

Mr. Hartmann discusses the introduction of the euro and its impact on payment systems Speech by Mr. Wendelin Hartmann, a member of the Directorate of the Deutsche Bundesbank, at Sibos Helsinki, Closing Plenary Session on 24/9/98.

It is a great honour for me to say a few words, here at this major conference, on the forthcoming, important changes that will accompany the introduction of the euro.

We are all aware that payment systems have long since moved from the seclusion of pure settlement arrangements to become the focus of political and strategic attention. It is not just a question of payments to settle the cost of economic activities. Much greater importance is attached to financial transactions in particular; over the past few years they have grown at a furious pace - not least as a result of globalisation and technological progress. The establishment of efficient and, above all, - as far as possible - risk free payment systems is therefore a necessity.

Payments will also play a significant role in the introduction of the euro: a major part of the preparations undertaken by the banks and central banks in Europe deals with that area. European economic and monetary union (EMU) will undoubtedly transform the payments landscape in Europe and - as a result - worldwide.

What is indisputably the most important project for the European central banks is the introduction of TARGET - meanwhile well known to the financial industry world-wide - which has been in the simulation phase since July of this year. The tests are proceeding satisfactorily overall and give cause for optimism; the credit institutions are now actually involved in all the countries of the European Union (EU).

The most recent decision of the Governing Council of the European Central Bank (ECB) to include the four EU countries not (yet) participating in EMU has also settled the last undecided points which were the subject of animated discussion in the past. Confirmation has been given that the RTGS systems of the "out" countries will be connected to TARGET but that they will be subject to special conditions regarding the provision of liquidity. The "out" central banks may maintain interest-bearing deposits with the European System of Central Banks (ESCB) and initiate payment orders from them. However, they may not receive non-interest-bearing overdrafts from the EMU-central banks, a facility for which there is provision in the settlement of TARGET payments for "in" central banks. The "out" central banks may grant a maximum intraday credit of 1 billion euros per bank to credit institutions in their euro RTGS systems against the deposit of appropriate collateral. Spilling over into an overnight credit and the associated monetary policy implications are to be prevented by repossession of the intraday credit at an earlier closing time and the setting of high penalty rates.

I would like to venture a brief look forward to the future payments landscape in Europe.

Features of foreign payments

Owing to the comparatively small number of cross-border transactions, there has so far been no real pressure for rationalising foreign payments. Most cross-border payments are still settled through a large number of correspondent banking relationships and, typically, with a two-day value date. Apart from the exchange of SWI.F.T. messages, very little is standardised - there are only the beginnings of a standard international bank code, for example. Complicated pre-printed forms and statistical reporting obligations make a simple exchange of payments more

difficult. However, this should not be regarded as an excuse for the existing shortcomings in cross-border payments, such as long settlement times and high charges still mainly occurring in the retail segment. In the euro area, these differences when compared with the efficient and cost-effective operations of the national systems will become very obvious and create political pressure on us all. In the interests of a fully functional European market, foreign payments will, at all events, need further improvements.

Large-value payments

As a result of their importance for monetary policy, large-value payments are especially "close to the heart" of the central banks. In order to guarantee a single money market and the necessary interest rate arbitrage in Stage Three of EMU, it will be necessary to settle payments - including cross-border-payments - not just within one business day but, where possible, within a matter of a few minutes. The TARGET system which has been developed by the central banks is thus the key medium for implementing the single monetary policy and an efficient euro money market.

TARGET will not be the only large-value payment system in the EU, however. Net settlement systems, too, may continue to operate if they meet what are known as the Lamfalussy minimum standards and settle payments through central bank accounts. Thus, the net settlement system of the Euro Banking Association (EBA), which still settles transactions in private ECU, is being re-equipped to process euro payments in future. In addition to this cross-border system, there will be other national net settlement systems: SNP in France, the Madrid Clearing House in Spain, the Finnish POPS system, and the LIPS system in Luxembourg. The German EAF (Electronic Access Frankfurt) combines the positive elements of gross and net settlement systems. As a hybrid system, it will thus provide - also after the euro has been introduced - what is, in our view, an optimum combination of early finality of payments and liquidity saving, as will CHIPS in New York in the future.

The distinction between cross-border and national payment systems will fundamentally become less important. Firstly, all systems will process the same currency - the euro - in future. Secondly, national systems will become increasingly international in character as a result of the expansion of the group of participants. Foreign banks, both from the EU and from third countries, will be able to participate in domestic systems through their branch offices or use the option of remote access without even having a local presence. Along with other central banks, the Bundesbank has been opening its large-value payment systems for remote access worldwide since the beginning of this year and offers interested banks indirect participation with their own clearing address. There has been a great response to this international stance, especially from outside the EU area.

The large number of different payment systems and the various forms of access will inevitably lead to fiercer competition among the systems and thus among financial centres. There are some who regard the coexistence of the various payment systems as problematical on the grounds that it will make liquidity management more difficult. Since the transaction currency will no longer be the major factor determining the channel of payment, they fear that the situation in Europe will be - to quote from the *Financial Times* - "at best a mess, at worst chaos"¹. This is a view which I am totally unable to share.

