CLS Bank International

Best Practices for Third Parties and Third Party Service Providers

April 2013

1.0 Background

CLS recognizes the need to identify and mitigate the systemic risks posed by both third party users of CLS as well as those Settlement Members that are third party service providers. These risks have risen and become more complex recently due to the rapid growth in the number of CLS third parties and concentration of third parties with a small number of service providers.

As a financial market infrastructure and systemically important financial market utility, CLS Bank International ("CLS Bank") seeks to identify, monitor, and manage risks that may arise from the submission of payment instructions by Members to the CLS settlement system, including risks relating to third party participants to the underlying foreign exchange (FX) transactions. Accordingly, CLS Bank Rule 2.1.1 provides that CLS Bank Members may not have business practices, internal risk management controls, or any other factor or condition that would create undue risk for CLS Bank or its Members.

1.1 Third Party Activity in CLS

Third parties have no contractual relationship with CLS. Third parties are customers of CLS Settlement Members. Third party service providers interface with CLS on behalf of their third parties and take legal obligation for their payments. Third party service providers handle all instructions and funding on behalf of their third parties.

Third parties have been mitigating their FX settlement risk at CLS since 2002. During the first half of 2012 approximately 9,000+ third party institutions settled transactions in CLS.

2.0 Risks Posed by Third Parties and Third Party Service Providers

In order to generate a set of best practices, it is important to recognize the following risks that third parties and third party service providers pose to each other as well as to the CLS Ecosystem.

2.1 Third Party Service Provider Failure

This risk develops when a third party service provider fails due to insolvency or major technical/operational failure. As a result the third party service provider is unable to submit instructions to CLS on behalf of its third parties.

<u>Third Party Impact (includes third parties using the failed third party service provider as their Settlement Member):</u> Existing instructions and any new instructions would not be able to settle in CLS until the orphaned third parties find new third party service providers. Considering that third party service providers offer services to funds in addition to banks and corporates, the number of third parties affected by a single third party service provider failure can be in the thousands.

<u>CLS Ecosystem Impact:</u> Settlement risk is reintroduced for affected third parties as well as other CLS participants who are counterparties to these trades.

2.2 Third Party Service Providers scale back their third party business due to higher liquidity/credit risk assessments

This risk develops if third party service providers decide to discontinue the third party service for existing clients and/or potential new third party clients.

Third Party Impact: Existing and potential new third parties have no access to CLS settlement risk reduction. Third parties are forced to settle outside CLS generating unmitigated settlement risk, unless they meet requirements to become a direct Member.

CLS Ecosystem Impact: Limited third party participation in CLS causing settlement risk to existing CLS participants as well as institutions who would like to be CLS participants via the CLS third party service.

2.3 Third Party Failure

The failure of a third party can pose credit risk to its third party service provider. This risk is increased if the failure occurs after the unilateral rescind deadline and the third party service provider has extended intra-day credit to the third party. Uncertainty is created for the counterparties of the third party if the third party service provider chooses to unilaterally rescind just prior to the deadline.

Third Party Service Provider Impact: Impact will vary depending on the extent of additional monitoring and other arrangements made by the third party service provider prior to the actual third party failure. If there is no pre-monitoring by the third party service provider and no arrangements on collateral or pre-funding, the third party service provider is at risk of making a Pay-in to CLS on behalf of a third party and not protecting itself from third party exposure. If a third party service provider doesn't rescind third party instructions by 00:00 CET, that third party service provider takes the responsibility for CLS funding on behalf of the third party.

CLS Ecosystem Impact: Should a third party fail while settlement is taking place, CLS would continue with settlement of all instructions, including the failed third party instructions.

2.4 Third Party Credit Deterioration

The credit deterioration of a third party can lead to similar outcomes as Risk 2.3 above if the deterioration leads to the third party service provider ceasing to act for the third party.

Third Party Impact: The third party service provider may decide to rescind their instructions from CLS. In this case, the third party's instructions would have to settle outside CLS, which generates unmitigated settlement risk. Counterparties may also decide not to trade with this institution if not in CLS.

Third Party Service Provider Impact: The third party service provider could potentially have a credit loss if not covered by collateral or pre-funding, as the third party may not have the ability to fund their short position accounts with the third party service provider.

CLS Ecosystem Impact: Uncertainty and inconsistency of the third party service provider reaction. If the third party is not insolvent but a third party service provider decides to rescind all instructions for this third party pre-emptively, instructions would have to settle outside CLS, precisely when CLS' Payment versus Payment (PvP) risk mitigation is most valuable to the third party and its FX counterparties.

3.0 Best Practices

Approved by the CLS Board's Risk Management Committee on August 21, 2012, these Best Practices are designed to identify and mitigate the systemic risks posed by both third party users of CLS as well as those Settlement Members that provide services to third parties.

The guidance set forth in this document is general in nature and does not constitute legal advice. The risks attributable to any third party relationship depend on the specific facts and circumstances applicable to that relationship and, as a result, third party service providers and third parties must analyze those risks on a case-by-case basis.

