CLS Bank International

Best Practices for Third Parties and Third Party Service Providers

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1. 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 ("Members") that are third party service providers. These risks are complex due to 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 of the CLS Bank International Rules (the "Rules") 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, its Members or CLS Services.

1.1 Third Party Activity in CLS

Third parties have been mitigating their FX settlement risk at CLS since 2002. 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.

2. Risks Posed by Third Parties and Third Party Service Providers

In order to generate 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, major technical/operational failure, resolution or some other reason. As a result, 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 Settlement Member): 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.

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

This risk arises if third party service providers decide to discontinue the 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 CLS settlement risk reduction. Third parties are forced to either find alternate providers further increasing the concentration within the existing third party service providers, or settle outside CLS generating unmitigated settlement risk.

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 (including Credit Deterioration)

The failure of a third party 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 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: 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 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.

CLS ecosystem Impact: There may be uncertainty and/or inconsistency in the third party service provider's 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.
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

These Best Practices are designed to identify and mitigate the 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 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, market and liquidity risks it incurs from its third party clients. In particular a third party service provider should monitor its funding arrangements with its third parties by currency.

Explanatory Guidance:

Risk overview:

- **Principal Risk (also referred to as settlement risk, cross currency funding risk 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.

- **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 does not fund its short currency positions with its 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 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. 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 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 this arrangement for each of their third parties concerning their 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, 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 related reasons, the third party service provider should provide reasonable advance notice to the Settlement Members through which the counterparties of the third party participate.

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, and not selectively rescind. 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 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 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 risk, cross currency funding risk 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 risk if its third party service provider fails and an instruction does not settle. If a third party has funded its short currency positions to its 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 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 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 provider's pay in requirements into CLS. Additional liquidity requirements may be generated as part of CLS' failure management processes that need to be met by the third party in accordance with its agreements with the 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 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

3.3 Best Practices in stress scenarios, including 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 a wide range of potential stress scenarios, including but not limited to 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 steps.

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

For additional information on CLS, refer to www.cls-group.com

Appendix I: Glossary / Definitions[2]

N/A

Additional Appendices

N/A

[1] dated August 20, 2021 at the time of publication of this Best Practice. Please refer to the most recent version of this document, as applicable.

[2] Capitalized terms not otherwise defined herein are used as defined in the Rules