2.3 The role of the Eurosystem with regard to the Payment and Securities Settlement Systems*

Summary

Most central bank activities can be considered under the heading of either monetary stability or financial stability. Central banks are typically the monetary authority and usually take part in financial stability issues. They are also in various ways, involved in payment systems matters, as one of the basic tasks of the ESCB is to promote the smooth operation of payment systems (art. 105 of the Treaty establishing the European Community and, art.3 of the Statute).

In general, central banks play a threefold role with respect to payment and settlement systems: they are users, they may be settlement agents and they may ensure their oversight. Since the Treaty of Maastricht, the framework for the oversight has become more formal within the SEBC, whose objectives mainly consist in systemic stability, efficiency, and security of payment systems.

Central banks are also important users of securities settlement systems. In addition, these systems are indispensable parts of the infrastructure of modern financial sectors and as such should be subject to a specific oversight, in which central banks have to be involved. All the more that the very fragmented European market, central banks need to monitor closely the consolidation process, which has started with the launch of the single currency.

2.3.1 A new multinational environment

This study focuses on the changes of the landscape in both areas after the launch of the monetary union and the ESCB back in January 1999, when participating national central banks were confronted with a unique institutional set-up. Since that day, a group of central banks are collectively in charge of the tasks and the missions, which each central bank had previously to fulfil on its own.

At the same time, market arrangements around the central banks, which hitherto were predominantly nationally oriented, had to be rearranged to cope with a new multi-national environment char-acterised by one single currency.

The term Eurosystem refers to the European Central Bank and the national central banks of the countries participating in monetary union.

2.3.2 The different roles of central banks with respect to the payment systems and securities settlement systems

In general, central banks play a threefold role with respect to payment and securities settlement systems. They are users, they may be settlement agents and they may ensure their oversight.

2.3.3. Central banks and payment systems

2.3.3.1 Central banks as users and operators of payment systems

Central banks have been involved in payment systems since their origin. In recent years, price stability and monetary policy as the major objectives of central banks have somewhat hidden other tasks. These tasks, among which the running of efficient payment systems, are nevertheless indispensable to the infrastructure of the financial sector and have by the way contributed to the creation of central banks during the last centuries.

Central banks were indeed created because of the needs for banks to have their inter-bank claims settled in an environment of reduced reserve ratios and because of the need of the public to ensure the timely conversion of deposits into currency. Banks were thus protected against solvency risk, while the need for liquidity required for the smooth flow of payments was minimised and the public could remain confident as regards the convertibility of their deposits. To be slightly provocative, one could say that central banks were created first of all to make payment systems efficient and robust.

* *Speech delivered by Pierre Beck, Head of the Payment systems department at the European Finance Convention in Paris on 20-24 November, 2000.*

The Target system (see Annex 1)

At the preparation for monetary union, it was clear from the outset – because of the single monetary policy – that the Eurosystem would need a secure and efficient payment system allowing for the execution of payments in euro with same day value inside the monetary union. In the absence of certainty concerning the exact participation, central banks decided to interlink existing national systems to a common decentralised system, Target. Target has meanwhile won its "lettres de noblesse".

The TARGET system (see Annex 2)

During the nine first months of 2000, it channelled per day 185 thousands payments for a total value of € 1 015 bn of which, 39 thousand were cross-border payments with a total value of € 431 bn.

2.3.3.2 Central banks and the oversight of payment systems

Because of their operational involvement in payment systems, it is not surprising that central banks of the industrial world have been entrusted also with their oversight. Prior to the adoption of the Maastricht Treaty, the framework for this oversight was in the different countries, although informal, rather effective. It has indeed been based on the technical experience and the moral authority of the central bank. One should recall in this context that their involvement includes crisis management in the case of a failure of the system, or of one or more participants, and thus touches upon their role as lender of last resort.

