

Ranee Jayamaha: Policy framework for regional cooperation and the role of the central banks

Speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at the Central Bank of Sri Lanka, Colombo, 6 July 2007.

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Thank you for this opportunity to share some thoughts on the need for cooperation to develop a regional payment initiative and the role of the central banks in that endeavour.

1. Background

As articulated by the Governor, the SAARC region's trade and financial services are developing at a faster rate, with India achieving a rapid growth of around 8-9%. Most of the SAARC Group of countries, including India, have opened up or are considering to open their capital accounts in keeping up with global trends and the regional needs. Accordingly, trade and investment flows and demand for financial services will exceed the present levels over the next couple of years. Hence, payment system gains much importance as it is a critical facilitator in cross-border flows, as well as domestic transactions. It should be able to cater not only to the present needs, but also the future demands.

For purposes of this presentation, the payment system is treated in a broader sense to encompass the payments, clearing and settlement systems. At a national level, some of the SAARC and ACU countries have already reformed or are about to reform their payment systems to minimize risks and increase safety and efficiency, although the degree of such reforms vary widely. Sri Lanka, India and Iran have completed their Stage I payment reforms. Pakistan is in the process of completing Stage I, while the other SAARC countries are now taking steps to modernize their payment systems.

The maintenance of a safe, sound and efficient payment system is a responsibility of the central bank as many of our central banks have increased focus on wider financial system stability as one of their core objectives. In that context, central banks are called upon to coordinate payment initiatives at national, regional and global levels to ensure that there are appropriate mechanisms for smooth payment flows.

2. Why payment systems are critical to regional development?

Payment services are highly integrated and interdependent systems comprising payers, payees, payment instruments, financial intermediaries, markets, service providers, technical infrastructure, legal and regulatory systems and organizational structures. The public policy objectives common to all stakeholders are to enhance public confidence, safety, integrity, access to finance and efficiency of payment systems. Therefore, we need to facilitate cross border trade and investment flows through appropriate payment instruments, clearing mechanisms and settlement systems.

In a globalized and highly integrated world, financial sector development is closely associated with cross border flows, including foreign direct investment which is critical to developing economies. Most of us in the SAARC region are FDI recipients. Although it is a Herculean task, establishing an acceptable level of regional coordination to generate and facilitate trade and investment and ensuring that cross border flows take place safely and efficiently, without disrupting the national financial systems is an imperative.

The rapidly changing global payment system infrastructure is challenging the existence of domestic and regional payment systems that are lagging behind in the pace of development of technology, communications and globalization. Each country has to reform their payment

systems to keep up with advanced technologies and complex processes. Given the nature of cross border transactions, the need to mitigate risks involved in them and the high cost of quality infrastructure, it is advantageous for countries in the region to undertake reforms collectively in coordination with each other. A regional payment group can attract rich intellectual and resource capacity for payment system development in the region. Within the framework of a common payment initiative, all members can create productive and collective working relationships to address issues relating to the common quest for developing the national and regional payment systems. In this regard, the central banks should promote close coordination among experts in the region to strengthen the payment system infrastructure.

3. Case for a SAARC region payment initiative

The SAARC region-wide payment system has a long way to go in improving its performances, as many others have organized themselves better for the task. The Southern African Development Community (SADC) payment system, led by the Reserve Bank of South Africa, was launched in 1996. Following the initiatives by the World Bank and the Center for Latin American Monetary Authorities (CEMLA), the Western Hemisphere Payments & Securities Settlement Initiative was launched in 1999. In 2004, the World Bank and the regional central banks launched the Commonwealth Independent States Payments and Securities Initiative to develop the payment systems in the former Soviet Union countries. In 2005, the Arab Payments and Securities Settlement Initiative was launched with the cooperation of 22 members and with the support of the Arab Fund. These are some of the successful regional initiatives.