¹ Financial Times, August 3, 1998: "What you would have is at best a mess, at worst chaos", said Eric Sepkes,..."

On the contrary, I regard competition as fundamentally desirable in this respect, too, since it is likely to lead to payment systems being organised in a more efficient and cost-effective manner. This statement also applies without qualification to the systems operated by the central banks (TARGET and EAF). That is because, just as the commercial banks operate their systems, such as EBA Clearing or SNP, without gainful intent, the central banks work theirs according to the principle of full cost recovering. The costs structure is regularly examined by independent auditors, for example. The Directorate General of the EU Commission responsible for issues relating to competition ensures that the EU central banks do not operate an unfair charges policy.

Besides charges, it will, above all, be quality features, such as speed and freedom from risk, that will play a crucial role in the choice of the payment channel. The TARGET system established by the central banks will settle large-value payments extremely efficiently in real time and with immediate finality. In the view of the central banks, this system should therefore be used for time-critical and very large payments, particularly for transactions in connection with money and foreign exchange market operations. This would make a considerable contribution to the EU-wide reduction of systemic risks.

One further advantage of TARGET is its comprehensive market coverage - almost all credit institutions in the EU will directly be accessible via TARGET. This will also enable institutions outside the EU to restructure and/or streamline their correspondent banking relationships with a view to gaining access to the euro area, since they will generally need only one link into the euro area for access to TARGET. Net settlement systems, such as EBA Clearing or the hybrid system EAF, tend to be geared more to a limited number of direct or indirect participants; other banks can be reached only through correspondents. These systems provide the particular advantage of liquidity saving, but do not ensure the finality of payments in real time. For that reason, they will probably be used for payments of lesser importance but with same-day settlement.

I therefore regard the coexistence of gross and net settlement systems as quite consistent with market requirements. One of these two types does not necessarily have to displace the other. Rather, they are complementary. Participants in payments will thus have the option of deciding which system is the more suitable in a given situation depending on the purpose and size of their payments.

The choice of the payment channel will therefore depend on customer needs. I feel that cartel agreements in the banking industry or regulation by the central banks are unnecessary. Even the "Heathrow Group", a grouping of 31 clearing banks, has arrived at the conclusion that there ought be no binding regulations on the use of certain payment systems. Instead, the existing principle of the channel of payment being agreed bilaterally or multilaterally between the credit institutions involved should be maintained. Standard Settlement Instructions (SSI) are helpful in this but must not lead to cartel agreements and thus clash with fair competition.

Despite all the optimism in respect of the major function of competition, it should not be forgotten that there must be a given volume of payments overall in order to ensure the viability of several coexisting large-value payment systems. According to a 1996 estimate by the EBA, a daily volume of between 318,000 and 473,000 crossborder commercial and financial payments in euros is to be expected from the start of next year. Furthermore, the EBA estimates that the volume will increase by 15% to 20% by the year 2004. The actual future trend in the volume of payments is, in my view, difficult to predict, however. The adoption of the single

currency will, at least, mean that there will be no transactions which aim at exchange rate positioning among the disappearing European currencies, as there are now. The current efforts to limit the foreign exchange settlement risk will have a similar impact. A significant increase in the use of netting procedures in foreign exchange dealings or the successful implementation of the CLS initiative might, in all probability, lead to a perceptible reduction in the number of transactions. The possibility of excess capacity arising in large-value payments cannot therefore be ruled out. Nevertheless, the effect might be tempered by new payment activities due to an increase in transactions resulting from enhanced efficiency in the EU market and an increase in the volume of payments involving third currencies. Again, the creation of the European money market itself is likely to impart a major stimulus to the volume of transactions.

I feel there are two conceivable developments if there really is excess capacity. Firstly, it might become necessary to close down individual systems because of a lack of sufficient use. Secondly, I could also well imagine that spare capacity might increasingly be used to settle retail payments, too, in the new, efficient large-value payment systems.

Retail payments

This would give a considerable boost to cross-border retail payments in Europe since these still do not meet the requirements of the single market in terms of speed, efficiency and cost.

A survey that was recently conducted in Frankfurt, for example, showed that the settlement of a cross-border payment still takes between 2 and 14 days and that a transaction to the equivalent value of around 800 euros costs 10-30 euros. If these costs are compared with those of the large-value payment systems, it becomes clear how much catching-up is still to be done in the area of retail payments. Depending on the amount submitted, a TARGET payment will cost no more than 0.80-1.75 euros. The EBA and the EAF will charge 0.25 and 0.15 euros, respectively, per transaction.

In my opinion, the banks have failed to eliminate these long-familiar shortcomings at the right time. A few years ago, in fact, there was a promising initiative to make retail payments more efficient and, above all, cost-effective by means of the ACH (Automated Clearing House) solution. The ACH approach would have offered the advantage of there being only one link for cross-border payments per country. Unfortunately, this solution was sacrificed to the short-term interests of the banking groups. The totally unsatisfactory level of technological standardisation in Europe has remained largely unchanged.