Supervision versus Oversight

Prudential supervision and payment system oversight have the shared objective of the stability of the financial system as a whole, they do not have the same focus. While the supervisor has to control the single financial institution to ensure its safety and soundness, the overseer focuses on the clearing and payment systems themselves. Overseers have to assess the various legal, contractual, technical and operational aspects of complex IT systems. Contrary to the supervisor, they need to closely monitor the activity of the system and their experience in this matter gives central banks a competitive advantage in this respect.

Given the traditional involvement of central banks in the field of payment systems, it is not surprising that the competence over payment systems has been enshrined in the Treaty establishing the European Community and in the statute of the ESCB and the ECB as one of their objectives. Art. 105 (2) and Art. 3 of the Statute state that "*The basic tasks to be carried out through the ESCB shall be […] to promote the smooth operation of payment systems*". In addition, article 22 of the Statute provides the Eurosystem with the right to have an operational role and the ECB with the right to issue regulations in the field of payment systems. The national legislations have been adjusted accordingly.

The Eurosystem has recently adopted a document called "The Role of the Eurosystem in the field of payment systems oversight", which is available on the ECB Web site.

The objectives of the oversight as enumerated by this document are first the maintenance of the systemic stability in payment systems and their efficiency, which is complementary to the systemic stability. Central banks are furthermore concerned with the security of the payment instruments used by the public, because it determines the confidence of the users in payment systems and in general the confidence of the public in the currency.

Last but not least, payment systems are the vehicle for the implementation of monetary policy operations and thus their oversight is aimed at safeguarding the transmission channel of the monetary policy.

The document further details the oversight activities in distinguishing between the formulation of a common policy stance, its enforcement and the management of emergency situations.

Whereas the first element is within the competence of the Governing Council of the ECB, the enforcement and the management of emergency situations are organised in line with the principle of subsidiarity in the country in which the concerned system is incorporated. In cases the national anchorage is not obvious, the Governing Council may decide to entrust the ECB with the oversight function. This is the case, for instance, for the European Banking Association (EBA) clearing or the future (CLS).

In its oversight activity, the Eurosystem primarily focuses on large value payment systems, because of the systemic risk that is involved, but it addresses also other issues like retail payments or electronic money.

In 1999 and in 2000 the ECB released reports covering different issues in the area of retail payments. At present the main concern of the Eurosystem in this area is the threat of the ineffective cross-border payment arrangements for the acceptance of the euro after January 2002.

In the September 99 report "Improving cross-border retail payment services in the euro area – the Eurosystem's view", the Eurosystem has listed 7 objectives for the banking sector to improve the efficiencies of the actual cross-border payment arrangements.

Another domain, which has been recently visited by the Eurosystem, is the electronic money. In August 98, the ECB set up a couple of requirements electronic money schemes should comply with to foster the confidence of the consumers in this new payment means and to avoid any resulting systemic risks for the financial sector.

2.3.4 Central banks and securities settlement systems

2.3.4.1 Central banks as users of securities settlement systems

Central banks are first of all users and important users of securities settlement systems (SSSs). Because the Treaty of Maastricht in the article 18 of the third protocol (on statute of the ESCB and the ECB) states that: "In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may (...) conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral."

The Eurosystem decided to require a full collateralisation of any credit granted to the participants in payment systems.

Furthermore, when preparing monetary union, it set up a list of eligible securities and made an assessment of each of the depository used in this context.

The assessment of the SSSs was based on standards, which have been made public in the report "Standards for the use of EU Securities Settlement Systems in ESCB credit operations," ECB June 1998.

The aim has been to protect the collateral provided to central banks against the custody risk, ensure the irrevocability of securities delivered to the central banks, and ensure the secure cross-border use of securities.

The Eurosystem indeed had not only to make sure that collateral was safe when presented in a national framework, it had also to make sure that it could be used in a cross-border manner, to avoid any unlevelled playing field among the counterparties.

There are at present two ways of cross-border use of collateral that are eligible and in use: The correspondent central banking model (CCBM) and the link model.

