

Best practices for nostro agents and nostro clients

CLS Bank International

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1. Background

As a financial market infrastructure, CLS seeks to understand the interdependencies between stakeholders in the CLS ecosystem, to evaluate potential threats to the systemic stability of the CLS ecosystem and surface systemic risk mitigation opportunities. CLS shall also maintain formal and constructive communications in seeking industry solutions and instilling best practices in the ecosystem. As part of this process, CLS seeks to identify and mitigate any material systemic risks that may arise from nostro agent concentration and failure. CLS has conducted analyses to assess the impact on the CLS ecosystem as well as engaged settlement members (members) on the risks associated with nostro agent failure. Specifically, CLS has discussed with members the need for resilience with respect to CLS pay-in capability should their nostro agent fail to execute CLS payments on their behalf.

1.1 CLS members reliance on nostro agents for CLS pay-ins

The 74 CLS members may self-clear or rely on nostro agents for some or all their CLS payments. Since all 74 members rely on nostro agents to some degree, nostro agents have an essential role in the day-to-day CLS funding process and the stability of the CLS ecosystem. Regardless of the pay-in method used, each CLS member is directly responsible for reliably delivering its pay-ins to CLS. In accordance with the CLS Bank International Rules, under Rule 2.1.1(e)(iii) and Rule 2.1.3(a), members are expected to satisfy operating capabilities, including: “adequate contingency plans in the event of its inability, or any of its Nostro Agents’ inability, to satisfy the funding requirements.”

1.2 Nostro concentrations

The number of members offering nostro agent payment services varies by CLS currency. For example, two major CLS currencies, USD and EUR, have the highest number of self-clearing members, as well as the highest number of banks offering nostro agent payment services. For this reason, the concentration¹ of nostro agents is relatively lower for USD and EUR when compared to currencies such as ILS or CHF that have fewer nostro agents and/or self-clearing members, resulting in higher nostro concentrations. In some cases a single nostro agent handles over 50% of the currency’s CLS pay-in. Higher nostro agent concentrations may result in multiple member pay-in failures arising from a single nostro agent failure, and undesirably larger systemic risk impact.

2. Nostro risks that drive best practices

In order to generate best practices, it is important to recognize the potential risks nostro agent clients (nostro clients) and nostro agents face with respect to CLS pay-in requirements.

2.1 Potential risk categories

The potential risks can be related to business as usual (BAU) and failure management situations.

BAU risks:

Risk A: Nostro clients exceed their credit limits.

This risk occurs when a member’s pay-in exceeds its daily average pay-in. The nostro clients’ occasional peak CLS pay-in positions may not be within their committed or uncommitted limits at its nostro agent. Peaks can occur with increased or decreased CLS activity, or on days when multilateral netting or trade down from in/out swaps are lower.

¹ Nostro concentration in a currency is defined as the proportion of the largest pay-in through a nostro against the total pay-ins in that currency in CLS.



The nostro agent may not promptly accommodate the larger credit requirement, resulting in a delayed or failed pay-in to CLS.

Failure management:

Risk A: Nostro agent operational failure, even after invoking manual contingency protocols.

This may occur if a nostro agent experiences operational problems where the normal contingency plans are ineffective. As a result of a failure, the nostro agent may not have the ability to operate its payment services on behalf of its nostro clients (members with CLS pay-in obligations).

Risk B: Nostro agent is subject to recovery, resolution or insolvency.

In these scenarios the nostro agent is or may be unable to make pay-ins to CLS on behalf of its nostro clients (members with CLS pay-in obligations), or nostro clients (i.e. members) do not wish to use the services of the nostro agent and need to find a new primary nostro agent.

Risk C: CLS issues pay-in calls (PICs), which are additional calls for liquidity, under its failure management processes.

A nostro client may receive a PIC for settlement or currency close if CLS has invoked failure management processes due to another unconnected member failure. While a PIC for settlement is optional, members should be aware that some of their CLS instructions will not settle if the PIC for settlement is not met. While a member may be willing to make the PIC for settlement to help its instructions settle in CLS, its nostro agent must also be willing to support this additional payment.

