

# **Payment system change and financial stability**

William White

During this conference we have looked at the process of managing change in payment systems. Much has been said about the difficulties that have arisen and the time that the process is taking. But I am pleased to say that it has become clear from the papers presented that an enormous amount has already been achieved. Indeed, one of the remarkable features of payment system change is that so many countries have been able to do a great deal in what is a relatively short space of time.

In these concluding remarks, I would like to put this impressive record of change into a wider context by showing how important it is to the task of achieving financial stability. Payment system change is not being carried out for its own sake. Payment systems play a crucial role in financial markets and thus the way they function can have an important bearing on how stable those markets are. This has always been true, and no doubt it always will be. But what I want to do in the next few minutes is suggest why achieving financial stability is becoming harder, and thus why adopting the right strategy to manage change is becoming more important. Or, in other words, to say something about why it is necessary that we continue to work so hard to improve our payment system infrastructures.

## **Why financial stability is important ....**

Let me start by briefly reviewing why financial stability is so important. Achieving stability in financial markets is part of the wider goal of achieving macroeconomic stability. What happens if financial stability is missing – what do you do if there is a financial crisis? Broadly speaking, you have two options. One is to provide financial support for the markets. But do this and you risk undermining macroeconomic policy: looser monetary policy can cause inflation and a greater risk of asset price bubbles. Moreover, the provision of safety nets can cause moral hazard problems that make future instability more likely. The other option is to

let the crisis run its course. But this is likely to lead to institutional failures, giving rise both to heavy costs for national treasuries and to a danger of systemic collapse with wider economic consequences. Neither option is attractive, so it is far better to try to prevent the financial instability emerging in the first place.

And the causality is not just from financial to monetary stability. It also works the other way round – that is to say, monetary instability can lead to financial fragility. This interdependence only makes the problem worse by creating the danger that financial instability may cause a spiral of increasingly severe problems.

#### **..... and why it is becoming harder to achieve**

This interdependence between financial and monetary stability has always existed and so financial stability has always been important. But achieving financial stability is arguably harder now than it ever has been: it requires more effort, and thus its importance has become more obvious.

The proximate causes of this are well understood. First, financial markets are becoming more international. Moreover, the fact that information, both substantiated and unsubstantiated, now flows almost costlessly and instantaneously around the world significantly increases the likelihood that shocks of whatever sort will be propagated elsewhere. Exaggerated market concerns about counterparty risk, or technical shortcomings in the payments infrastructure, could pose further threats to international financial stability if they lead to a sudden loss of liquidity in important markets or an inability to settle transactions. Achieving financial stability is thus increasingly less possible at the national level without international cooperation.

Second, the pace of change is increasing. The assessment of existing shortcomings in the system and possible solutions is made more difficult by the extraordinary pace of change in modern markets. Driven in part by dramatic advances in technology, the target at which policy-makers must aim is constantly moving. At the same time the volume of transactions, as well as their complexity and opacity, has increased sharply as the cost of carrying out transactions has been drastically reduced.

The world is therefore a busier, more complex and more interdependent place. Underlying these proximate causes are perhaps

two more fundamental causes. An obvious one is change in technology – both in processing power and in communications. But another fundamental cause is deregulation – the decision to put more emphasis on market mechanisms, whether in the move away from planned economies or in the liberalisation of existing market economies. In the financial sector (as elsewhere), there is less emphasis now on direct control and more on allowing the market to clear, to find its own equilibrium. This increased emphasis on market mechanisms is desirable because of the gains in economic efficiency it can bring. But we can also say that it is to some extent inevitable, since the changes in technology have been making regulations increasingly easy to avoid and thus direct control over markets increasingly hard to maintain.

#### **The need to make market infrastructures safe and efficient**

The result is markets that are more volatile – and where there is more chance that extreme movements in one market will spill over into others. From a regulator's point of view, this volatility can be unnerving. Bereft of our traditional instruments, regulating the market can be a little like travelling on a roller-coaster. How do we cope? I suggest we need to keep our heads and concentrate on ensuring that the infrastructure is sound. After all, travelling on a roller-coaster can even be enjoyable if you do not have to worry about the strength of the pillars supporting it. Perhaps the same will be true of the financial system. In the financial system there are three main pillars: the financial institutions, the markets they trade in and, of most interest to this conference, the mechanisms to settle the trades in those markets, including payment systems. Our task as regulators is to ensure that these three pillars are strong enough to cope with their growing, more onerous task. Perhaps then we can begin to enjoy the ride.

So strengthening payment systems is a key part of the task of achieving financial stability. Is this the only reason why payment systems are changing? During this conference, and indeed more generally when talking about payment system change, we sometimes make a distinction between change that is designed to achieve greater efficiency in the systems and change that is designed to make the systems more robust against risk. But seen in the light of the trend towards allowing markets to clear, efficiency and risk are actually not so distinct. Payment systems have to be both

efficient and risk-robust in order to play the strong supporting role required of them. They need to be efficient so that the costs of settlement (both financial costs and others) do not interfere with the effective clearing of markets. But equally they need to be robust against risk, both so that they are not themselves the cause of financial crises and so that they do not transmit and exacerbate crises started elsewhere.

### **What sort of strategy is needed to achieve financial stability?**

So how do we go about strengthening the payment systems infrastructure to make it more stable? Indeed, how do we tackle financial stability more generally? In the light of what I said earlier, I suggest we need a strategy that recognises that the pace of change is extraordinary, ongoing and irreversible. The strategy also needs to take into account the fact that transactions are becoming increasingly complex and interdependent and involve an ever-widening and changing range of participants. The reality is that the system which policy-makers aim to stabilise is both fuzzy and fast-moving.

