

Enhancing payment systems to cope with the liberalisation and globalisation of financial markets: the UK experience

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The theme of this conference, managing change in payment systems, was well chosen by the BIS as it is clear that, while each country faces different specific challenges, we all face the common challenge of managing change. It may just be that I am getting old, but I have the strong impression that the pace of change has been increasing. Certainly the United Kingdom, in common with many other countries, faces very many separate projects and developments. Faced with such complexity, it seems to me that it is crucial to be clear about one's overall objectives and to have a sufficiently detailed overall strategy in order to achieve the highest specific priorities.

Objectives

The principal objective for the Bank of England is to reduce risk in payment and settlement systems, especially the risk of systemic disturbances being transmitted from one participant to another. The risks with which we concern ourselves are wide-ranging and are listed in the glossaries of many BIS publications! They range from operational and legal risk through liquidity risk to the various forms of credit risk (e.g. market and principal risk). Good design and operation of payments infrastructure can reduce or eliminate many of these risks.

But it is not enough to be concerned with risk reduction or elimination. One could have the safest system in the world but it would be of no use if the system were not used. We therefore equally have to have an eye on the attractiveness of the system and we express this as a second objective, which is to promote the efficiency of the system. As a consequence of our objectives in this area the Bank of England has some involvement in both the design and, in some cases, the operation of payment and settlement systems, especially those dealing with wholesale

transactions, where the biggest values occur and where there is the greatest risk of systemic threats. In the United Kingdom this has meant that the Bank of England operates the core of the payment system, effecting the transfers between the banks which are direct members of the system, and we operate the securities settlement systems for government bonds (gilts) and for money market instruments. Both these systems deal predominantly with high-value transactions. Other systems, however, including the equity and corporate bond settlement system, CREST, and the clearing house for derivative transactions (LCH), are privately owned.

The developments in payment and settlement systems in the United Kingdom can best be understood against the background of developments in the financial system domestically and internationally. This background can indeed be characterised – as suggested in the title for this session – as one of liberalisation and globalisation.

Background of liberalisation and globalisation

There have been many factors which have contributed to the liberalisation and globalisation of markets in the United Kingdom, as in other countries, but I might draw attention to two or three. First, there has been a worldwide trend towards freeing capital movements, and in the United Kingdom exchange control was abolished in 1979.

Second, the United Kingdom has a tradition of markets and trading systems which are relatively open by world standards and this was further enhanced by a series of reforms in the 1970s and 1980s which encouraged open competition in financial markets. Two key developments of both practical and symbolic importance were the introduction of “Competition and Credit Control” in 1971, which ensured that banks competed for customer business by varying interest rates without hindrance from direct controls on their lending or deposit base, and the so-called “Big Bang” in the Stock Exchange in 1986 which opened membership of the exchange to better-capitalised firms, many of which were foreign. And it is indeed the openness to foreign firms – both to participate in UK-based financial markets, and to own even the major domestic firms in those markets – that is one of the defining characteristics of the London market. The result is that it has grown as an international financial centre

and the volume and value of financial activity in London is huge. This is perhaps epitomised by the foreign exchange market, where, according to the BIS statistics for 1995, London-based trades generated settlement flows in various currencies approaching nearly \$1 trillion per day (30% of the global total).

These developments have been associated with the third factor: rapid growth in cross-border transactions. Such transactions have been encouraged both by the increasing openness of many markets worldwide and by the development of global institutions, many of which centralise the management of their trading book and the control of risk.

Against this background the Bank needed to set its strategy to achieve the objectives of reducing risk and promoting efficiency in payment and settlement systems.

The Bank of England's strategy

Our strategy for payment and settlement issues has three main goals, one in each of foreign exchange, payment and securities settlement.

In foreign exchange settlement the strategy has been to implement the G-10 approach to the pressing need for banks to monitor, control and reduce the exposures which arise as a result of foreign exchange activity. This strategy involves action by individual banks, by industry groups and by central banks. In the case of individual banks, action by UK banks is being encouraged by my colleagues in the supervision department of the Bank, who have been taking a close interest in the response of individual banks to the Allsopp Report on foreign exchange settlement risk. In the case of industry initiatives, the Bank has again been involved, both as the current regulator of the ECHO multilateral netting system and through our active participation in the CPSS's FX settlement risk steering group which is overseeing the development of the continuous linked settlement approach and which has encouraged the merger between CLS, ECHO and Multinet. The third strand of the G-10 strategy towards FX settlement has been direct activity by central banks, which, so far, has largely involved publicising the issue. We have therefore taken an active role both on the conference circuit to highlight these issues, and also through individual meetings with banks involved in the FX market. We have also played an active role in the G-10 central banks' steering group

on FX settlement risk, notably through carrying out part of the surveys undertaken to monitor and assess progress.

