

A Japanese perspective on payment system reform

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Ongoing projects

There are a number of ongoing projects to improve payment and settlement systems in Japan.

Funds transfer systems

In the area of funds transfer systems, the Bank of Japan will discontinue designated-time net settlement (DNS) and make real-time gross settlement (RTGS) the only method of settlement for the funds transfer service of the Bank of Japan Financial Network System (the BOJ-NET funds transfer system) by the end of the year 2000.¹

For funds transfer systems operated by the private sector, a variety of measures have been or will be implemented. For example, the Foreign Exchange Yen Clearing System (FEYCS),² which is a large-value clearing system for cross-border yen transactions, is going to adopt the CHIPS-type method to improve risk management measures. The Zengin System,³ which clears interbank transactions for third-party payments, currently has a mechanism whereby the central bank provides liquidity to complete timely settlement on behalf of the failed bank in the event of a default. However, market participants are now studying ways to replace it with alternative risk management measures. In addition, Japanese banks, including those participating in the work to establish the continuous linked settlement (CLS) mechanism, a private sector initiative to reduce settlement risk arising from foreign exchange transactions, are

discussing what they need to change in the Tokyo market to make the CLS function work.

Securities settlement systems

In the area of securities settlement systems, intensive efforts are being made to enhance risk reduction measures. For example, Japanese government bonds (JGBs) had long been settled on a net basis, with several days' transactions being netted out and processed together, causing long delivery lags. With the creation of the JGB repo market this net settlement scheme was modified to a T+3 rolling settlement mechanism. For non-JGS bonds, including corporate bonds, a new settlement system, the Japan Bond Settlement Network (JB Net), which will begin operating in December 1997, will convert traditional paper-based transactions into online transactions. With regard to the settlement of stocks traded in the Tokyo Stock Exchange, same-day settlement has replaced next-day settlement. In addition, the implementation of delivery-versus-payment (DVP) settlement for stocks and the corresponding funds is now being considered.

Entry of non-financial institutions into payment services

As for non-financial institutions, there are moves to reduce settlement costs by introducing multilateral netting arrangements, since these institutions will also be allowed to handle foreign currencies from April 1998, when foreign exchange transactions will be liberalised. Also, many projects relating to electronic money and electronic commerce have been initiated with the participation of these non-financial institutions.

Background

Factors promoting projects

Ongoing globalisation and technological innovation in the financial industry can be cited as the common reason behind the increased number of projects in many countries. In addition, there are two other reasons in Japan. One is a growing awareness of settlement risks associated with the

¹ The BOJ-NET is an online large-value transfer service provided by the Bank of Japan. It provides both funds transfer services and Japanese government securities (JGS) transfer services.

² The FEYCS is managed by the Tokyo Bankers Association and is operated by the Bank of Japan as part of the BOJ-NET, which conducts settlement for FEYCS payments.

³ The Zengin System is an electronic domestic funds clearing system for third-party payments managed by the Tokyo Bankers Association.

increase in cases of failure. The second is the preparation for the approaching Japanese “Big Bang” – namely, the need to modify infrastructure and develop new business opportunities after the financial deregulation.

Growing recognition of settlement risk

For more than 50 years no financial institution had failed in Japan. Thus, it was believed that credits to financial institutions were safe and secure. This is why risks inherent in designated-time net settlement have never been a serious concern for financial institutions. Since it was introduced in 1988, the BOJ-NET funds transfer system, the interbank online system for large-value funds transfers provided by the Bank of Japan, has offered both designated-time net settlement mode and RTGS mode. In practice, more than 99% of transactions over the BOJ-NET have been settled in the former mode. It would not be too great an exaggeration to say that until very recently settlement risk was not recognised as a real risk.

In the last three years, since autumn 1994, failures of financial institutions have become a reality in Japan, and have prompted banks to drastically change their perception of settlement risk. Also, the Barings incident has demonstrated the immense risk associated with securities settlement. When the Bank of Japan decided to make RTGS the only method of settlement in the BOJ-NET and asked commercial banks for comments in 1996, there was strong support for the proposals and I believe this was a sign that banks had come to really recognise settlement risk.

The Japanese “Big Bang”

In connection with the Japanese “Big Bang”, the motivation to improve payment and settlement systems has two aspects.

The first is the recognition among market participants that, with the growing competition among international financial markets, it is becoming more important to enhance the attractiveness of the Tokyo market and thus it is indispensable to improve payment and settlement systems, which are the basic infrastructure for the market. In other words, market participants are well aware of the risk of financial institutions and other “customers” leaving the market, causing a hollowing-out of their home market. The projects I mentioned at the beginning are based on such an

awareness, which is most evident in the efforts promoted by industry groups to improve the securities settlement systems.