If CLS has invoked its failure management process due to a member failure, some members may also receive a PIC for currency close. The PIC for currency close is a mandatory obligation that members must meet, since it is funding required for instructions that have already settled, using the members' short position limits. The proceeds of the PIC for currency close are required in order to pay out long positions to eligible members for instructions that have already settled.

Summary:

CLS members who are nostro clients are directly impacted by the risks mentioned above, as their pay-in to CLS is at risk of being delayed or not met. Both nostro agents and nostro clients face reputational risk for failing to make CLS pay-ins, regardless of the underlying cause.

With no mitigants in place for nostro agent failure, the CLS ecosystem faces the risk of multiple pay-in failures and a resulting high percentage of unsettled instructions and disruptions to other downstream payments affecting all CLS members, regardless of the extent of nostro agent reliance.

3. Best practices for nostro agents and nostro clients

In the interests of systemic stability, CLS has developed potential mitigants and solutions for potential nostro agent failures. In the course of discussions with members, it became clear that no single solution can be applied for all members. As a result, at this time, CLS has established a set of best practices for nostro agents and nostro clients. Members should use the mitigants best suited to their specific needs in each CLS currency. CLS also recognizes each potential nostro agent failure condition may have other unknowns and that best practices may not be practical in all situations.

The relationship between a CLS member and its nostro agent is a private, bilaterally negotiated and documented arrangement that does not involve CLS. The basis on which the nostro agent is willing to make pay-ins and receive pay-outs for the settlement member depends on their arrangement. Nostro agents and nostro clients are expected to review their agreements by incorporating relevant recommendations included in this document.



3.1 Best practices for nostro clients

Best practice 1:

A member may consider having one secondary nostro account in each CLS currency to prevent CLS pay-in disruptions in the event that its primary nostro agent is unable to make the member's pay-in.

Explanatory guidance:

A secondary CLS nostro account can be an existing nostro account used by a different business line/product, or a CLS specific back-up nostro account. It is recommended that members have an internal documented operational/technical procedure for switching CLS nostro accounts where a secondary or alternate account has been established. Where possible, members may also consider using their branches or affiliates with existing connections to local RTGS systems as contingency accounts.

Best practice 2:

In the interests of an effective and efficient CLS funding process, members should notify their nostro agent(s) of their expected average and peak CLS pay-in activity. Members should also ensure that any changes to the profile of internal trading activity that can result in an increase to their CLS pay-ins are communicated to their nostro agent(s).

Explanatory guidance:

Notifications between nostro clients and nostro agents on average and peak pay-ins:

As part of the initial implementation, members should inform their nostro agents of the expected average and peak pay-ins to the CLS system. Members should have a clear understanding of the extent each nostro agent is willing and able to support their peak activity, and the process to be followed when the peak is exceeded. Members are encouraged to keep their nostro agents informed of any changes in daily averages and peaks. This can include any changes to internal trading limits that may result in an increase to CLS pay-ins.

Failure management:

Members are also expected to inform their nostro agents of PIC levels in the event of CLS failure management that may result in deferral of instructions. Members are expected to know if their PIC for settlement levels would be supported by their nostro agents and assess the impact in the event that their nostro agent would not support a PIC for settlement. Members should confirm if their PIC(s) for currency close would be supported, as this type of PIC is a mandatory obligation. CLS actively engages with members on an ongoing basis where they are made aware of the (average and peak) values by currency of their PICs, based on CLS's stress testing program. Members should ensure that they are prepared for the possibility of settlement deferral in all circumstances, including testing and contingency planning, as appropriate. Settlement deferral can occur in a variety of circumstances, including but not limited to failure (operational, liquidity, stress, resolution, etc.) of some or all of the ecosystem participants.

Best practice 3:

Members are expected to manage their daily CLS positions.

Explanatory guidance:

Managing pay-ins:

To ensure pay-in positions are within the pre-notified nostro levels, members may consider the following liquidity management practices:



- Adjust in/out swap credit limits in accordance with risk appetite to manage reduction from Initial pay-in Schedule (IPIS) to Revised Pay-in Schedule (RPIS)
- Assess the impacts of their historical average and lowest in/out swap efficiency percentage by currency to their IPIS positions to determine whether the position is supported by the nostro agent or whether there may be a need to apply liquidity contingency measures
- Have liquidity contingency arrangements in place in case the CLS position is not supported by their nostro agent (or the IPIS positions have to be funded).

