Ranee Jayamaha: The significance of payment reforms in financial system stability

Opening address by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at the seminar on “Payment systems and cheque imaging” organised by the Royalist Bankers’ Club, Colombo, 25 May 2006.

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Let me thank the President and members of the Royal Bankers’ Club for inviting me to deliver the opening remarks at the seminar on ‘Payment Systems and Cheque Imaging’. I am honoured to be speaking to this distinguished group and it is encouraging to note that the subject is of interest to a good cross section of the financial community. In my opening remarks, I will give an overview of the significance and rationale of payment reforms in financial stability and then set out the impact of payment reforms on the financial system, institutional arrangements that are in place, and the need to change payment practices of banks and the public. It may also be important to note that the term “Payment Systems” covers payments, clearing and settlement systems.

As you are aware, the Central Bank’s role in the payment system stems from its primary function of providing payment, clearing and settlement service. Economic policy reforms, the ever increasing complexities in the financial system and the changing role of central banks have resulted in central banks to be at the center of payment reforms which, from the Central banks’ point of view, is helpful in achieving the objective of financial system stability.

The national payment system is the backbone of a country’s monetary and financial system and it plays a critical role in a country’s economic development. It is through the payment system that money is transferred between savers and lenders, buyers and sellers or from one point to another. Developing a national payment system is an ongoing process. By reforming and developing the national payment system, it is possible to reduce the overall transaction costs and expand opportunities for commercial and financial transactions in an economy. In recent years, there has been a rapid acceleration in fundamental reforms to national payment systems worldwide, although the pace of implementation of reforms in different countries has been uneven. Planned outcomes have not always been achieved in terms of expected use, benefits or costs of payment system reform projects and many planned reforms have been unexpectedly slow to complete.

In its modernization programme which commenced in 2001, the Central Bank refocused on its core objectives, i.e. the economic and price stability and the financial system stability. The financial system stability objective encompasses a wide range of subjects of which, the establishment of a safe and sound payment system was seen crucial for the development of the financial sector, which is also complementary to the maintenance of price stability. In this context, the Central Bank examined the adequacy and the efficiency of the payment system to satisfy the needs of an evolving economy and decided to undertake comprehensive payment reforms. The broader objectives of the reforms were to reduce transaction costs, increase efficiency, ensure safety and reduce credit, liquidity and systemic risks.

Payment modes are wide ranging. Cash is the common mode of payment, because it has a finality in settlement of a transaction and is readily and legally acceptable as a medium of exchange. However, the inconvenience of carrying cash and increased security threats have encouraged the move towards other payment media. Non-cash payment modes are considered to be more secured payment instruments, but paper-based instruments like cheques, drafts and travellers cheques are also not so convenient instruments. In modern times, card and electronic payments are treated as the most convenient and safer instruments, although they too are subject to certain risks, card frauds in particular and technology related issues.

There are two systemically important payment systems in Sri Lanka. They are the high value and time critical payment system used by banks, primary dealers, the Central Bank and the corporates and the cheque-based retail payment system which is used by all segments of the population. Reforming these two systemically important payment systems were necessary to mitigate settlement risks, increase efficiency and enhance accessibility. The reforms were also in line with the public policy objectives which require attention of the Government and regulatory authorities.

The implementation of the Real Time Gross Settlement System (RTGS) and the Scripless Securities Settlement Systems (SSSS) with a SWIFT link was the most significant reform effected in recent times. The RTGS was implemented in September 2003 and the system facilitates large value and time critical fund transfers and settlements electronically and on real time. In February 2004, the SSSS module was integrated to the RTGS System. To facilitate the operations of these systems, government securities are issued in scripless form and the system facilitates simultaneous transfer of government securities and settlement of funds through the RTGS on a Delivery versus Payment basis. The Central Bank continues to upgrade and enhance facilities to these two systems and in December 2005, the internet based facility called LankaSecureNet which enables the account holders of the Scripless Securities Depository System to obtain up to date details of their investments through the internet was introduced. While eliminating the systemic risks that was involved in the high value and time critical transactions, the Central Bank became the owner and operator of both the RTGS and SSS systems.

The service provider of the retail payment system is LankaClear (Pvt) Ltd which is owned jointly by the Central Bank and the commercial banks. Two weeks ago, LankaClear (Pvt) Ltd introduced the Cheque Imaging and Truncation System to ensure that cheques deposited in any part of the country is cleared and settled within two days except in uncleared areas. The cheque imaging system eliminates regional disparities in cheque clearing and establishes a common clearing schedule. In addition to these two systemically important payment systems, there are other small scale payments and settlements arrangements. They include the SLIPS system which is also owned and operated by LankaClear and the US$ clearing system operated by a commercial bank. Mr Anura de Silva, General Manager LankaClear will give you the technical details of the CIT System including some of the glitches that have surfaced in implementing the cheque imaging project.

Let me now deal with the institutional and legal arrangements and the impact of payment reforms very briefly. The focus will be on (i) the market arrangements for payment services (ii) the legal and regulatory framework; (iii) the coordination of oversight of the payment system and regulation affecting the system; and (iv) mechanisms for consultation with stakeholders.

The RTGS and SSS systems speedily transfer funds and make settlements of banks, primary dealers, financial institutions, investors, customers, the government and the public. These two systems bring about financial discipline among these stakeholders as they have to maintain adequate cash and reserves in their accounts to meet payment obligations. This also improves the liquidity management by banks as treasurers and fund managers have to produce accurate estimates of their daily liquidity requirements. More importantly, the users of the RTGS and SSS systems can use Central Bank funds throughout the day for settlement purposes and return them at the end of the day. Subject to the availability of acceptable collateral, the banks and primary dealers are provided with intra day liquidity by the Central Bank.

To underpin the payment reforms undertaken by the Central Bank and enhance integrity and safety of such systems, a comprehensive legislation to govern payment, clearing and settlement systems in general and to provide the Central Bank with oversight and regulatory powers over various payment systems and money transfer service providers has been enacted through the Payment and Settlement Systems Act of 2005. The Act empowered the Central Bank to be the authority responsible for the national payment system, which requires oversight and continuous surveillance of all payment systems to ensure its efficiency and effectiveness. The systemically important payment systems will be reviewed periodically to ensure that the design and operation meet with international standards and best practice.

Some of you may be aware that a couple of months ago, the Central Bank established a National Payments Council which is the highest decision making body with regard to payment systems. This committee represented by all stakeholders provides a forum for constant dialogue on payment issues to take place within the industry. The National Payments Council is responsible for developing the payment and settlements infrastructure in collaboration with all the relevant authorities and stakeholders. Currently, it is in the process of finalizing a road map for the development of the national payment system in the next five years, which will be in line with the vision of the financial sector.

In implementing the road map, it is vital that all stakeholders in the payment system understands the significance of payment systems, their impact on financial stability and take ownership and leadership. Most central banks at some point or other have been owners, operators, catalysts, overseers and users of the payment system. Over the years, central banks have given up their ownership and operator's role and, in some cases, even the catalyst role. Banks and financial institutions and even the corporates should play an important role in shaping the national payment system in Sri Lanka.

Let me conclude now by giving an important message. Payment reforms help to adopt best practices by all stakeholders. With or without payment system reforms, banks and financial institutions should be able to meet their payment obligations. Some of the benefits enjoyed by banks and customers over the years will no longer be there under the CIT system. The public too has to make adjustments in their payment practices and ensure that there are funds in their accounts when cheques are issued. All stakeholders should change their past practices and fall in line with reforms which are aimed at improving facilities.

Once again, I thank the Royal Bankers Club for inviting me and extend my good wishes for all its future activities.