BANK OF CANADA

What makes a good payments system?

Comments for a panel discussion by
John W. Crow
Governor of the Bank of Canada

at the
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Canadian Bankers' Association
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WHAT MAKES A GOOD PAYMENTS SYSTEM?

The topic for discussion on this panel -- What makes a good payments system? -- is important, both to the public in general and the central bank in particular. What I propose to do this morning is to contribute a perspective from a public policy point of view.

The particular interest of the Bank of Canada stems from the fact that the final settlement of payments takes place through transfers of balances among deposit accounts that financial institutions hold with the Bank. What this implies is that the Bank is the ultimate source of liquidity to the financial system, and hence that we have a responsibility as lender of last resort. Moreover, the Bank's ability to expand or contract the supply of settlement balances is our main lever for implementing monetary policy. I should also note that the Canadian Payments Association Act requires that an officer of the Bank be named as Chairman of the Association.

The payments system plays a central role in all modern economies by providing the means for settling transactions between buyers and sellers of goods, services and financial instruments. It is also an expanding role as the number and value of the flows through the payments systems in virtually all industrialized countries have grown much more rapidly in recent years than their economies. In Canada over two billion payment items were cleared in 1991 with a value of over 18 trillion dollars. That amounts to over 26 times the value of our gross domestic product.

Given the central role of payments, a good payments system has an important contribution to make to the overall performance of the Canadian economy and to the activities of individual users of payments services.

What makes a good payments system?

In many ways a good payments system is like a good plumbing system -- efficient, reliable, not overly expensive, and ignored as long as it is functioning smoothly. Users know that the system is important for their well-being even if they typically pay little attention to it. However, every now and then it may need modernizing.

Even if they may not think about the matter a great deal, what do individual users -- households, businesses, and governments -- look for in payments services? Undoubtedly, they are concerned with the speed and security with which payments are made. They also want to be able to confirm readily that their transactions have taken place and to obtain information on the associated changes in their deposit accounts. And if they have had any experience with a deposited cheque being returned to them, for whatever reason, and the transaction reversed, they are interested in obtaining finality of payment. Finally, of course, they are concerned about the cost to them of obtaining these payments services.

Let me now shift from the users' perspective to what constitutes a good payments system from the public policy point of view.

Public policy authorities obviously share the interest of users in the efficiency of the payments system. The contribution public policy can make to promote efficiency is to put in place a regulatory framework that encourages competition among providers of payments services so that high quality services are offered at the lowest possible cost. A good payments system, therefore, welcomes competition in the provision of payments services and permits access to sound potential providers of such services.

But open access for anyone to offer payments services without appropriate prudential standards would compromise the other main public policy concern, the integrity of the payments system. Since payments are at the heart of the day-to-day operation of a monetary economy, the spill-over effects can be serious if something goes wrong inside the payments system. Financial institutions that participate directly in the system will be immediately affected, and those effects can in turn spread to other sectors of the economy. Thus, the public policy criteria for a good payments system also involve risk management measures to protect the integrity of the system.

How does our present system measure up?

Canada currently has a very efficient paper-based payments system, probably the most efficient in the world. There is active competition in the provision of payments services and well-established rules of access for participants through the Canadian Payments Association. Nonetheless, in recent years, there has been increasing interest, on the part of both the private sector and the public authorities, in ways to improve the system in the areas where it falls short of some of the basic attributes listed above.

The present system does not provide finality of payment to users. This may not be unreasonable for small value items. But it can be a serious shortcoming when it comes to payments that are large enough to be crucial to the operations and even to the survival of a user of payments services. However, it is currently difficult, and indeed imprudent, for Canadian financial institutions to offer immediate, absolute finality of payment to users. The problem is the absence of arrangements that provide prompt and certain settlement for clearings of payment items among financial institutions. The lack of promptness reflects the processing lag in a paper-based system that delays the final clearing of payments items. The settlement risk in our current arrangements relates to the possible default of a participating financial institution that results in settlement not taking place and the clearings being unwound.

This possibility, that settlement will not take place and the clearings will be unwound, represents a potentially large and unpredictable risk to the institutions participating in the payments system and, therefore, to the integrity of the system itself. The commercial world is becoming too complex, particularly in its financial transactions, to contemplate unwinding as an appropriate means of dealing with serious problems that hit the payments system.