All these initiatives have a common vision to ensure that reforms result in efficient and effective payment systems built on international best practice. Within that vision, they assist individual member countries to prepare domestic payment system development strategies and define a coordinated regional approach to ensure safe cross border payments, taking into consideration the implications for trade and investment activities. Another common feature of these initiatives is the availability of well functioning real time gross settlement systems operated either by central banks or, in some cases, by other operators. This is the platform that links the central banks in the group. These regional initiatives have also built institutional capacities within the national economies, as well as in the region, to sustain continued payment system development. Several of these initiatives have taken on the challenging task of linking regional payment systems on appropriate technological platforms, thus ensuring resilience and safety of common payment systems. With peer pressure, significant reforms have been introduced in payment instruments, payment mechanisms, infrastructure systems, clearing processes, cross-border clearing and settlement systems in individual countries.

To ensure efficiency and safety and achieve common goals, there should be a clear commitment by all member countries, which can be clearly displayed by working together as a group. A collective effort and cooperative agenda should support self-help mechanisms and also complement the coordination and cooperation with other regional initiatives and international institutions. As a group, we can mobilize and optimize technical support from other regional initiatives and international bodies like the World Bank, IMF and CPSS of the BIS.

A logical conclusion of some of these payment initiatives would be to work towards a single payment mechanism like the Single Euro Payment Area (SEPA). This is obviously a long-term objective for the SAARC region and we need to be very cautious in taking a decision towards a single payment mechanism. At the moment, there is no visible political or official commitment towards such a move, but it is worth examining the processes that have taken place in Europe to learn some valuable lessons and avoid potential pitfalls in working towards a single payment space. Since 1999, the European Union has been using a single

currency, the euro, as the common currency within the Union. The current move through SEPA is to establish an integrated non-cash payments system throughout the Union. This means that individuals, banks and financial institutions, corporations and all other entities in the Euro region will be able to make cashless payments throughout the Euro area from a single payment account anywhere, from any country, using a single set of payment instruments, easily, efficiently and safely on the same way that they make payments at the national level.

4. Lessons learned

It is worth mentioning some of the challenges and problems encountered in the SEPA process in order to avoid similar problems that may come up in establishing a SAARC payment initiative, or to remember them if and when SAARC countries wish to move towards a single payment area at a future date. It also highlights the need for a committed leadership when undertaking sophisticated region-wide projects like SEPA. From the beginning, when the SEPA policy framework was set by the authorities in the EU area, it was shared with the market led by banks and financial institutions which were entrusted to implement it.

However, due to lack of high-level commitment, the difficulties encountered in the coordination of the diverse interests of the banking and financial service industry and the severe competition among service providers have caused delays in implementing this project. When the implementation was slow, at the end of 2003, the European Central Bank (ECB) intervened to speed up the process outlining to the banking community a defined and stringent timetable and requiring greater commitment from the banking industry in delivering SEPA. The governance of SEPA has also been entrusted to banks and banking associations implying the need for extra regulatory processing. This move too failed and resulted in unsatisfactory outcomes. Similarly, product development has not been advantageous to the users as expected earlier. Another problem encountered by SEPA was that some of the SEPA instruments were seen as too basic to fit both the user requirements and the efficiency improvement in the European payment system. A market driven migration from existing national non-cash payment products to the new Euro area-wide SEPA products have not been able to provide the same minimum service levels that exist in individual countries. In order to ensure that the new Euro area-wide products use technology developments and produce future oriented or forward looking payment instruments, the ECB had to intervene and caution product developers.

SEPA is an example which illustrates the consequences of leaving matters with a group which is not fully committed to the task, without appropriate leadership. The ECB has to step-in to ensure successful completion of the initiative and to move the project on a time target. This episode indicates that the selection of a catalyst and a responsible leader is essential for national as well as regional payment reforms. In many instances, the payment system development leaders or catalysts have been the central banks, but we should recognize that a central bank's core objectives should prevail when they are required to make a choice.