The second component of the Bank of England's strategy towards payment and settlement systems has been in the area of payment systems themselves. Here our approach has been to introduce real-time gross settlement systems for high-value payments. RTGS was introduced into the domestic high-value sterling payment system, CHAPS, in April 1996. An RTGS system eliminates the receiver risk which arises between participants in a deferred net settlement system. But RTGS systems need careful management to ensure that they work efficiently. RTGS systems make explicit the credit which is implicit in a net end-of-day system. Participants can undertake payments only if they have cash or an overdraft facility at the moment they wish to make a payment. In common with other central banks in Europe and many other parts of the world, the Bank of England's approach has been to make credit freely available against appropriate collateral. As a result collateral management, and its cost, has been an important issue to be addressed to ensure that the RTGS system is efficient, so that it is used, and so that the risk-reducing benefits are achieved.

The Bank of England has taken a similar attitude in the development of the TARGET system for high-value euro payments. TARGET comprises the euro RTGS systems of European Union countries and extends the risk-reducing benefits of RTGS across borders. The Bank has played an active role in both the technical and business development of the TARGET system in the belief that it is desirable to have a successful euro RTGS system which will be efficient and widely used. In our view, similar issues arise in a European context to those to which I have referred in the United Kingdom about the provision of credit and the management of collateral. The issues are particularly acute within Europe, where there are a variety of national systems and a greater choice of methods of making euro payments.

The third part of our payment and settlement strategy is to improve securities settlement procedures. In particular, we wish to extend the delivery-versus-payment (DVP) system that we operate in the United Kingdom. We currently have what we call an "assured payment system", which, in the terminology of the CPSS report on DVP, is called a Model 2 system. A Model 2 system is one where the securities move gross in real time but the cash is settled net at the end of the day. In the United

Kingdom's assured payment model the delivery of securities is synchronised with a form of payment inasmuch as the large settlement banks act as guarantor for their customers. This means that most users of the system do not give up their stock without exchanging it for a high degree of assurance of payment. But the banks themselves are left as unsecured creditors to each other and effectively take on the same sort of exposures as arise in a net end-of-day payment system. Just as we decided to replace our net end-of-day payment system with an RTGS system, so we wish to replace our Model 2 DVP system with a Model 1 DVP system where both title to the security and cash (in this case, central bank cash) are exchanged in real time.

In addition to promoting this risk-reducing measure we have been having discussions with our market participants about the desirability of merging our separate securities settlement systems which cover gilt-edged securities (GCO), market instruments (CMO), and equities and corporate bonds (CREST). It may well be that efficiency would be enhanced by merger. Finally in the field of securities settlement, the question of cross-border settlement and links between securities settlement systems, particularly within the European Union, is highly topical. We will be assessing these developments against the objectives of risk reduction and promotion of efficiency that I outlined at the beginning, and we are about to embark on a formal consultation process addressing these issues.

Achieving the strategy

The Bank is not able to impose solutions on the financial community in this field. We do, however, have considerable influence in a number of ways. First, we have responsibility for the oversight of the payment system. The term "oversight" is used deliberately because we have no formal statutory power to carry it out. We certainly do not have a direct supervisory role over the payment systems operators or participants. But our role is recognised in practice and will be recognised implicitly in statute. The Bank of England Bill, currently before Parliament, allows supervisors to share information with the central bank not only in its role as monetary authority but also as overseer of payment systems. That statutory recognition will underpin our authority. Second, the Bank acts

as the settlement agent for the payment systems, including, ultimately, for securities settlement systems. We have the power to grant, or not to grant, direct access to central bank accounts. This has to be exercised responsibly and in a non-discriminatory fashion, but it does give us a direct role in vetting the arrangements in payment and settlement systems where we are responsible for providing the final settlements. Finally, the Bank tries to take a leading role in the domestic debate about the development of payment and settlement services – contributing to both practical and more academic discussions. This takes the form of producing articles for publication in Bank of England publications (such as our Quarterly Bulletin and Financial Stability Review), or private sector specialist magazines, as well as contributing to conferences and having regular meetings with other interested parties.

