

A ROADMAP FOR THIRD PARTIES TO ACHIEVE OPERATIONAL READINESS FOR CLS

Preparing for CLS



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To be or not to be *prepared*; that is the question CLS third parties should be asking at this point in time. Or

they may find it's the question that keeps them awake as night as CLS becomes the industry standard for processing FX transactions. Testing and live trialing of CLS Bank and Settlement Members has proceeded smoothly, reminding us that despite the many delays and setbacks, CLS has arrived.

IMPLICATIONS FOR CLS THIRD PARTIES

Before long, CLS third parties will be joining other CLS participants in proving to regulators that CLS works and participants can collectively process FX transactions in this more integrated straight-through processing (STP) environment. But to prepare for CLS, third parties must change their systems and operational procedures. They must take into account their projected volumes as well as their internal systems, processing costs, reporting needs, and other requirements to establish parameters for transaction initiation and reporting, and funding. Once critical system parameters are established, third parties need training. Operational staffs have to learn how to manage parallel production lines to accommodate FX transactions that settle inside of CLS as well as transactions that continue to settle outside of CLS. Finally, by adhering to a stringent testing methodology and standards – third parties will have the opportunity to establish the high level of comfort and

confidence needed to operate in the live CLS environment.

On the road to implementation there are basic questions third parties need to ask about transaction initiation and reporting, the funding process, training and testing. The 'answers' or implementation choices third parties make will depend on their own unique requirements. Ideally, the third party's Settlement Member will provide a well-defined implementation and testing programme and guide them through the process.

TRANSACTION INITIATION & REPORTING Preferred entry methods

The first question for CLS third parties to ask is: What is the best way for my company to submit CLS instructions?

The options for submitting CLS instructions are:

- SWIFT Third Party Service (TPS) or 'Tcopy services'
- SWIFT through a direct submission to the Settlement Member
- File transfer
- Entering instructions through the front-end interface provided by the Settlement Member

SWIFT Third Party Service (TPS), also known as Tcopy services, is likely to be the standard and

RECOMMENDED CLS STATUS MESSAGES

STATUS NOTIFICATIONS REQUIRING ACTION

Pre-CLS: Trade capture

DUPL	Duplicate exception found
RPIR	Repair required
FNCL	Trade exceeded financial limits stored in system

Pre-CLS: Validation

APRV	Trade approval required
CFCN	Cancelled trade requires confirmation
DKEX	DK exception, need to re-submit trade

In-CLS: Matching

IURT	Unmatched trade requires investigation or repair
ALGD	Alleged trade requires investigation or follow-up with counterparty
DMTC	De-matched; trade once matched becomes unmatched and requires investigation or repair

In-CLS: Settlement

FVAL	Failed validation of trade by CLS Bank requires investigation, repair or rescinding from CLS
NISP	Notification that trade currency or CLS Settlement Member was suspended; requires investigation and possible rescind from CLS

STATUS NOTIFICATIONS REQUIRING NO ACTION

In-CLS

WTAK	Waiting acknowledgement from CLS Bank
IMAT	Matched
SMAT	Settlement mature trade (waiting for CLS Bank to settle in upcoming settlement cycle)

FINAL STATUS NOTIFICATIONS FOR VIEWING ONLY

Pre-CLS

CNCL	Cancelled trade
RCNF	Rejected trade

Post-CLS

SOKS	Settled trade at CLS Bank
SRST	Trade rescinded from CLS Bank settlement
RCNF, RINP, RINS, FRIN	Rejected trade
THRE	Threshold of trade value was met so trade was split by CLS Bank

best option for large volume clients who need the highest level of integration in their FX confirmation process. With SWIFT TPS, SWIFT copies confirmations to Settlement Members as counterparties confirm. This makes initiating a separate transaction for the Settlement Member unnecessary. The 'SWIFT Tcopy' confirmation process is totally integrated which means that as soon as the client confirms to their counterparty, SWIFT copies the message to their Settlement Member.