Instead, individual groups, such as the cooperative and savings bank sector, have now established their own linking systems. In terms of efficiency and cost, these initiatives are not enough, however. Rather, technological diversity has resulted in settlement that is uneconomic in the long term. The situation is unsustainable - especially in the light of the cost-effective settlement of large-value payments - and is likely to call the consumer protection associations into action again. The banking industry must seriously consider how substantive improvements can be achieved.

In my view, this requires progress in the area of standardisation, in particular. Linking the national retail payment systems throughout Europe has failed so far because the national standards are not compatible with each other. The bank code has a different number of digits in the individual countries, for example; the IBAN is only gradually gaining acceptance.

Differing standards mean that foreign payments are, in most cases, still passed on in systems that are separate from domestic payments and encumbered with special charges. A complete conversion to combined processing in a given country's domestic payment system is not always possible and is also fairly labour-intensive on account of the large number of possible combinations. It is only gradually that bridging standards are being developed for a link of this kind, one example of which is the message type S.W.I.F.T. MT 102. These bring about a significant reduction in the amount of work needed, since there only has to be one single conversion from the national standard to the S.W.I.F.T. message type or, alternatively, from the S.W.I.F.T. message type into the national standard. A complete cost-effective harmonisation would require standardisation throughout Europe, however. The EU central banks and the European Monetary Institute (EMI) have repeatedly drawn attention to this problem; I cite merely the seminar on standardisation that the EMI held at the beginning of this year with representatives of the European banking industry. The private sector still has a lot to do in this respect. In their payments oversight function, the central banks repeatedly find themselves in the situation of being compelled to point out the existing failings. They are also willing to take an active part in supporting the work on European standards.

The role of S.W.I.F.T.

Naturally, whenever the subject of standardisation is mentioned, I immediately think of our host, S.W.I.F.T.. Looking at this audience, it once again becomes clear what a major role S.W.I.F.T. plays in terms of payment systems worldwide. We are all users of S.W.I.F.T.. And that has led, of course, to the S.W.I.F.T. formats now being more or less the only international standard for payments between banks. A wide range of participants uses the S.W.I.F.T. telecommunications network for international correspondent banking business. National large-value payment systems, too, such as the Belgian RTGS system ELLIPS or TBF in France, use the S.W.I.F.T. network for communication between their participants. By contrast, participation in the Bundesbank's large-value payment systems, EAF and ELS, is based on proprietary solutions; the Datex P of Deutsche Telekom AG is used for telecommunications. The Bundesbank thus takes due account of the variety of systems operated by its customers by providing them with open and, in the broadest terms, neutral access, to its services. This principle is also being applied to the opening of large-value payment procedures for worldwide remote access. Nevertheless, for those interested in remote access to EAF and ELS, we are also developing a cost-effective access option which uses the S.W.I.F.T. network as a platform and the customary S.W.I.F.T. standards for communication. This means that banks abroad will be able to use their normal foreign payments procedures without additional modification work, and this will make installation and communication easier. This solution is expected to be available from the start of 1999.

S.W.I.F.T.'s role in Stage Three of EMU is being extended, since the EU central banks have decided to use S.W.I.F.T. as a carrier for the cross-border TARGET system. This means that S.W.I.F.T. has taken on an even greater amount of responsibility. In particular, this includes the commitment to ensuring smooth and trouble-free operation. It is my belief that the high standard set by S.W.I.F.T. in the past will ensure that the TARGET system will operate smoothly, too. This is borne out by the first-rate spirit of cooperation and the transparency provided by S.W.I.F.T. - not least with respect to the auditing by the Belgian central bank. Overall, I am optimistic that SWIFT will also master future challenges, such as the year-2000 problem.

Outlook

However pressing and topical the centennial project of EMU may be, the example of the year-2000 problem makes us realise - if we have not done so already - that cooperation in the field of payments must not stop at Europe's borders. Europe must look beyond its own immediate concerns in order not to become isolated. The EU central banks will therefore continue their dialogue with central banks throughout the world. The introduction of the euro will, in any case, not leave third countries unaffected. Credit institutions outside the EU will restructure their correspondent banking relationships and possibly find new counterparties. Concentration on a small number of access points to the euro area will offer them the opportunity of easier liquidity management. This will also strengthen competition between European financial centres. Issues of this kind relating to competition also came into the, often animated, negotiations on connecting the "out" central banks to TARGET. At times these central banks had feared discrimination. On the other hand, they do happen to be outside the euro area and cannot therefore benefit from all the advantages of the single currency area. Off-shore centres must play a neutral role in terms of monetary policy - something which, in my view, made the imposition of conditions indispensable. I believe, however, that we must not forget that these countries will one day become fully-fledged members of EMU and that procedures will then be harmonised in any case. In terms of the restructuring of payments in EMU and the rearrangement of business relationships - in other words, including acquisitions - fairness should take priority over everything else. What matters, after all, is successfully realising the joint project of monetary union on an enduring basis.