CLS is aware that there are limits to the extent that CLS can influence the commercial relationships between third parties and their third party service providers. However, our goal is to create industry guidance regarding the use of CLS by third parties.

3.1 Conversion of Third Parties to Settlement Membership

Best Practice 1:

CLS believes that systemic risk is reduced if large institutions settle FX transactions as a direct Settlement Member. This set of best practices includes a risk-based recommendation for the conversion of large third parties to Settlement Members.

CLS will monitor the following settlement and funding metrics of third parties on a regular basis to identify those third parties whose level of activity is similar to the activity of a CLS Settlement Member.

a) A third party's share of total CLS daily settlement volume (i.e. number of transactions).

b) A third party's share of total CLS daily settlement value (i.e. the gross value of transactions)

c) A third party's average daily multilateral net Pay-in requirement

Explanatory Guidance:

CLS considers each metric (Volume, Value, Net Pay-In requirement) individually sufficient to trigger a CLS review and discussion with the third party's service provider. The relative importance of each criterion will depend on the profile of the third party in the context of its service provider.

» **Gross Value Settled:** CLS recognizes high third party Gross Value is not an accurate indicator of projected Pay-ins, as positions may net down to low levels. However, CLS considers 'Gross Value

Settled' an important indicator of underlying problems that may occur. One example is a change in a third party's trading pattern, causing higher Pay-ins for the third party service provider. The third party service provider may not be prepared to support the third party's higher liquidity requirement.

» **Volume:** The third party service provider may not have the technical capacity to manage increased third party volume levels, resulting in delayed or incomplete third party service provider instructions reaching CLS.

» **Net Pay-in Requirement:** A much larger requirement adds to funding pressure for a third party service provider and its ability to make CLS Pay-ins in a timely manner.

Best Practice 2:

When any third party thresholds are exceeded, CLS (supported by the third party service provider) will conduct a risk analysis of the third party's activity to assess its impact on its third party service provider and the CLS Ecosystem.

For these thresholds CLS will identify concentration levels that would place the applicable third party in the top half of current CLS Settlement Members. CLS will first contact the third party service provider of a third party exceeding these thresholds and discuss with the third party service provider an appropriate plan for converting the identified third party to full Settlement Membership.

CLS will also notify the applicable regulatory supervisors of both the third party service provider and the third party of the conversion opportunity identified.

CLS recognizes that not all third parties would be eligible for Settlement Membership under the current CLS Bank Rules criteria. CLS will explore the feasibility of expanding its Settlement Membership eligibility to other types of non-bank institutions.

Explanatory Guidance:

For those third parties who exceed thresholds but are not eligible for CLS Membership, CLS will work with the relevant third party service provider on appropriate solutions to mitigate the risks to the third party service provider and to the CLS Ecosystem. Those solutions could include requiring the third party to split its CLS activity among multiple third party service providers.
If a third party exceeds thresholds and qualifies for membership but is unwilling because of the direct cost of membership, CLS will discuss the best approach with the relevant third party service provider and prudential regulatory authority (of both the third party service provider and the third party).

3.2 Best Practices for Third Party Service Providers

The following set of best practice recommendations for third party service providers are designed to mitigate the risks associated with the provision of third party services. These best practices are intended to augment third party service providers' own due diligence processes and risk analysis for on-boarding third parties.

Best Practice 1:

A third party service provider should fully understand and manage the principal, credit and liquidity risks it incurs from its third party clients. In particular a third party service provider should closely monitor its extension of intra-day liquidity overdrafts by currency (to its third parties).

Explanatory Guidance:

Risk overview:

- **Principal Risk (also referred to as Settlement, Cross Currency Funding or Herstatt Risk):** While CLS mitigates settlement risk via PvP settlement between its Members, third party service providers face settlement risk on the amounts due to them from their third parties. The risk a third party service provider faces is paying a third party's long currency positions to (or at the direction of) its third party where there is an early RTGS system closure, but not receiving funding from the third party in the short currency positions that have a late RTGS system closure.

- **Credit/Market Risk:** Third party service providers incur this risk if instructions relating to a third party's underlying transactions settle in CLS but the third party doesn't fund its short currency positions with its third party service provider. A third party service provider is faced with market risk on a third party's long currency positions with the third party service provider if those long positions are not paid out.

- **Liquidity Risk:** CLS defines liquidity risk as the risk of a Settlement Member's inability to settle or fund obligations as scheduled because of the Settlement Member's liquidity constraints. As third party service providers make a net Pay-in to CLS in connection with their own activity and their third party activity, unexpected peaks in third party positions may result in a liquidity risk for a third party service provider. A third party may not have the ability to provide the funds in time for the CLS timed payments made by the third party service provider.

  In monitoring day-to- day risk, third party service providers may consider assigning limits on intra-day credit that they provide to each third party on a per currency and total basis, similar to how Short Position Limits for Pay-ins by currency and Aggregate Short Position Limits on the total daily Pay-in apply to the third party service providers. Third party service providers should also have additional oversight for exceeded limits.

Certain third party activities:

As of December 17, 2012, all third party service providers adding or modifying the scope of third party service for an FMI or G-SIFI are now subject to a prior notice and consent requirement by CLS. See Member Notice No. 48/12.