For third parties with low volumes, the advantages of the SWIFT Tcopy service may not be worth the expense. SWIFT charges a set-up fee, an annual maintenance fee, and EUR0.25, or USD0.22, per SWIFT Tcopy transaction. With no volume-based tiered pricing, the cost for SWIFT Tcopy services can quickly accrue.

For third parties who are looking for a more cost-efficient solution but still want to send instructions to Settlement Members via SWIFT, they can copy confirmations to Settlement Members themselves via MT300 or MT304. With SWIFT TPS, third parties confirm to their counterparties; SWIFT does the rest. When using MT300s and MT304s, third parties must make sure they generate all the proper instructions to their Settlement Members. For third parties with low volumes and cost constraints, trading process efficiency for cost savings might be the right choice.

File transfer is another option for those wishing to reduce messaging costs. Clients can string their SWIFT messages into a file and upload it to their Settlement Member, most likely through a secure link from their FX back-office system.

Some clients with low volumes might choose to send instructions through their Settlement Member's internet-based front-end interface. For example, Citibank third party clients could send instructions via CitiDirect® Online Banking, our web-based banking platform.

There is ultimately no 'best method' for initiating third party CLS transactions, since the best

method depends on the client's volume and existing processes. High volume clients are likely to use SWIFT for initiation and a web-based banking platform as a monitoring interface and back-up to the SWIFT interface. Low volume clients might find they don't want to pay for SWIFT and may elect to use a web-based banking platform for both transaction initiation and monitoring.

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Settlement member information reporting

There is a lot of flexibility regarding the transaction information Settlement Members can provide to third parties. Third parties need to determine: What information do I want my Settlement Member to provide? Do I want to see all the status messages that CLS Bank offers? Do I want to receive those back via SWIFT? Or do I want ‘view-only’ access – to generate reports from the browser interface my Settlement Member provides?

Third parties can choose from the status notifications and alerts generated by CLS Bank and their Settlement Member and decide for each one if they want it or not. CLS Bank provides over 60 trade settlement status notifications that cover the entire flow of trade processing at CLS Bank, including message capture, validation, matching and settlement. Settlement Members receive these notifications from CLS Bank and can pass them on to their third party customers. In addition, some Settlement Members offer notifications on pre and post CLS activity. Settlement Members like Citibank, that have installed and customised a CLS life-cycle reporting mechanism, can track the

whole life-cycle of the CLS transaction and report it back to the third party client in great detail, from receipt of instruction through settlement and funding. They can also monitor each status by value date and across value dates.

Clients are likely to use a small subset of the CLS status notifications, including, for example, acknowledgments that:

- The Settlement Member received instruction from the client
- The instruction matched in CLS
- The instruction did not match in CLS
- The transaction settled in CLS

Notifications of ‘alleged trades’ that counterparties entered into CLS, let third party clients know that a counterparty already sent a message to CLS and they have to confirm the trade. Alleged trades that have been outstanding for an extended period of time indicate that an investigation is needed.

Citibank has identified 23 primary status notifications that third parties should use, and an additional 25 status notifications that might also be useful.

Citibank third party clients have 24-hour access to online, real-time information about their CLS transactions via CitiDirect® Online Banking. Clients, in fact, have access to the same information available to Citibank's dedicated client service and operations team. They can see their CLS transactions the same way and in the same timeframe as their service representative. Our clients will find that although a service representative is available 24 hours a day, there will often be no need to call them. It will be easy to find answers online to questions such as, “What's the status of my transaction?”

THE FUNDING PROCESS Flexible pay-ins and payouts

When do I need to pay my Settlement Member

and when does the Settlement Member pay me? The answer to this question is typically driven by intraday credit concerns (daylight overdrafts). Nevertheless, there is flexibility in how these payments can be structured.

For someone in good credit standing, the pay-in may not be required until end-of-day in the respective local currency. For example, a third party client might need to fund the Settlement Member pound sterling by 4:00pm UTC time; or US and Canadian dollars by 4:00pm EST.