5. Role of central banks in leading regional payments initiatives

From the central banks' point of view, the development of a safe and efficient national payment system has relevance for monetary policy, financial stability and overall economic development interests. Central banks, therefore, monitor developments in the payment systems to assess their impact on the demand for money, monetary policy and financial system stability. In many of the SAARC countries and elsewhere, the central banks have been playing multifaceted roles like operators, owners, facilitators, regulators, overseers, users and service providers of their national payment systems. Through these roles, central banks have acquired expertise, skills and in-depth knowledge on the role of the payment mechanisms in the financial system and the economy. We need to make use of this

expertise and share it with others in the region and elsewhere. A regional payment initiative would be a vehicle which would help to achieve this objective. Central banks can advise on payment related financial policy and act as effective catalysts, together with private sector organizations, in initiating, promoting and contributing to payment system reforms. By and large, payment reforms, be it national or regional, have been promoted and led by central banks, except in few countries like Canada where the private sector initiative has been significant.

The central banks in the SAARC region also have the ability to play the leadership or catalyst role by providing policy directions, preparing roadmaps in consultation with other stakeholders and guiding national and regional payment system reforms and taking the responsibility to develop a common payment policy framework acceptable to all countries in the region.

We need to pay attention to the existing regional clearing mechanisms as well. As in the case of the Asian Clearing Union (ACU), if there are delays in processing payment instruments, combined with official accounting practices for payments that give rise to a float on the balance sheets of the central banks, that will contribute to inefficiency and uncertainty in the payment process. It is significant to note that such inefficiencies can extend to the central bank's monetary operations and liquidity estimates as floating ACU balances cannot be treated as part of the international reserves of member central banks. Lack of clarity about rights and responsibilities regarding funds on the move is another shortcoming, especially where processing systems and accounting procedures result in long delays between the time a payment instruction is issued and the time it is cleared and settled.

Both at national and regional level, supervision and oversight of payment systems have always received less attention compared to the supervision of banks and financial institutions. When there are cross border payments and common clearing and settlement mechanisms, it is important to ensure that there is a well-designed supervisory system. The supervisors should focus on interbank credit and liquidity risks and system-wide risks that can arise in cross border fund transfer processes and multi-currency transactions and take action to mitigate such risks. In general, consumer protection concerns may be an important consideration if relationships are not well-defined and imperfections in the operational environment provide opportunities for intermediaries and service providers to benefit from inefficiencies relating to customer transfers.

Central banks in the SAARC region should also concentrate on the legal and regulatory aspects of common clearing and settlement mechanisms. The fundamental purpose of rules governing payment relationships in a market is to define clearly the rights and obligations of each party to a payment transaction, be it domestic or cross border. This includes the payer, payee and banking intermediaries. In this regard, the SAARC region needs comprehensive governing laws which (a) provide certainty and predictability with respect to the rights and duties of parties to a payment transaction; (b) ensure that payments are made efficiently, at low cost, and with adequate security; (c) minimize credit, liquidity and systemic risks; and (d) support commercial transactions in the region. Of special concern is that payment laws should provide clarity as to how credit exposures arising in connection with payments are resolved when a counterparty fails to perform or other types of losses are incurred.

All of the above potential sources of trouble in the payment system, i.e. operational inefficiency, poorly designed accounting practices, legal uncertainty and inadequate supervision, can degrade the performance of national as well as regional financial markets, frustrate exporters, importers and businesses. Further, these conditions can lead to dramatic manifestations of inefficiency and abuse, and challenge the credibility of the central banks in our countries. When the SAARC region trade and investment flows increase, we will not be able to reform the clearing mechanism urgently to accommodate cross border flows. The ACU has reached crossroads, requiring urgent reforms, if member countries are still interested in maintaining the long-established goodwill and regional cooperation through it.

