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## **CPSS / IOSCO: PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES - CONSULTATIVE REPORT**

On behalf of Bacs Payment Schemes Limited (the system operator of the UK's Direct Debit and Direct Credit schemes) and CHAPS Clearing Company Limited (the system operator of the UK's high value, real time CHAPS system and the Faster Payment scheme) I am pleased to respond to the CPSS – IOSCO consultative report on Principles for financial market infrastructures.

In addition to our system operator responsibilities, and in conjunction with the Payments Council, the scheme companies also have an interest in ensuring that there are efficient arrangements in place to manage the positions of the settlement banks who provide credit and cash liquidity to their customers in these systems, often in very large sums. The overall objective is to ensure that the payment systems continue to operate efficiently and that the essential economic function which they provide is not compromised in even the most stressed scenarios.

Over many years we have worked closely with the Bank of England with the objective of ensuring that the country's principle payments systems are robust and are capable of withstanding shocks whether arising from external independent factors or from internal malfunctions. In this context most of the consultative report resembles closely the regime towards which the Bank of England's payments systems supervision doctrines aspire and it is helpful that it does so. We believe we have a good working relationship with our overseers and much useful and helpful work has been achieved in the past although the Bank's own oversight reports and this consultative report show that there is more to be done.

### **Summary of response**

In the context of a Deferred Net Settlement (DNS) payment system, especially one which is designed principally as a retail system, the Principles are designed to ensure the system is

efficient, reasonably priced, robust, fit for purpose and will survive the shock of the failure of a large participant. The Principles discuss, for example, the need to maintain liquidity to manage the failure of more than one of its participants. They also mention the importance of defining clearly points of irrevocability and final settlement.

We feel that, without clearly defining the limits of responsibility of a payments system, there is a risk of moral hazard creeping in. It would be not difficult for it to be thought that the payments system could take over responsibility for ensuring the end-to-end performance of payments, much as a CCP interposes itself between the counterparties to a securities transaction. We do not believe this is intended. But if it is (on public good grounds, for example), the limits of responsibility need to be clearly expressed and public debate needs to begin on what happens if a major payments system fails (just as debate is beginning on how to prevent the failure of a major CCP).

The paper also refers to the possibility of transferring payments between systems, and the desirability of common internationally accepted communication procedures and standards. We question whether, in the case of a mature domestic payments system, re-engineering to such standards (which would themselves be updated from time to time) would be in the best interests of all concerned.

## **Detailed responses**

We are broadly in agreement with the bulk of the points made in the consultative paper but we would make the following observations where we take a different view.

### **Principle 5: Collateral**

For the UK schemes collateral activity is undertaken by the Bank of England and not by the individual schemes. We question whether there is any benefit in applying haircuts or concentration limits at scheme level although we understand that there will be a greater interest from the overseer in respect of the quality of collateral.

### **Principle 7: Liquidity Risk**

Embedded in this Principle is the requirement for a payments system to survive the failure of the [one/two] participant(s) ...that would generate the largest aggregate liquidity need in extreme but plausible market conditions. We believe that the principle should be “cover one” and we make the following observations:

- i) The current UK mechanism to manage liquidity risk covers up to any three participants but is limited to the largest payment obligations observed in the previous year. Partly this is because the two biggest UK domestic payments systems do not yet have a formal mechanism to limit the value of payments instructed by customers.

- ii) The Principle is unclear about how to manage a circumstance where the two biggest players have failed. It is not reasonable, for example, to make the Principle apply immediately and unconditionally to the next biggest two players since that would place an unfair burden on the last players left standing.
- iii) It is important to build in break points such that the authorities can review the banking system as a whole when the symptoms of stress are so extreme that there is clearly something fundamentally wrong.
- iv) Where more than one member of a banking group is a member of a payments system, responsibility for ensuring sufficient liquidity is available should be at group level and sanctions applicable to a single member should apply (in this case) to all members of the banking group.

3.7.6 suggests that payments systems “should have the operational capacity to reroute payments....” in times of stress. It is unclear how this would be helpful if it simply transfers the stress to another system without offering a cure.

3.7.17 refers to potentially uncovered liquidity shortfalls and mentions specifically reductions in payouts to participants. This is an example of a requirement for absolute clarity of limits to payments obligations, not only within the payments system itself but also within the end participant institutions in relation to their obligations to credit customers.

## **Principle 8: Settlement Finality**

This Principle addresses the proper definitions of the point beyond which a payment cannot be withdrawn from the system and the point at which settlement becomes final. The two are different and it is questionable whether this is made sufficiently clear. 3.1.6 describes the need to define “the point at which transactions are irrevocable”, and goes on to speak separately of settlement finality. The wording in the section on Principle 8 does indicate the need to define the points at which settlement is irrevocable and unconditional and when unsettled payment or transfer instructions may not be revoked. The concern is that, without a high degree of clarity, confusion may arise because of the mistaken belief that, because a payment instruction may not be revoked, it is guaranteed to settle.

There is also a lack of clarity about what settlement finality means. In the context of the consultative paper it appears to refer to the point of central settlement between the participants concerned (and preferably across the books of the central bank). But to the end customer, especially a retail customer, the distinction between that point and the point at which his account is debited or credited at his bank is still a potential source of confusion. It would be helpful if the consultative paper made clear which point of settlement it refers to.

## **Principle 16: Custody and Investment Risk**

In the UK this activity is undertaken as a central bank function, we suggest that this that this might be relevant to FMI's outside of the UK.

## **Principle 22: Communications procedures and standards**

The principle calls for the use of relevant internationally accepted communication procedures and standards. Bacs, one of the UK's two principle mass volume electronic payments systems, uses the standard prevalent at the time when the system was designed. We suggest that a mature system like Bacs, designed for a single currency use, and to which a very large number of users connect directly, would become the source of significant disruption if it were required to change its communication standards. We are pleased to see that footnote 130 notes this approach for purely domestic transactions.

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