

Bank of England Settlement Accounts

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BANK OF ENGLAND SETTLEMENT ACCOUNTS:
A POLICY DOCUMENT

1. In its paper, *Oversight of Payment Systems*, published in November 2000, the Bank said that it would set out its policy on the provision of settlement accounts for payment system members. This document meets that commitment.

2. The first section (paragraphs 3 to 6) looks broadly at the role and purpose of settlement accounts, whether provided by central banks or other institutions. The next section (paragraphs 7 to 10) gives some background on the current position in the UK. The third section (paragraphs 11 to 15) reviews the considerations which the Bank believes are relevant in deciding whether it should grant settlement accounts. The final section (paragraphs 16 to 29) sets out the Bank's policy on the granting of settlement accounts.

What is a settlement account?

3. In *Oversight of Payment Systems*, a payment system is defined as an arrangement which allows the transfer of funds between its members. It involves: agreed technical standards for payment messages and their transmission (including agreement on the infrastructure to be used, typically networks and switches for routing messages); a set of common operating procedures and rules; and an agreed means of providing settlement of the claims which arise among system members. This settlement typically involves the transfer of a particular asset, "the settlement asset", which is in turn the liability of an institution, the "settlement agent", represented by a balance on an account ("settlement account") held with that agent.

4. Settlement accounts therefore exist in the context of payment system membership. The same account may, however, be used as a settlement account when a firm is a member of several payment systems, and may also be used for non-settlement purposes.

5. Settlement accounts may have infrequent entries – perhaps only one payment or receipt per day in a multilateral net settlement system – or could involve large numbers of entries each day. Again, accounts may operate without credit facilities – that is, they have to

be pre-funded – or they may offer access to intra-day credit. The settlement agent may in turn insist that such credit is collateralised. The use of, and the terms which apply to, settlement accounts can therefore vary.

6. Settlement accounts can in principle be provided, subject to agreement among a payment system's members, by any deposit-taking institution (or indeed, in principle, by any institution whose obligations are acceptable to system members). In practice, payment systems will normally seek to use a highly creditworthy, reliable and, where possible, independent settlement agent. Central banks fit these criteria and so often take on the role of settlement agent for the main payment systems in a country. In these cases, the settlement asset is central bank money.

General considerations

7. The criteria for central bank provision of settlement accounts have been the focus of increasing attention, partly because of the impact which rapidly developing technology has had on the range of possible payment system structures and on competition.

8. In the UK, some payment systems require, as a condition of membership, that their members have a settlement account at the Bank of England.¹ The Bank is therefore keen to ensure that its policy on access to settlement accounts is both fair and transparent, insofar as denying a settlement account to a firm would disqualify that firm from direct membership of these systems.

9. The use of new technology and of public rather than bespoke messaging networks have made it economic for institutions with lower volumes than previously to become direct members of payment systems. While payment systems will normally retain rules governing the technical competence of would-be members, and rules to ensure that any financial or operational risks they bring to the system and its other participants are managed effectively, they are now less likely to include volume criteria for membership. Nevertheless the economics of the industry still make it likely that firms with low payment volumes will not find it attractive to seek direct membership.

10. Widening direct participation promises to increase competition among providers of payment services. These providers are nevertheless predominantly banks and building societies (i.e. deposit-takers) – which is unsurprising given that what payment systems typically transfer is a deposit and this is, by definition, the liability of such deposit-taking institutions. But there has also been an increase in non-bank membership of certain payment systems. Such institutions are able to use their own deposits with a bank to make payment to a counterparty on behalf of their customers. For example LINK – which enables the holder of a payment card issued by one member to use the automated teller machines (ATMs) of another member – now includes non-bank ATM operators among its members. These ATM operators provide customers with cash (on credit) and claim the funds from the issuer of the customer’s card (which might be a credit, debit, charge or cash card). Such non-bank institutions often wish to have a way of settling directly with other members of the payment system.

Considerations in providing settlement accounts

11. The Bank considers that there are five main arguments for a central bank to act as settlement agent for a payment system. These are:

- **Risk reduction** – central bank liabilities are generally regarded as being free of credit risk. Using central bank money to effect settlement eliminates counterparty risk among the participants in a payment system once settlement has taken place. This can be an effective tool to reduce systemic risk.
- **Service assurance** – central banks typically continue in existence even in circumstances of severe financial stress. So the risk of interruption to the settlement service from a financial failure of the settlement agent is avoided. (Central banks do, however, face similar operational risks to private sector agents.)
- **Competitive neutrality** – using the central bank as a settlement agent ensures that payment system participants are not forced to rely on an actual or potential competitor for settlement, to whom they might then be exposing details of their payment system flows.
- **Efficiency** – once a settlement agent, such as a central bank, settles for one payment system, the cost of providing settlement facilities to other systems is likely to be small. Perhaps more importantly, using the same settlement agent for a variety of payment systems may allow settlement account holders to manage their liquidity more efficiently.
- **Liquidity provision** – the settlement agent's ability to inject liquidity into the system can be an important determinant of settlement efficiency. Unlike commercial banks,

¹ Such as CHAPS (rule 1.4.1).

central banks are not constrained in their ability to expand their balance sheets as required in high value payment systems.