The second is the opportunity to achieve cost reductions and enter new lines of business with the Japanese “Big Bang”. For instance, foreign exchange transactions have in principle had to be settled by authorised foreign exchange banks in Japan; however, from next April, when foreign exchange transactions are liberalised, any non-bank entity will be able to provide foreign-currency-related services. Companies active in exporting and importing goods and services have therefore started to introduce their own netting arrangements for foreign currencies in order to reduce settlement costs. Also, some convenience stores are reportedly planning to sell foreign banknotes and coins in their storefront. More generally, the participation of non-banks in electronic money and electronic commerce projects can also be seen as being closely related to the prospective deregulation.

As the essence of the “Big Bang” lies in deregulation and international compatibility, it will expand business opportunities for individual market participants and at the same time will require them to have corresponding risk management capabilities. It was thus to be expected that new developments would emerge in the field of payment and settlement systems in response to the implementation of the Japanese “Big Bang”, and we have, I believe, already seen the dawn of these new developments.

Future perspective

Basic criteria for the assessment of payment and settlement system reform: risk management and efficiency

In evaluating the quality of payment and settlement systems several aspects may be taken into consideration. The most basic and important aspects are, I think everyone would agree, risk management and efficiency. Improvements to payment and settlement systems should therefore achieve higher levels of risk management and/or efficiency. Let me illustrate the ongoing projects in Japan which I mentioned earlier in terms of key features of payment and settlement systems.

First, from the standpoint of risk management, there is still room for wider use of DVP settlement for various securities. For example, a DVP

mechanism for non-JGS bonds such as corporate bonds and bank debentures is expected to be established soon, by linking a newly created online book-entry system with the BOJ-NET funds transfer system. From a longer-term perspective, some form of DVP mechanism for money market instruments such as CDs and CP may also be introduced when an online book-entry system for these instruments is in place. Of course, the development of a book-entry system not only helps to improve efficiency, it enhances risk management capability as well.

The CLS initiative to reduce the risk associated with foreign exchange transactions basically aims more at better risk management than greater efficiency. In order to support the CLS mechanism initiative, we are now examining the possibility of extending the operating hours of the BOJ-NET, first by a few hours, but in the future possibly up to 24 hours.

Second, from the efficiency standpoint, there are projects that are putting more emphasis on greater efficiency in payment and settlement. Most of the projects that utilise advanced technology, including electronic money and electronic commerce, are more or less aiming at increasing efficiency, paying due attention of course to safety or risk management.

Role of the central bank

In any project to improve the functioning of payment and settlement systems, it is important to balance advanced risk management against greater efficiency, since these two factors may be incompatible in some cases. One of the main roles that the central bank is expected to play is to enable a balance to be struck. This can be put as a matter of accommodating the respective roles of the central bank and the private sector in the field of payment and settlement systems, or the sharing of roles between them. The question is, then, how to put it into practice.

While there may be various answers to this question, I should like to present some conclusions drawn from our experience. First, the Bank of Japan has promoted risk management in payment and settlement systems, which has so far proved successful. However, as mentioned earlier, it is indispensable for market participants themselves to have a proper, but not excessive, awareness of settlement risk in order to achieve the effective risk management. This seems to suggest the importance of having an appropriate competition policy in the financial sector and accepting the exit of financial institutions from the market.

Second, in order to improve risk management, it is important to foster initiatives by market participants. If only the central bank pays attention to the management of risk in payment and settlement systems without private initiatives, this could give rise to problems of moral hazard. Although there are some arguments concerning the Japanese "Big Bang", it has prompted a positive response at least in the area of payment and settlement systems.

Third, needless to say, it is private sector innovation that will be a locomotive for the improvement of payment and settlement systems. Positive efforts by the private sector are thus highly important in enhancing payment systems in the country.

To summarise, I think that, fundamentally, in the area of payment and settlement systems, the private sector should take the lead in improving efficiency, paying due attention to risk management, while the central bank should encourage those efforts, focusing chiefly on the risk management aspect. This view is consistent with our experience in recent years, with central banks cooperating, for example, to draw up the Lamfalussy standards.

The new Bank of Japan Law, which will come into effect next April, clearly states that the stability of payment and settlement systems is one of the Bank's objectives. Article 1 of the Law stipulates: "The objective of the Bank of Japan, as the central bank of Japan, is to issue banknotes and to carry out currency and monetary control". In addition, the Bank's objective is to ensure the smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system.

This Article simply puts in statutory form what the Bank has pursued so far, and will not change our actions in four months' time. Nevertheless, as a central bank staff member involved with payment and settlement systems, I think it is important that "to ensure the smooth settlement of funds among financial institutions" is specifically defined as a central bank objective. In conclusion, we are determined to make the utmost effort to constantly improve the operation of payment and settlement systems in Japan, in order to adhere to our objectives as stipulated in the new law.