6. Outline of a policy framework

It is hard to come up with a blue print or reference framework for establishing a regional payments group without deliberating the topic with the SAARC member central banks. Nevertheless, I wish to outline the key elements of such a framework and a road map which can be developed further by task forces or a working group appointed for the purpose. **First** and foremost, it is necessary to get the commitment and consent of central banks in forming the regional payment initiative. **Second**, it is necessary to engage in a stocktaking exercise to gauge the effectiveness and appropriateness of the existing payment instruments, payment systems, clearing mechanisms, settlement systems and infrastructure in the region to identify their weaknesses, inefficiencies, safety levels and risks. We need to assess these systems against some benchmarks or international norms which would help to increase efficiency, safety and the integrity at national and regional level. In doing so, it may also be useful to look at the benchmarks set by the regional initiatives such as CEMLA, SADEC, CIS, API or other advanced payment systems. **Third**, the framework need not aim to introduce or formalize too extravagant payment mechanisms for the SAARC countries at this stage, but it should focus on the need to elevate the national payment systems of member countries to a level capable of facilitating present and future trade and investment flows and mitigating risks in cross border transactions. This task can be facilitated by setting up National Payment Councils (NPCs) in their own countries and complying with common standards, harmonization policies and international best practice. **Fourth**, the framework should broadly include the following:

- A time targeted vision acceptable to all members.
- A clear mission accompanied by a statement of the roles and commitment and responsibilities of all members.
- Policy objectives necessary to facilitate the present and future trade and investment flows within the region.
- Funding sources, budgetary allocations and an appropriate subscription formula.
- Guiding principles for mitigating risks and reaping benefits.

7. Road map and way forward

If SAARC central bank representatives consent to establish a SAARC regional payment initiative, it will be necessary to appoint an apex body which is capable of taking the reforms forward. The member countries can decide on an appropriate name and the structure of the apex body. For convenience, I have taken the liberty to name it as the SAARC Payments Council (SPC) which can be chaired by a member central bank or co-chaired by two central banks. The Council should draft vision and mission statements for the SAARC region and prepare a road map for payment reforms for the next 5 – 10 years, taking into consideration the modernization that needs to be attended to by member countries at national and regional levels. Under SPC, there should be several task forces consisting of senior officials of central banks and other financial institutions directly involved in payment and settlement related activities who will attend to the preliminary work, such as stocktaking and identification of gaps in the national payment systems. There should be task forces on (a) policy and operational matters; (b) legal and regulatory aspects; (c) technical and institutional infrastructure; and (d) communication and exchange of information. The task forces should make their recommendations to the SPC, which will take considered decisions. In nominating members to the task forces, where possible, countries should select officers from their respective NPCs, as such councils are expected to have representatives of all stakeholders with the necessary skills and expertise to handle work relating to the above areas. Sri Lanka has already established an NPC with a clear mandate to take forward payment reforms across the nation. The NPC has prepared a well-focused action plan after detailed deliberations with all stakeholders and is the apex body for payment system development policies and operations. I understand that India and some other countries too have NPCs. It

may also be important to set up a secretariat in one of the countries to lead the regional payment initiative. The SPC, as well as the task forces, should establish close links with international organizations such as the WB, IMF, BIS and also with other regional payment groups and developed country central banks for guidance and technical assistance.

As I mentioned before, the ACU is the only regional clearing mechanism that exists today among SAARC member countries. It needs a clear reform agenda to mitigate risks involved in that system and ensure safe payment flows among the member countries. Already, a technical committee has been appointed under the Chairmanship of Sri Lanka to look into some elements of modernizing the ACU. The whole of yesterday we debated on some of the short-term measures that need to be introduced to the ACU clearing arrangements in order to avoid any disruptions to cross border flows. That committee too could report its recommendations to the SPC.

There may be many other modifications, modernizations and reforms that need to be introduced at national and regional levels which will shape the annual work program of the SAARC regional payment initiative. It is in that context the topic "Working Towards a SAARC Regional Payments Group" was chosen as the theme for this conference.

8. Conclusion

We need not wait till the SAARC region's trade and investment flows rise significantly to modernize our payment systems. The SAARC member central banks need to decide early to establish a regional payments initiative to reap the benefits of expanding trade and investment flows within the region. The deliberations of this conference during the rest of the day will focus on this topic and I hope that the central banks represented here will bring this conference to a logical conclusion of moving towards reaching consensus on the formation of the SAARC Region's Payments Initiative.

Thank you.