Best Practice 2:

A third party service provider should ensure that its third parties have sufficient funding and other financial resources to cover these credit and liquidity risks including peak day exposures.

Explanatory Guidance:

Sufficient funding and other financial resources may include accessible / liquid collateral or pre-funding arrangements. Third party service providers are expected to review this arrangement for each of their third parties on average activity and peak activity.

Third party service providers also are expected to have well developed and formal contingency plans for dealing with third party clients in distress, including procedures for reducing credit limits, pre-collateralization of exposures, and communication with the relevant third party and CLS.

Best Practice 3:

If a third party service provider intends to rescind the CLS instructions of a third party customer for credit reasons, the third party service provider should provide reasonable advance notice to the Settlement Members of the counterparties of the third party.

Explanatory Guidance:

If the third party service provider decides that for credit reasons rescinding is its best option, then CLS expects the third party service provider to rescind all the third party instructions, and not engage in selective rescinds[1]. CLS also expects third party service providers to consider the impact on the CLS Ecosystem with respect to last minute rescinds of their third party instructions. It is recommended third party service providers carefully monitor their risk when dealing with third parties in distress, and notify CLS by 22:00 CET of their intention to rescind third party instructions.

Best Practice 4:

Regulators in many jurisdictions are formulating special resolution regimes to provide a framework for dealing with troubled institutions. A third party service provider should understand the nature of these regimes in the jurisdictions of its third party customers. Third party service providers are encouraged to continue to provide CLS settlement services to a third party customer that is subject to a special resolution regime.

Explanatory Guidance: None at this time

[1] Selective rescinds are discouraged from all Settlement Members regardless of a third party service provider's decision

3.3 Best Practices for Third Parties

The following set of best practice recommendations for third parties are designed to mitigate the risks associated with the provision of third party services. All references to a third party's short or long positions refer to the third party's short or long currency position with its third party service provider.

Best Practice 1:

A third party should fully understand and manage the principal, credit and liquidity risks it incurs from its third party service provider. In particular the third party should perform the appropriate due diligence to ascertain that its own CLS settlement activity can be accommodated by the third party service provider.

Explanatory Guidance:

- **Principal Risk (also referred to as Settlement or Herstatt Risk):** While CLS mitigates settlement risk via PvP settlement between its Members, third parties face settlement risk on the amounts due to them from their third party service providers. The risk a third party faces is paying its short currency positions to its third party service provider where there is an early RTGS system closure, but not having access to its long currency positions with its third party service provider upon its third party service provider's failure.
- **Credit/Market Risk:** A third party incurs credit/market risk if its third party service provider fails and an instruction doesn't settle. If a third party has its third party service provider submit instructions for CLS settlement and the third party service provider fails, depending on the timing of settlement and when the third party service provider fails, those third party instructions may not settle in CLS. This third party incurs market risk on any unsettled instructions that relate to the third party's underlying transactions.
- **Liquidity Risk:** A third party incurs this risk when its third party service provider expects funding for the third party's short currency positions with a late RTGS system closure before releasing the third party's long currency positions with an early RTGS system closure. The third party may not have access to its long currency positions with its third party service provider until later in the day.

Best Practice 2:

A third party should have contingency plans in place in the event that its third party service provider is no longer able to provide the third party with CLS settlement services. A large third party may wish to consider the desirability of splitting its CLS settlement activity among several third party service providers. A large third party should also periodically assess the costs and benefits of becoming a CLS Settlement Member.

Explanatory Guidance:

Third parties are encouraged to have contingency plans in place should their third party service provider no longer provide the service. While switching to another third party service provider may take time, third parties are encouraged to have an immediate and short term solution.

- An immediate solution may include settlements outside CLS. Third parties should take the following into consideration for settlement outside CLS:
  - Operational Risk: third parties should have the operational and technical capability of switching to settlement outside CLS on very short notice.
  - Principal (Settlement) Risk reintroduced: alternate settlement methods may reintroduce the risk of paying out one currency before receiving counter value.
  - Trading activity may be reduced as the sudden increase of settlement risk may quickly exceed the bilateral credit risk limits set by the counterparties if settlement occurs outside CLS.
- Short term solution:
  - Third parties should work on finding a new third party service provider as soon as possible, recognizing that a switch can work only as quickly as the new third party service provider is prepared to on-board the third party.
- Splitting CLS activity: a third party may consider splitting its CLS activity between two third party service providers as part of its initial CLS implementation or as recommended by their third party service provider and CLS. Third parties are encouraged to review the operational (complexity) and liquidity impact (including multiple third party service providers funding and reduced netting efficiency) of splitting their CLS business.

  With multiple third party service providers, third parties should explore ways that would enable rapid switching when necessary.

Best Practice 3:

A third party should fully understand the scope of the benefits that it receives from CLS settlement. In particular the third party should understand how the CLS Rules regarding settlement finality apply to its own transactions.

Explanatory Guidance: None at this time.

These Best Practices are subject to change as approved by the Risk Management Committee.

Please contact asuljic@cls-bank.com at CLS New York Risk Management for additional information.