What is clear is that the approach we take has to be cooperative. Domestically this means working with the private sector clearing organisations. The most important of these is the Association for Payment Clearing Services (APACS), which is responsible for all the main payment clearings in the United Kingdom. The most prominent of these is the CHAPS system, which is controlled by the CHAPS Company. The company is owned by the private sector banks and the Bank, but we have only a very small share. Our experience has been that the commercial banks can have different priorities from the central bank, in particular with respect to the trade-off between risk reduction and cost. Nevertheless we have also found that, if our arguments are good, the commercial banks have typically been persuaded of the merits of collective approaches to reducing risk. This has been particularly apparent in the case of RTGS systems, where we originally encountered some concern and opposition to the idea of moving from a net system to an RTGS system. A joint working party was therefore set up between the Bank and the CHAPS Company, including representatives from many of the commercial banks involved. This group conducted an extensive investigation into the consequences of moving to an RTGS system and, in particular, undertook detailed modelling of the likely impact on payments flows and the peak demands for liquidity in the course of the day. This was then compared with the ability of individual banks to provide collateral to secure adequate credit to enable them to process their payments to a timetable which suited them and their customers. After this modelling work the banks agreed to move to RTGS and are now enthusiastic about

the sterling RTGS system in the United Kingdom. That modelling work is now being adapted for use by CLS in its own business planning for its proposed foreign exchange settlement system.

In addition to talking to the main industry groups like APACS and the London Clearing House (for derivatives), we also maintain an active dialogue with individual firms and organisations including trade associations, like the British Bankers Association, and the various other banking and securities groupings. We believe that persuasion is usually an effective way of implementing the strategy even though it may take some time.

Internationally the approach is bound to be similar. There is no overarching authority to impose solutions in payment and settlement and therefore progress can be achieved only through cooperation. The main basis of such cooperation is through other central banks, both bilaterally and collectively. The Bank of England is therefore keen to take part in activities such as today's CPSS seminar as well as in more formal groupings such as those within the European Union and in the BIS or regional groupings.

The future

Change will undoubtedly continue to be a major theme in payment and settlement policy in the United Kingdom.

Our domestic arrangements for the division of responsibility between official bodies is changing as a result of the Bank of England Bill, and the prospective Financial Services Reform Bill. These measures will involve the amalgamation of the Bank of England's supervision department with the supervisors responsible for securities firms and markets and for insurance and building societies. Responsibility for financial stability, by which we mean mainly systemic threats, however, will remain with the Bank of England. The example which is usually quoted to illustrate this responsibility for overall financial stability, other than in respect of individual institutions, is the oversight of payment and settlement systems. Clearly it will be important to retain close liaison with those carrying out the day-to-day supervision of individual firms and markets to protect consumers. Equally our focus on risk reduction and on the promotion of efficiency has been reinforced by these administrative changes.

In terms of payments projects themselves there is a degree of project congestion at present. Markets, clearing organisations and individual firms have been preoccupied with preparation for European economic and monetary union (EMU) and with work to deal with the Year 2000 problem. The preparations for EMU were made somewhat more complicated in the United Kingdom to the extent that we have been preparing both for the possibility of being a founder member of EMU (being "in" in the jargon) and for not being a member at the outset (being "out"). In practice many of the preparations are the same – because London's wholesale markets will actively trade and settle the euro whether or not the United Kingdom is an initial member of EMU – but the Chancellor's recent statement making clear that the United Kingdom would not join in 1999 but expressing a strong desire to join as soon as possible after the next election has aided preparations. Wholesale markets now plan on a consistent basis and the announcement has also encouraged sensible preparation on the retail side. The United Kingdom now regards itself as a "pre-in", that is, a country preparing to join EMU within the next few years.

These projects, including the Year 2000 projects, take a great deal of resources, both technical resources and – probably as important – middle and senior management time. The result is that we are not rushing ahead with other desirable projects in the field of payment and settlement systems because it would not be prudent to introduce risk-reducing measures in a risky way. Nevertheless it will be clear from what I have said that we have a number of high priorities for the next few years. The first is to move to Model 1 DVP in our securities settlement systems as soon as practicable. This is primarily a risk-reducing measure. The second is to look seriously at the advantages of consolidating the various securities settlement systems in order to promote efficiency. Third is to consider the case for links between the UK and various foreign securities settlement systems which, if done in a robust way, could contribute to the achievement of both the risk and the efficiency objectives.

We feel that we have made some progress in the United Kingdom in recent years in developing our payment and settlement infrastructure. Equally we feel that there is more to do. Managing change is, and will continue to be, a continuous process.