Most clients want to make a single funding payment to their Settlement Member, not multiple payments. They also prefer a single credit instead of ongoing multiple credits to their account during the settlement process, for obvious reason; reconciliation is easier with fewer payments.

Early payouts for Asia Pacific currencies

An important factor to consider during implementation is whether or not the Settlement Member can support early payouts for Asia Pacific currencies. The CLS process runs late in the Asian day. Most banks (both Settlement Members and third parties) use correspondent banks that make non-CLS payments during the day. As a result the correspondent banks may be in an overdraft position as they wait for funding from the CLS process. Settlement Members may therefore need to make early payouts for some Asia Pacific currencies to cover overdrafts or other business activity by the end of day. These payouts will be made based on an estimated settlement, before settlement is actually complete.

Citibank clears the Asia Pacific currencies directly, has a high degree of liquidity in the currencies, and can easily support early payouts.

Options for funding multiple branches and subsidiaries

Clients with multiple branches or subsidiaries need to work with their Settlement Member to choose either a decentralised or centralised funding structure. For example, the Settlement

Member could receive one aggregated lump sum payment from a 'parent' but keep all subsidiary information separate and submit separate pay-in schedules to each branch. Or, alternatively, treat all branches and subsidiaries separately as distinct clients.

TRAINING OPTIONS AND BEST PRACTICE

Once third parties have made the transaction, initiation, reporting and funding decisions, next they need to train staff. Settlement Members will no doubt use a variety of traditional and non-traditional training approaches. Consultants, eager to provide implementation support to third parties as they convert to CLS, are likely to regard training third parties on CLS as a revenue opportunity. In order to contain operational readiness costs, third parties should take advantage of the free training their Settlement Members may provide, rather than pay added implementation and training costs to consultants. Third parties should also be aware that it may be difficult to access qualified CLS trainers, especially as the CLS third party launch date approaches and there is a high demand for qualified trainers.

Citibank offers a comprehensive CLS training or 'e-learning' programme, delivered via the internet, which teaches employees of third party clients, by job function, the background and basics of CLS. It teaches them how to use our system, how the funding process works, issues in risk management, etc. Every lesson includes quizzes in a multiple choice question format. The system displays the correct answers online.

Citibank's web-based e-learning programme is the most convenient and cost-effective way for our busy clients to learn about CLS. With the e-learning programme they can access expert CLS training at their leisure, whenever and wherever they want to do so. The CLS e-learning programme is linked to our CLS User Guide and both are continuously updated. The CLS e-learning programme is available on demand and can be accessed easily by those who might want a CLS refresher course, as well as by new users.

At Citibank, as part of our CLS training effort,

we host a question and answer session for our clients, by phone or videoconference, after they have completed the e-learning programme. Once the training process is complete, clients are ready to move into testing.

ADHERING TO STRINGENT TESTING METHODOLOGIES AND STANDARDS

CLS represents a landmark change in the global financial market as it introduces an entirely new, more integrated settlement infrastructure. For the first time, an FX settlement system (CLS Bank) and seven of the world's central payment systems will be linked together in real time, enabling simultaneous FX settlement of matched instructions that satisfy CLS criteria – irrespective of the time zones applicable to the relevant settlement currencies.

In order to ensure CLS works, CLS Bank and Settlement Members have focused much time and many resources on a thorough end-to-end testing effort, including testing and live trialing of CLS Bank, and Settlement Member trialing with CLS Bank, including 'controlled scripted live trialing' and 'controlled unscripted live trialing'. CLS third parties must also participate in a stringent testing effort to test both connectivity to CLS and functionality – to test modified systems and new operational processes and procedures. For some time, third parties and other participants will be operating in a dual processing environment, increasing the complexity and workload of operational staffs. Although Settlement Members can ease the burden of implementation and testing for their third party clients, they cannot eliminate or downplay the need to engage in a real testing effort.

Recommended guidelines for CLS testing

Testing, by definition, requires adherence to certain guidelines such as the use of well-defined test scripts. Citibank recommends adhering to the following guidelines:

- Conduct CLS testing using well-defined test scripts and expected results. Compare the results of each test to the expected results.

