are the advantages and disadvantages? Does the technical solution differ for a corporate? Why hasn't your house bank approached you about it? All these issues will be discussed in this article. A description of the process and the technical way payment-versus-payment and settlement works is available on the CLS site.

UNDERSTAND YOUR RISKS Ask a corporate client what they know about CLS and the answer will be either "Nothing" or "Isn't that something that banks use to eliminate Herstatt risk?" It is easier to deal with the first answer. The second comment is often followed by: "We only deal with the top 10 banks whose financial standing is impeccable, so we don't have that problem," which means it is going to be a long meeting! Herstatt risk – the risk that a counterparty in a two–way transaction could pay the currency sold without receiving the currency purchased – is a type of credit risk. But to assume that CLS merely deals with credit risks is to misunderstand both the CLS infrastructure and an organisation's risk position.

Any corporate dealing with the banking sector faces a variety of risks. In its choice of house bank, the corporate needs to consider banker risk – the risk that the bank holding its funds becomes insolvent. In a multi-currency environment, many corporates hold a set of currency accounts for their treasury with a single bank. Some of the largest corporates work in the same way as banks themselves, and use separate banks for different currencies. Both approaches have advantages and disadvantages and banker risk is not addressed by participation in CLS.

Foreign exchange trading introduces the concept of settlement risk – the risk that settlement in a transfer system doesn't take place as

Executive summary

- Continuous Linked Settlement deals with a variety of risks that any corporate faces dealing with the banking sector.
- Benefits accrue in terms of settlement risk reduction, cashflow benefits and back-office efficiencies.
- The pioneer stage for corporate third-party CLS membership is over, and a wider group of multinationals should evaluate membership.

expected. This is a collective term for a number of other risks. For example, liquidity risk is the risk that a counterparty settles the obligation after the due date. Should this happen, the party involved would be faced with replacement risk – the cost of replacing the original transaction.

Next time you are delayed at an airport because of something that happened in another country, consider the systemic risks associated with air travel. A similar risk exists in the financial system.

When was the last time you argued with your bank over incorrect delivery of funds due to human error? Operational risks occur on a daily basis in undermanned treasury departments and the resulting costs can be substantial. Operational risks are not confined to the back office. Membership of CLS and the matching of transactions a short period after they are made makes it more difficult to have unauthorised dealing positions.

A corporate can argue that they have reduced their credit risks by restricting the number of banks they deal with, but they still have exposure to all the other components of settlement risk.

WHAT EXACTLY IS BEING SOLD? A corporate that becomes a CLS third party has no contractual relationship with CLS Bank. It settles its trades via its settlement member. To qualify for membership, both settlement members and third parties have to demonstrate their operational and financial robustness. CLS evaluates these criteria when a settlement member goes live and then monitors members on an ongoing basis.

The financial evaluation of third parties is undertaken by the settlement member, and the operational evaluation by the settlement member in association with CLS and, on an ongoing basis, the whole CLS community. A third party is buying access to an infrastructure so as to reduce dramatically the risks previously outlined. However, a settlement member does not assume the credit risk of the third party. All trades are still owned by the third party until the start of the settlement process. If there are any indications that a third party is about to become insolvent, then a settlement member would terminate its contract with the third party or withdraw the trades the third party has within CLS so as to avoid having to settle the third party’s net obligations on settlement day. Should this happen, the trades would need to be settled outside of CLS, and I for one would want to see the incoming funds credited before remitting the outgoing.

COST BENEFIT ANALYSIS OF MEMBERSHIP With credit risk remaining with the corporate, you might wonder whether there is a good business case for membership. Charges resulting from membership are obviously a matter for the settlement member and the corporate. There will almost certainly be a transaction cost and probably some form of fixed charge. A project implementation charge would also be reasonable. Finally, the corporate is likely to need to make some modifications to its treasury management system (TMS). Benefits accrue in the following areas:

1. Settlement Risk Reduction The CLS technical process ensures that settlement members and third parties are protected in a way that can't be achieved otherwise. Translating this into a financial benefit is tricky in terms of Herstatt risk elimination but easy in terms of eliminating operational errors and their associated cost.