Other ways are possible, like the remote access of central banks to Central Securities Depositaries (CSDs) abroad. But it was felt that this would not comply with the policy stance, which requires central bank to remain neutral in market developments and to promote a level playing field. The market has evolved and the question of remote access has reappeared in the case of Ireland, which decided recently to abandon its NCSD and to transfer the eligible collateral to EoC.

A second way would be to use the so-called relayed links, which add a link in the existing chain between "issuer-SSS" and "investor-SSS". But because of this additional link, relayed links do not comply with standard 3 of the ECB and can therefore not be assessed by the Eurosystem.

The CCBM

The correspondant central banking model (CCBM) has been implemented by the central banks to offer to the banking sector a way to mobilise any eligible security, wherever it may have been issued, for the purpose of collateral in ESCB credit operations.

The correspondent central bank holds collateral a counterparty has provided in safe custody at its NCSD on behalf of the other central bank, the socalled home central bank, which grants credit to the counterparty. The procedure is cumbersome and slow because, largely based on manual intervention, but reliable and therefore apparently quite popular in the banking sector. From the perspective of the central banks, it has been seen as a transitory solution and should be complemented and later on replaced by a solution coming from the market. The first initiative in this sense was the so-called "Link-model" from the European Central Securities Depositaries Association (ECSDA).

The ECSDA model

The idea behind the ECSDA model was to interlink all the SSSs, so to create a "TARGET of SSSs". The goal seems difficult to reach.

The Eurosystem used the same framework for the assessment of each of the links as for the assessment of the systems themselves. That is why not all available links are eligible. The list of the eligible links is published on the ECB web site.

The use of the links is not the one its promoters expected. Some of them are hardly used; others do not allow the transfer of all the eligible collateral. Price and operational issues seem to be further hurdles for a more general use of this model.

Cross-border holdings of collateral (see Annex 3)

The overall holdings of collateral are about € 670 bn. The figures clearly show that most of the non-domestic collateral is held via the CCBM (82%) and less than a fifth (18%) have been transferred through links.

2.3.4.2 The legal basis

The role of the Eurosystem as overseer of securities settlement systems is however not clear. The Treaty of Maastricht does not mention SSSs and in some countries other public authorities are involved in the oversight of SSSs.

2.3.4.3 The main risks in securities settlements systems

Risks that are at stake in the SSSs are the traditional financial and operational risks: credit, liquidity, settlement and custody risks are the most important. The Delivery versus Payment (DVP) procedure, which was one of the Group of Thirty's recommendation in March 89 and, which is nowadays used in any state of the art system, has eliminated the credit risk in the settlement process. DVP compliant systems indeed check the availability of both the payment and the securities before the settlement of each transaction is performed.

It has also been recognised that through the effect of the netting, cash positions are relatively modest compared to the value that is exchanged.

Liquidity and replacement costs risks remain in case a settlement fails. The impact of the missing liquidity, however modest, may be important and impact on other systems.

Credit risks, also called cash-deposit risk, is at stake when the SSS settles in commercial bank money, that is to say if the SSS uses a private settlement agent or, as in the case of Clearstream, it settles in its own books and has recourse to cash correspondents. Credit exposures do exist vis-à-vis the settlement agent and vis-à-vis the cash correspondents used for transferring liquidity to or from the settlement agent.

Another typical risk for SSSs that are at the same time custodians is the custody risk, which is of particular importance in case sub-custodians are used or when securities are mobilised through links between different systems. The assessment of these risks is even more complex when the different links of a custody chain are established under different jurisdictions.

As any financial system and because there are at their heart complex IT systems, SSSs are of course subject to the operational risks.

Finally, as SSSs are interlinked with other systems, clearing systems, payments systems and so forth, any major failure of the system or of one or several of its weighty participants may materialise into systemic risk.

