Best practices for third parties and third-party service providers

CLS Bank International

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1. Background

CLS recognizes the need to identify and mitigate the systemic risks posed by both third-party participants of CLS as well as those settlement members (members) that are third-party service providers. These risks are complex due to the number of CLS third parties and the concentration of third parties with a small number of service providers.

As a systemically important financial market infrastructure, 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 of the CLS Bank International Rules (the Rules) provides that members may not have business practices, internal risk management controls, or any other factor or condition that would create undue risk for CLS or its members.

1.1 Third-party activity in CLS

Third parties have been mitigating FX settlement risk using CLS since 2002. Third parties have no contractual relationship with CLS. Third parties are customers of members (third-party service providers) that interface with CLS on behalf of their customers and take on the legal obligation for their payments. Third-party service providers handle all instructions and funding on behalf of their customers.

2. Risks posed by third parties and third-party service providers

To generate best practices, it is important to recognize the 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

There is a risk that a third-party service provider may fail due to insolvency, major technical/operational failure, resolution or some other reason. If this happens, the third-party service provider may be unable to submit instructions to CLS on behalf of its third parties.

Third-party impact (includes third parties using the failed third-party service provider as their member): Existing instructions and any new instructions would not be able to settle in CLSSettlement until the orphaned third parties find a new third-party service provider. 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.

CLS ecosystem impact: 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

There is a risk that a third-party service provider may discontinue its third-party service for existing clients and/or potential new third-party clients. This may be due to either incremental liquidity and/or credit risk assessments as a result of regulatory requirements or changes to business strategy.

Third-party impact: Existing and potential new third parties have no access to settlement risk reduction through CLS. Third parties are forced to either find alternate providers, further increasing the concentration within the existing third-party service providers, or settle outside CLSSettlement, generating unmitigated settlement risk.

CLS ecosystem impact: Limited third-party participation in CLSSettlement leading to greater exposure to settlement risk to existing CLSSettlement participants as well as institutions who would like to access CLSSettlement as a third-party participant.

2.3 Third-party failure (including credit deterioration)

The failure of a third-party participant or a deterioration in its credit can pose a risk to its third-party service provider. This risk is increased if the failure or credit deterioration occurs after the unilateral rescind deadline of 00:00 CET 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 impact: The third-party service provider may decide to rescind the third party's 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 it is not using CLSSettlement.

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 for 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 does not unilaterally 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 participant.

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 CLSSettlement, precisely when CLS's payment-versus-payment (PvP) risk mitigation is most valuable to the third party and its FX counterparties.

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

3. Best practices

The following best practices are designed to identify and mitigate the risks posed by both third party participants as well as third-party service providers.

The guidance 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 it 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 CLSSettlement by third parties.

3.1 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 analyses. .

Best practice 1:

A third-party service provider should fully understand and manage the principal, market and liquidity risks it incurs from its third-party clients. In particular a third-party service provider should monitor its funding arrangements by currency with 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) the 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.

- **Market risk:** Third-party service providers incur this risk if instructions relating to its third party's underlying transactions settle in CLS, but the third party doesn't fund its short currency positions with the third-party service provider. A third-party service provider is faced with risks due to adverse FX rate changes on its third-party client's long currency positions if those long positions are not paid out.

- **Liquidity risk:** CLS defines liquidity risk as the risk of a member's inability to settle or fund obligations as scheduled because of the 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. It is recommended that third-party service providers periodically monitor the gross settled value of their third-party clients, as any material increases can impact liquidity requirements in business as usual (BAU) and during failure management. In addition, third-party service providers should have resources to fund incremental liquidity requirements as part of CLS's failure management processes for their primary and third-party activities. Any impacts as a result of deferral of instructions need to be managed accordingly, and deferrals should be communicated by third-party service providers to their clients.

In monitoring day-to-day risk, where applicable third-party service providers may consider assigning thresholds or limits on intra-day credit that they provide to each third party on a per currency and total basis. Third-party service providers should also have additional oversight for exceeded limits.

Best practice 2:

A third-party service provider should ensure that its third parties have sufficient funding and other financial resources to cover their funding obligations 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 these arrangements 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, collateralizing exposures and communicating 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-related reasons, the third-party service provider should provide reasonable advance notice to the members of the counterparties of the third party.

Explanatory guidance:

If the third-party service provider decides that for credit-related reasons rescinding is its best option, then CLS expects the third-party service provider to rescind all the third-party instructions, not selective instructions. 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. CLS recommends that third-party service providers carefully monitor their risks when dealing with third parties in distress and notify CLS of their intention to rescind third-party instructions.

3.2 Best practices for third parties

The following set of best practice recommendations for third parties are designed to mitigate the risks associated with participating in CLSSettlement through a third-party service provider. 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 CLSSettlement activity can be accommodated by the third-party service provider.

Explanatory guidance:

- **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 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 and market risk:** A third party incurs credit risk if its third-party service provider fails and an instruction doesn't settle. If a third party has funded its short currency positions to its third-party service provider and the third-party service provider fails, depending on the timing of settlement and the failure of the third-party service provider, those third-party instructions may not settle in CLSSettlement. The third party incurs market risk on any unsettled instructions that relate to the third party's underlying transactions.

- **Liquidity risk:** A third party incurs liquidity risk when its third-party service provider expects funding for the third party's short currency positions on a timed basis to align with the third-party service provider's pay-in requirements to CLSSettlement. Additional liquidity requirements may be generated as part of CLS's failure management processes that need to be met by the third party in accordance with the agreements with the third-party service provider.

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 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 member.

Explanatory guidance:

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

- An immediate solution may include settlement outside CLSSettlement. In this case, third parties should take the following into consideration:

  - Operational risk: third parties should have the operational and technical capability of switching to settlement outside CLSSettlement on very short notice

- Reintroduction of principal (settlement) risk: alternate settlement methods may reintroduce the risk of paying out one currency before receiving the counter currency

- Trading activity may be reduced as the sudden increase in exposure to settlement risk may quickly exceed the bilateral credit risk limits set by the counterparties if settlement occurs outside CLSSettlement.

- 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 onboard the third party.
- Splitting CLS activity: A third party may consider splitting its CLS activity among multiple 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 CLSSettlement. 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

3.3 Best practices for third-party service providers and third parties in recovery and resolution scenarios

Third-party service providers and third parties should take all necessary steps to maximize the likelihood that third parties will continue to be able to access CLS in recovery and resolution scenarios (i.e., with respect to the third-party service provider or the third party itself). Accordingly, third-party service providers should review the relevant confidential documentation that CLS has distributed to members, including CLS's response to the Financial Stability Board's questions relating to "Continuity of Access to Financial Market Infrastructures for Firms in Resolution". Third-party service providers and their clients should likewise familiarize themselves with the Financial Stability Board's guidance entitled "Continuity of Access to FMI Services (FMI Intermediaries) for Firms in Resolution"[1] and take any appropriate next steps.

For further information regarding third-party services, please contact your CLS sales representative.

For additional information on CLS visit www.cls-group.com

[1] Dated 20 August 2021 at the time of publication of this best practice document, and available at: https://www.fsb.org/2021/08/continuity-of-access-to-fmi-services-fmi-intermediaries-for-firms-in-resolution-framework-for-information-from-fmi-intermediaries-to-support-resolution-planning/. Please refer to the most recent version of this document, as applicable.