The test script provided by your Settlement Member should reflect regular cases as well as abnormal scenarios – failure and contingency scenarios.

- Make sure the testing process reflects as closely as possible your actual production process and environment. For example, if you plan to use SWIFT TPS services, SWIFT TPS should be part of your testing programme.
- Require the individuals who will run the CLS operation in the live production environment to participate in testing rather than only the testing staff.
- Conduct testing as close to the anticipated live date as possible. This ensures your operations staff remains familiar with the new CLS process and reduces the risk that they will miss a change in the process introduced after training was completed.

Testing misconceptions

We hear a number of misconceptions relating to CLS third party testing in the industry at this time. For example, third parties should understand what is meant by 'third party trialing'. CLS Bank itself does not currently support, as part of their trialing programme, direct participation of third parties. However, CLS Bank does support third party testing through its Member Test services, i.e. via a CLS simulator of sorts, a test system, but not in the production system.

Another misconception clients have is that they can adequately test their systems via free testing. The term 'testing' is a misnomer here. What is being offered is better described as 'transaction sampling'. The third party client sends some messages and receives some messages or reports back. Transaction sampling does not meet rigorous standards of testing; nor does it prepare clients to 'go live'. If systems and processes have not been properly set up to mirror the production environment; if test scripts are not used; and if results are not compared to expected results; the testing effort is of limited value.

CLS THIRD PARTY "TESTING" TERM CLARIFICATION

CLS BANK TRIALING

This is testing in the live production environment, conducted by CLS Bank and its Settlement Members; it includes 'controlled scripted live trialing' and 'controlled unscripted live trialing'. CLS Bank trialing is not available to third parties.

THIRD PARTY "TESTING" OFFERED BY SETTLEMENT MEMBERS

Settlement Member test programmes should meet established standards of testing (described under 'Recommended Guidelines for CLS Testing') and might or might not include moving transactions through Member Test services, supported by CLS Bank.

FREE "TESTING" OR TRANSACTION SAMPLING

Free testing may be educational but does not adhere to stringent standards of testing. As such, it may provide a false sense of confidence to third parties who have not engaged in a testing effort that adheres to more stringent standards of testing.

It might be important to note that third parties are unlikely to participate in an adequate testing effort without making a commitment to a specific Settlement Member. This is because to use, for example, SWIFT Tcopy services, third parties have to register with SWIFT and sign a tri-party agreement with SWIFT and their Settlement Member before they can use their Member trialing services. Testing with SWIFT is not done on an ad hoc basis.

The necessity for real testing

While transaction sampling may be educational for some third party clients, it does not meet rigorous standards of testing. Third parties should not be fooled into thinking such a testing effort will leave them adequately prepared to operate in a live CLS production environment.

Third party clients who participate in a rigorous testing process will have the confidence of knowing they can process transactions on behalf

of their customers. Only at that point will they be ready to comfortably migrate into the live production environment.

THE PREPARATION PAYOFF – A SMOOTH TRANSITION TO CLS

Like EMU and Y2K, CLS represents a 'change management' challenge for operations teams everywhere. Third party clients should not underestimate the impact of CLS on their systems, operational processes and procedures, and most significantly, their people. Ideally, the implementation experience will include:

- Support during the set up of transaction initiation and reporting, and funding parameters
- Easy access to a comprehensive, leading-edge, and up-to-date training programme, as well as access to people who are CLS-savvy
- Adherence to a stringent testing methodology and standards.

Once CLS is launched, third parties are likely to experience pressure from their own customers to reduce their FX settlement risk by settling their transactions in CLS. Third parties will also have to deal with the added internal pressure of operating in a dual processing environment. By following a well-defined implementation roadmap and adhering to stringent testing, CLS third parties can minimise the impact of the transition to CLS on their staffs. A methodical approach to operational readiness will not only ensure a smooth transition to CLS, but also enhance CLS third parties' ability to meet their own customers' increased expectations.

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