This reality has three strategic implications. First, the strategy must be comprehensive across sectors to cope with interdependencies. Second, the strategy must be international. And third, the strategy must increasingly rely on market-led processes, albeit ones that complement, rather than replace, traditional regulatory activity.

Looking specifically at the implications for payment system change, such a strategy means, first, that we should not tackle payment systems in isolation. To be fully effective, the changes to payment systems must be part of a broader plan of reform that includes not just other settlement mechanisms but also the other two pillars of the financial system, namely financial institutions and financial markets.

Second, the strategy has to recognise that we can no longer safely see payment and settlement system reform as a purely domestic matter. You only have to look at Euroclear, Cedel, TARGET, S.W.I.F.T., ECHO, Multinet, the planned CLS Bank, VISA and MasterCard to see truly international systems that are growing in importance and whose smooth and efficient operation has implications for an ever-increasing number of countries. And even systems that seem still to be purely domestic – those we use to make payments in our own currencies – are in

reality increasingly interconnected. This is partly through overlapping memberships: many banks with extensive international operations are now direct participants in the payment systems of a number of different countries. But the interconnection also arises because an important source of traffic in many “domestic” systems is the settlement of the domestic element of cross-border transactions; and as we continue to reduce the risks that arise when settling these international trades, we will find that our actions inevitably have the effect of making settlement in different countries more inextricably interdependent.

The third main implication of the strategy for achieving financial stability concerns the form of regulation. Regulators are finding it difficult to keep up with a complex and rapidly changing financial system. Increasingly, therefore, they have felt it useful – perhaps necessary – to get the market itself involved in the regulatory process. So there is more emphasis now on consultation with the market to determine the appropriate form of regulatory activity. And there is also more emphasis on self-regulation and on market transparency to complement traditional regulatory activity.

When it comes to payment systems in particular, the regulatory situation varies from country to country. Some central banks do not operate payment systems themselves and also do not have explicit regulatory powers over private sector payment systems. In these circumstances, central banks have little choice but to work with the market. In other cases, the central bank owns and operates the payment systems, and so it may be tempted to impose a solution on the market. But as the presentations during this conference have shown, even where it is possible to impose a solution, it is rarely the most effective approach. Consultation with the market can be slow, difficult and sometimes frustrating, but experience suggests that it pays dividends.

Of course, the central bank will usually have certain overriding interests (such as avoiding systemic risk) that are likely to be a lower priority for the market itself. So the central bank will typically have to set the objectives of the reform. And ultimately the central bank may have to override the wishes of the market in some areas. But if the experience of the private sector is drawn on wherever possible, the objectives of reform are likely to be met more effectively. This is partly because the market can exert a positive influence on the design of the reforms. A good example of this approach put into action is the strategy adopted by G-10

central banks to tackle the issue of foreign exchange settlement risk: the market has been set the objective of developing appropriate multicurrency services, but how it reaches that objective is largely up to it to determine. And market involvement can do more than help to shape the form of the solution. *Implementation* of the reform is also likely to be much easier if it is on the basis of an agreed solution rather than one that is imposed.

### **The Basle approach**

The Basle approach that Andrew Crockett talked about in his introductory remarks yesterday is a good example of this comprehensive, international and market-aware strategy being used to increase financial stability. As Andrew explained, the Basle approach is based firmly on the principle of national control, recognising the reality that sovereignty in the modern world still resides at the level of the nation state. But by working together, central banks can not only increase their understanding of problems and their possible solutions but, where appropriate, also agree on a common approach that each can then implement nationally.

Of course, the approach has its shortcomings. Sometimes it does not work as fast as we would like; sometimes it takes a crisis before we are galvanised into action. But this is understandable, even if not entirely desirable. Before action can be taken, much work needs to be done to develop a common understanding of the problems and possible solutions. And it is clear from the presentations during this conference that it is often easier to persuade people to tackle problems once they have crystallised than when they are merely theoretical.

Another concern, and one that is becoming increasingly pertinent, is geographical representation. At the moment the Basle approach is primarily a G-10 process. This helps in the sense that the G-10 is a relatively small group of countries which by now have a long tradition of working together; the group has shared experience, concepts and values. But if the credibility of the decision-making process rests on the involvement of national experts from jurisdictions most affected by the decisions taken, then input from a wider range of countries will be increasingly important. The challenge will be to achieve this without destroying the club atmosphere that makes the Basle approach work.

### **Conclusion**

In conclusion, I hope that through this conference you have been able to learn something from the experience of others that will help you to manage your own process of change more effectively. If you have, then one of the objectives of the conference will certainly have been achieved.

But there is also another objective – and that relates to the challenge I just mentioned of geographical representation. This conference is a small but significant part of the BIS's programme of "global outreach". By this I mean our plan to involve an increasing number of countries in the work of the BIS so that the BIS becomes a truly global institution, drawing on the experience and knowledge of countries from all continents to spread the message about financial stability ever more widely. The CPSS has already been active in this area, both through the seminars it has organised for a number of regional central bank groupings and through the special meetings it has held here at the BIS with payment system policy-makers from a number of non-G-10 countries. As Andrew indicated in his opening remarks, we hope that from this conference we can discover further ways for the BIS and the CPSS to develop their relationship with central banks around the world. If we can, then that will be an important step forward towards achieving our other objective.

Thank you all for your participation here in this conference and, on behalf of the BIS and the CPSS, we look forward to working with you in the future.