Best practice 4:

Members should ensure that contingency processes with their nostro agents are updated and tested regularly. Such processes should be invoked promptly in the event of a failure of BAU processes.

Explanatory guidance:

If a member experiences a technical or an operational issue due to which it is unable to make its CLS pay-ins via normal processes, it should invoke its contingency process applicable to the nostro agent promptly so that CLS pay-ins are not delayed. These processes should be tested regularly (at least annually) to ensure seamless execution. Further, these processes should be reviewed and updated so that they are aligned to industry best practices and technological changes.

3.2 Best practices for nostro agents

Best practice 1:

In the interests of maintaining a safe CLS ecosystem, nostro agents may consider supporting two types of nostro client accounts related to CLS pay-ins:

- Primary CLS client accounts for regular pay-ins to CLS
- Secondary CLS client accounts with infrequent pay-ins to CLS. A nostro agent should inform its clients of any expected pre-notifications for CLS pay-ins.

When all nostro client criteria are met, either by a primary client account or secondary client account, nostro agents are expected to treat all CLS payments as priority (timed) payments.

Explanatory guidance:

A nostro agent should inform its primary CLS nostro clients of its ability and willingness to support average and peak pay-ins. A nostro agent should also inform its clients of the process to be followed when peaks are exceeded.

A nostro agent should clearly specify any restrictions or requirements regarding the use of nostro accounts as secondary CLS accounts, where applicable.

Nostro agents may want to consider adding CLS-related questions/clauses to their standard nostro agreements to help assess account usage for primary or secondary account CLS pay-ins.

Best practice 2:

In evaluating its CLS liquidity requirements, a nostro agent should periodically assess its ability to meet daily BAU CLS liquidity requirements along with failure management liquidity demands.



Explanatory guidance:

In addition to its own CLS pay-in obligations, a nostro agent should evaluate its CLS nostro liquidity requirements to support all the points below:

- Regular and peak CLS pay-in requirements for CLS nostro clients
- Failure management: In addition to the above liquidity requirements, a nostro agent should assess its ability to support PICs for settlement and PICs for currency close for its own activity as well as nostro client needs. PIC obligations are in addition to regular pay-in requirements. Note that from the very nature of PICs, multiple nostro clients will likely require liquidity at the same time.

Best practice 3:

Nostro agents should ensure that contingency processes with their nostro clients and RTGS system operators are updated and tested regularly. Such processes should be invoked promptly in the event of a failure of BAU processes.

Explanatory guidance:

If a nostro agent experiences a technical or an operational issue due to which it is unable to make its CLS pay-ins via normal processes, it should invoke its contingency process (with nostro clients and RTGS system operators) so that CLS pay-ins are not delayed. These processes should be tested regularly (at least annually) to ensure seamless execution. Further, these processes should be reviewed and updated so that they are aligned to industry best practices and technological changes.

3.3 Best practices for nostro agents and nostro clients in recovery and resolution scenarios

Members and nostro agents should take all necessary steps to maximize the likelihood that nostro agents will continue to fund the member's pay-in obligations to CLS in all relevant currencies in recovery and resolution scenarios. In particular, members should understand any additional requirements that their nostro agents are likely to impose on a member in these scenarios, including requests for collateral or pre-funding, and should review (and amend as appropriate) their contractual agreements with their nostro agents. Members and nostro agents should ensure that their nostro agents will have the ability to confirm to CLS their intent to fund on behalf of the member, and that any confidentiality constraints are addressed *ex-ante*. In addition, members should understand whether each of their nostro agents would continue to provide nostro services in relevant currencies to nostro agent clients in the event of the recovery or resolution of the nostro agent. Members should activate their alternate funding arrangements into CLS should the nostro agent not be able to meet their pay-in requirements in such scenarios.

Members and nostro agents 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". Members and nostro agents should likewise familiarize themselves with the Financial Stability Board's guidance entitled "Continuity of Access to FMI Services (FMI Intermediaries) for Firms in Resolution"², and take any appropriate next steps.

Please contact your CLS sales representative for additional information.

² 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.