12. There are also, however, a number of counter-arguments:

- **Competitive distortion** – by providing settlement accounts to private sector institutions, central banks risk disintermediating potential commercial providers of these accounts and associated services to third parties. A central bank should provide such accounts only if there is a public policy reason for doing so.
- **Direct risk** – notwithstanding the terms on which settlement accounts are offered, central banks may in practice find it impossible to avoid some credit risk against the account holder. They would typically not wish to put public money at risk unless there was a clear public benefit in doing so.
- **Moral hazard** – the provision of a settlement account could increase the perception that a central bank would be willing to provide emergency liquidity assistance to the account holder. Central banks would generally wish to discourage any such perception.

13. In deciding when to act as settlement agent for a payment system the Bank needs to balance these various considerations in the context of the Bank’s three Core Purposes which are to maintain monetary stability, to maintain the stability of the financial system, and to maintain the effectiveness of financial services in the UK.

14. The Bank believes that the essential consideration in deciding whether or not to act as settlement agent is the nature of the payment system itself. In the paper *Oversight of Payment Systems*, the Bank categorised payment systems according to the impact they could have on the stability of the financial system as a whole. It distinguished those which are systemically important, those which are of system-wide importance, and other systems, although the boundary between these categories is not always clear cut².

- **Systemically important** payment systems are those systems which, if disrupted for example by the failure of a member or of the system itself, could cause serious and widespread disruption within the financial system, with consequent costs to the economy as a whole. Typically the values transferred in such a system are large in relation to the balance sheets and capital resources of at least some of the members. In practice this usually means systems used to settle wholesale financial transactions in the money, foreign exchange and securities markets. Examples of such systems include CHAPS (sterling and euro), the embedded payment system in CREST and CLS.

² For a fuller discussion of systemically important payment systems see “*Core Principles for Systemically Important Payment Systems*” (BIS, 2001) and of the other categories see “*Oversight of Payment Systems*”.

- The second category, payment systems of **system-wide importance**, recognises that there are other payment systems which are of importance for the economy as a whole but which are unlikely to generate or transmit financial instability of the type described above. Such systems, however, are widely-used and have poor short-term substitutes. If they were disrupted, they would be likely to cause considerable disturbance and inconvenience in the economy generally. Current examples include BACS – which provides the direct credit and direct debit payment services – and the Cheque & Credit Clearings.
- The third category of **other** payment systems includes everything else. These systems, even if they suffered disruption, would cause inconvenience but would be unlikely to trigger serious disturbances elsewhere, perhaps because of the availability of close substitutes or because the values involved are small. Examples might include store cards or low circulation credit cards.

15. As well as considering whether to act as a settlement agent for a particular payment system, there may in some cases also be a question of whether the Bank should provide settlement accounts to all members of a system, and if so on what terms. In some systems, the question of differentiating in this way between different system members does not arise. It is a condition of system membership that members have a settlement account at the Bank. This is the case, for example, in the CHAPS system where individual transactions are booked in real time to the accounts of the members. In other cases, for example systems which settle on a multilateral net basis, it is not necessary for every member of the payment system to have its own settlement account. Settlement could involve only one payment per day and an arrangement where one member makes the payment to settle the obligations of another member may well be efficient. Whatever the arrangements for settlement, the Bank – in its capacity as overseer of payment systems – will review the rules of the system to ensure that the financial risks are managed effectively.

The Bank's policy

Payment systems

16. For **systemically important** sterling payment systems, settlement in central bank money eliminates the inter-bank credit exposures which would arise if settlement occurred in commercial bank money. The risks in these systems typically have a low probability of crystallising but a potentially very large impact if they do. The Bank, therefore, acts as settlement agent for systemically important sterling payment systems.

17. Where a systemically important system settles payments in a number of foreign currencies a single central bank would normally be unable to provide an all-purpose settlement account. In such circumstances, and subject to a judgement that the private sector settlement agent was robust and creditworthy, the Bank would nevertheless be prepared in principle to provide settlement services in support of the system – as it is doing for CLS Bank.

18. With regard to payment systems of **system-wide importance**, the Bank already acts as settlement agent to BACS and the Cheque and Credit Clearings and will continue to do so. The Bank would, in addition, consider proposals from operators of other such systems who wished to avoid inter-member credit risks, or who wished to make a case on the basis of service assurance, competitive neutrality or efficiency considerations. But the Bank would not actively seek to settle for such systems, because the potential credit exposures between participants are not large enough to pose a risk to financial stability or to make it necessary to use central bank money as a way to ameliorate it.

19. With regard to **other** systems, the Bank would not normally expect to act as settlement agent. In some circumstances, however, the Bank would be prepared to consider the case for doing so – for example on grounds of competitive neutrality or the efficiency of liquidity management – if the Bank, in consultation where appropriate with the OFT, concluded that provision of the service did not materially distort competition. The Bank currently provides settlement services for the LINK ATM switch network and will continue to do so.