2.3.4.4 Interests of central banks in securities settlement systems

Beyond the interests as users of SSSs, the European central banks are of the opinion that SSSs are important elements of a modern financial sector and, as such, they should be subject to a specific oversight. First to protect payment systems for which central banks have a clear competence of oversight, second, a failure of a SSS would most likely heavily impact the general liquidity situation and thus the monetary policy operations. And finally, central banks are together with other authorities in charge of the stability of the financial market at large. The oversight of such systems needs to take also into account the increasing cross-border activity of the major European SSSs.

2.3.5 The consolidation of the securities settlement systems' industry

2.3.5.1 Hub and spokes model

With the introduction of the single currency, the market started a consolidation process in a very fragmented market. This process constitutes a challenge for central banks too; insofar it is likely to impact on the different roles central banks are playing with regard to the securities settlement industry.

During the last three decades, the so-called hub and spokes model was the preferred way that the market had chosen to execute cross-border deals. The ICSDs were the only practical way for financial institutions to participate directly in different national markets.

2.3.5.2 The recent mergers

Amazingly, the two mergers that have taken place until now, were the merger of two major national Central Securities Depositaries (CSDs) and the two ICSD. These mergers place the European financial sector, and in particular the European central banks, before a totally new situation.

A certain number of issues result indeed from these consolidations. An important issue refers to the legal situations of the new entities and the legal regime under which they operate, given their multi-national environment. Another particular problem is the way SSS settle their transactions. Until now all the major national systems settled in central bank money. Only the two ICSDs have used so far commercial bank money. The pros and cons of central bank money are summarised on the following slide.

2.3.5.3 The issue of the settlement asset

Central banks also act as settlement agents. Some of the major European securities settlement systems use indeed central bank money for settlement against securities transactions. In other words, the cash-leg of securities transactions is posted in accounts that are included in the balance sheet of a central bank. This practice is surely risk averse and fully compatible with the standards such as defined by the Eurosystem with respect to ESCB credit operations. It is nevertheless not an obligation to any extend for commercial transactions and as such even the G10/IOSCO recommendations refrain from imposing central bank money as the sole cash asset for securities transactions.

Central bank money as settlement asset clearly is the optimal choice. It eliminates the credit risk and reduces liquidity risks by conferring finality to any transaction that is settled with it.

The aforementioned consolidation process highlights however the issue, of access to central bank money. In the previous, fragmented world, each customer, who had access to the national SSS, had also access to his central bank. In a multi-national environment, like the ICSDs, not all customers have access to the central bank issuing the currency used for the settlement of the transaction. The construction of the European monetary union adds a further hurdle: because of the decentralised organisation of the eurosystem, a truly pan-European SSS would need a connection to all the national central banks to settle in euros. An alternative could be that the SSS would use one or several access to TARGET to allow the 5 000 participants of TARGET to settle their transaction via their settlement accounts.

Because of the various risks taken by SSSs and because of their impact on the financial system at large, central banks feel compelled to adopt a larger view. They need to protect payment systems, to prevent any liquidity shortage so to ensure the stability of the financial market, which is one of the missions of the Eurosystem.

2.3.6 Conclusion

The consolidation of the industry is an issue of particular importance for the Eurosystem. It is a natural consequence of the monetary union that such a consolidation process has started and it should foster the single market. Central banks have to monitor closely the developments, but they are not the only public authorities involved. The creation in 1998 of the European Central Bank and the ESCB provided Europe with a body able to formulate and implement a co-ordinated policy in the field of its competence. For other national authorities the situation is less clear. They draw their competence exclusively from national legislation, which albeit being subject to a certain harmonisation process, have not the same degree of homogeneity than the Eurosystem. The recent wise men initiative, chaired by Alexandre Lamfalussy, clearly indicates the weaknesses of the present arrangements and the need for enhancing the co-operation between the regulators.

The market will require a vast co-ordination of all the public authorities including the central banks to support the future developments.