2. Cashflow Benefits Your bank will provide you with a web interface where all matching and settlement activity can be seen in real-time. On each business day, settlement will be on a net basis – a single debit or credit per currency. This net position is shown for all days for which trades have been made, so an instant cashflow forecast is always available. On each settlement day, a corporate treasury is able to fix its cash positions much earlier because CLS payouts are completed by 12.00 CET (Central European time).

3. Back-Office Efficiencies Most of the easily quantifiable monetary and labour savings can be made here, in the areas of deal registration, confirmation, settlement and reconciliation change, as follows:

Deal registration Both before and after CLS, a deal is registered in the TMS. For CLS membership, however, it is advisable (and is the best solution for non-Swift corporates) to build a small application programming interface to facilitate the transmission of relevant instructions to your settlement member. Solutions based on copies of confirmations are best avoided.

Deal confirmation Prior to CLS, this was probably undertaken using a third-party confirmation system or by fax. CLS best practice is not to confirm CLS deals because that is done via the CLS process itself.

Deal settlement The number of transactions required for settlement

will reduce dramatically. Outside CLS, financial transactions are settled on a gross basis or with bilateral netting. Each settlement involves originating an outgoing same day value payment together with the receipt and booking of the incoming amount. For these services, your house bank would require a fee. In CLS, there is one net booking per currency on each of your currency accounts for all gross trades maturing on a particular value day.

Deal reconciliation Outside CLS, this can only be done when all funds have been credited to your account – in practice, this could well be on the following day because of time zone issues. Within CLS, the receipt of your net amounts around 12.00 CET completes this process.

OTHER ISSUES Clients are extremely satisfied with the end result, making comments such as: "How did we manage without this?" and "We haven't had a wrong settlement since we went into CLS." However, CLS may not suit all clients. In particular, the following issues need to be considered.

1. Transaction volumes and value Third-party membership of CLS is most suitable for corporate clients with a sizable treasury operation.

2. CLS doesn't cover all currencies or products Depending on the mix of currencies traded it may well be necessary to retain a separate process for non-CLS currencies. This is unfortunate but unavoidable, at least in the short term. CLS is looking at expanding the number of currencies and the range of products offered.

3. Centralisation and bank risk Most corporates like to spread their risk and their business between different banks. CLS is a powerful driver for centralisation and fits well with global centralisation of a corporate's treasury operations. But it works best for corporates that use the same house bank for all their currencies and are prepared to use that house bank as their CLS settlement member. The CLS settlement cycle makes stringent requirements for currency cut-off times, particularly in Asia-Pacific. This leads to practical problems for corporates wishing to split the roles of CLS supplier and house bank between different organisations.

WHY SO FEW CORPORATES? Responsibility for this must be divided equally between the banking community and corporates themselves. Only a relatively small number of settlement members are currently offering third-party services to corporate clients. Some have taken a conscious decision not to enter the third-party market for commercial reasons or because they lack the technical environment. Others appear to have decided that CLS isn't for corporate clients, while actively marketing third-party services to banks and financial institutions.

Among corporates, there is a misconception about the need and complexity. A major multinational corporate has the same risks as an international bank, albeit with lower transaction volumes. The "We don't have this problem" argument simply isn't valid. In terms of project complexity, the lead time for a corporate in this type of project will be around four months and is an undertaking of similar magnitude to integrating a TMS to a new e-banking application. The most time-consuming item will probably be the service level agreement (SLA), although this is time well spent, as a well-written SLA will ensure an effective process for both parties.

It is time to follow the leaders. The pioneer stage for corporate third-party membership of CLS is over. Technical solutions are available, SLAs have been written and TMSs modified. It is now time for a wider group of multinational corporates to evaluate membership.

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