20. Where the Bank agrees to act as settlement agent for a payment system, the Bank would in all cases expect the system to demonstrate that it has reasonable procedures for ensuring the continuing operational competence of its members, as well as a high degree of system security and operational reliability, including contingency arrangements for timely completion of daily processing.

Payment system members

21. Where a payment system qualifies under the criteria set out in paragraphs 16-20, and the Bank has decided to act as settlement agent, it will normally be prepared to open

settlement accounts for all members of that system. Members will not be obliged to open a settlement account with the Bank unless the rules of the payment system require it. The terms and facilities associated with the settlement account at the Bank will vary according to the nature of the member, as described below.

22. Except as discussed in paragraphs 23-24 below, settlement accounts do not provide access to credit; and participants in a payment system who have been provided with such accounts will be required to pre-fund their accounts before settlement can be effected. If the account is not funded, payment will not normally be made. The rules of the payment system will need to make clear what happens in such cases³.

23. The operation of some payment systems, however, typically those settling on a real time gross basis, requires members to make payments continuously throughout the day. The cumulative net debits at certain times in the day may exceed the pre-funding which members provide (or which it would be reasonable to expect them to provide) on a standard settlement account. To support the efficient functioning of these systems, the Bank – in addition to providing settlement accounts – will be prepared to provide intra-day liquidity to certain regulated financial institutions⁴. This liquidity will typically be provided through the sale and repurchase (repo) of high quality assets. The Bank publishes and maintains a list of acceptable assets.

24. All European Economic Area (EEA) credit institutions will be eligible to maintain, if they so wish and in the context of qualifying payment systems, settlement accounts with access to these liquidity arrangements at the Bank⁵. The amount of liquidity provided will normally be limited only by the availability of acceptable collateral, although the Bank reserves the right to limit credit to reflect other factors, for example the overall financial resources of the borrowing institution or the needs of the relevant payment system. The Bank is prepared to consider granting liquidity facilities as described above to credit

³ In its capacity as overseer of payment systems the Bank expects payment systems to have adequate procedures to deal with the credit and liquidity consequences of the failure of a participant to settle. In the case of a systemically important payment system the Bank would expect the system to comply with the G10 Core Principles for such systems – as discussed in *Oversight of Payment Systems*.

⁴ The policy on intra-day liquidity in payment systems does not affect other overnight or longer-term facilities available to monetary policy counterparties.

⁵ EEA credit institutions are subject to the regulatory requirements of EU banking directives. The provision of intra-day liquidity in euro is subject to ECB rules: for example, intra-day liquidity to remote participants is not currently allowed.

institutions outside the EEA, either via branches or via remote access, but this would require a careful analysis of any legal risks arising from the fact that the prospective member was based in a foreign jurisdiction. The Bank is also ready to consider granting liquidity facilities to other regulated financial institutions⁶ where the scale of their own payment activities would make them significant direct participants in a systemically important payment system and when doing so would reduce risk for the financial system. Some investment firms, for example, manage the settlement of large volumes and values of securities transactions in CREST, including for their customers, and hold and disburse substantial client monies for settlement purposes.

25. The Bank wishes to emphasise, however, that the provision of a settlement account, within the framework set out above, is at the Bank's discretion in the context of a bank-customer relationship. Moreover, the provision of such an account carries no implication that the Bank would be prepared to extend emergency financial assistance to the institution concerned.

Costs and charges

26. The Bank proposes to set charges for the provision and operation of settlement accounts so as fully to recover its costs. Those costs will include operational costs, an appropriate share of overheads including costs of capital, and any other direct costs (such as legal agreements or a fair share of the installation of dedicated new equipment) associated with the establishment of new facilities, as well as reflecting any residual risk which might fall on the Bank.

27. The Bank has a narrow range of customers and for the most part handles lower volumes of transactions (albeit with high average values) than many payment banks. Its operational costs reflect this lack of material economies of scale. In consequence, its charges to operate settlement accounts are likely to be higher than those that commercial banks would charge.

⁶ In this context "regulated financial institutions" refers to firms authorised by the Financial Services Authority to undertake regulated activities. A foreign institution is considered appropriately regulated if it is regulated by an equivalent foreign regulator or if it is eligible to operate in the UK under the passporting arrangements of the EU Banking Consolidation Directive (2000/12/EC).

28. In real time gross settlement systems, such as CHAPS, central banks operate all or part of the system. Each payment gives rise to an individual debit and credit across the respective settlement accounts. The Bank's charges in this case reflect its significant investment in IT and other systems designed to ensure high levels of availability; the capacity to deal with peak volumes; robust contingency, security and liquidity arrangements; and payment traffic management. These costs are recovered principally as a per item charge and the Bank sets annual tariffs to achieve cost recovery, taking one year with another.

29. Direct membership of CHAPS involves significant investments in IT and significant third party network charges, as well as the costs associated with holding sufficient high quality assets to generate the liquidity required to meet payment obligations. The judgement whether to apply to become a direct CHAPS participant, with a settlement account at the Bank, is one which each potential direct participant would need to make on the basis of its individual circumstances. In practice, direct participants are likely to have a significant volume of payments.