In response to these concerns, work has been under way to examine the feasibility of an electronic payments system for large value transactions. Systems of this sort are already in place in a number of other countries. In Canada the proposed system has been labelled a large value transfer system - LVTS for short.

An LVTS would permit financial institutions to provide finality of payment for a large majority of transactions in terms of total dollar value. The funds received by customers in these large value transactions would no longer be subject to reversal as a result of the failure either of the payor or of its financial institution. Financial institutions would benefit from the promptness and certainty of settlement for the bulk of their daily clearings. And system risk would be reduced since any potential unwinding of payments flows, should a financial institution fail, would essentially be limited to paper-based transactions.

Not surprisingly, interest in developing an LVTS has been stimulated by the failures in recent years of a number of financial institutions. These events focussed attention on the rules governing the operation of the payments system following a failure -- rules which have their origin in the early years of this century. More recently, interest in an LVTS has also been encouraged by the recognition that same-day finality of payment will reduce risk in the system for netting securities transactions being developed by the Canadian Depository for Securities.

Design standards for a large value transfer system

The appropriate design of an LVTS has been the subject of active debate over the past few years. From a public policy point of view, it is important that an LVTS meet the two criteria I spelled out above. First, the design should ensure competition in the provision of payment services by providing access on an equitable basis to financial institutions. At the same time, this access has to be conditional on meeting appropriate prudential standards. Second, the design should include provisions for effective containment and management of risk in order to protect the integrity of the payments system.

I will focus mainly on the need to protect the integrity of the system because this is an extremely important attribute of any properly-built system for clearing and settlement. A new LVTS should be designed to be a source of strength to the overall financial system in difficult circumstances, not a transmitter of weakness and failure. Obviously an LVTS must be able to function effectively in good times, but it is just as important to ensure that it does not break down in stormy weather. If something goes wrong, we do not want the problem to be aggravated or spread via the payments system.

I should also emphasize that it is not tenable for the integrity of any new payments system to be based on the presumption that there are institutions that cannot, for any reason, fail. Thus, an LVTS should be designed to be able to cope with even the unlikely shock of the failure of a major financial institution. Moreover, any presumption that some institutions are immune to failure would remove crucial market discipline from the payments system. This is the discipline that comes from participants having to make careful risk assessments of potential counterparties and judgements about the appropriate degree of exposure to them.

There are three basic components needed for effective arrangements to contain systemic risk in the proposals for an LVTS. The first is a ceiling on the net payments debit of each individual financial institution so that the risk it brings to the system is limited. The second is the existence of explicit, legally-binding rules for allocation of any losses in the event of the failure of a participating institution. When such loss allocation arrangements are based on the maximum exposures of individual institutions to other participants in the system, they provide a helpful added incentive to limit risk. The rules should also require pledging of collateral to provide assurance that the settlement of payments will take place at the end of the day even if a failure occurs. The third feature is some form of oversight to monitor participants and enforce these requirements.

Setting out the precise rules for risk management in an LVTS does of course involve complex trade-offs and raises difficult choices for both the participants and the public policy authorities.

One of the most difficult choices is the appropriate balance between the objectives of risk minimization and competition in deciding what kind of access there should be for financial institutions wanting to become participants in the LVTS. In any new system, the judgement as to what constitutes equitable access will be greatly influenced by the type of risk management arrangement that is chosen. The public policy interest will be to ensure that the access criteria are appropriate, transparent and applied objectively.

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Let me conclude by reiterating that the Bank of Canada strongly supports the initiatives to develop an LVTS. Such a development has the potential to strengthen the efficiency, soundness and stability of our payments system. But it will only provide those benefits if it is well designed. That is why it is so important to continue the dialogue now going on within the Canadian Payments Association and between members of the Association and the public policy authorities.

We currently lag behind a number of industrialized countries in resolving these issues. With increasingly globalized and interactive financial markets, an LVTS is important to the ability of our financial institutions to compete effectively with institutions from other countries. An LVTS is equally important to the users of payments services and to the competitiveness of our economy more generally. We need to get on with it.