BANK OF ENGLAND

Speech

Keynote address at S.W.I.F.T.U.K Regional Conference

Speech given by

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Ladies and gentlemen, it is a great pleasure to be here today.

Since its formation in the early 1970s S.W.I.F.T. has become a key part of the financial services infrastructure. It has moved well beyond its original business – carrying electronic messages relating to interbank payments – and its services now underpin a whole range of systems, including CGO, CREST, CHAPS Euro, and TARGET, which are at the core of the UK, and indeed global, financial system. So I thought it would be appropriate to talk today about why the Bank maintains a keen interest in issues relating to payment and settlement systems; and what looking forward we see as some of the key challenges in this area. So I will say a bit about work the G10 is doing to update and extend the Lamfalussy principles; something about foreign exchange settlement and Delivery-versus-Payment in securities settlement; and finally, and inevitably, a bit about Year 2000 issues.

First, the rationale for the Bank's involvement in payment and settlement system issues. Ever since it acquired monetary policy independence in May 1997 the Bank, and especially the Monetary Policy Committee, has scarcely been out of the news. But the pursuit of monetary stability is actually just one of our three overall objectives, or "core purposes" as we term them. We are also responsible for promoting financial stability – our second core purpose – and aim also to promote the efficiency and effectiveness of UK based financial services. Indeed it is in large part because of these latter two functions, and particularly our financial stability role, that we take a very close interest in payment and settlement system issues. So I would like to begin by outlining the Bank's financial stability role and how it relates to payment and settlement system issues.

The Bank's financial stability role is not a new one. But it has been brought into sharper focus by the changes to the Bank's responsibilities announced in May 1997. The 1997 Memorandum of Understanding between the Bank, the Treasury, and the FSA, states that the Bank is responsible for the overall stability of the financial system as a whole. That is distinct from the role of the new FSA – to which the Bank's former responsibility for banking supervision has passed – which is responsible for the supervision of individual financial institutions.

What does this financial stability role mean in practice? Broadly speaking, promoting systemic stability means working to ensure that the financial system functions smoothly in carrying out its three key functions. Those are, first, to provide a secure means of transferring value and settling financial transactions; second, to provide liquid markets for the exchange of financial instruments; and third to intermediate between savers and borrowers. In its financial stability work the Bank looks both at the underlying robustness of the financial system, and at potential triggers which – at times of stress – could precipitate a crisis.

Given this, a key part of our work has to be to look very closely at the position of the core infrastructure of the financial system. This includes the clearing and settlement systems for transactions in all types of securities, commodities and derivatives. But it is payment systems issues which are probably the most central to our interests in this area. And indeed the Bank's role in relation to payment systems is explicitly singled out in the MOU.

Payment systems have traditionally stood at the heart of Central Banking concerns. Almost all Central Banks either run their country's key payment systems, or exercise some form of oversight over them. There are a number of strong reasons for that. First, Central Banks actually evolved from being bankers to the banking system, and the liabilities of the Central Bank, whether bank notes or transfers across the commercial banks' accounts at the Central Bank, remain the means of final settlement in almost all currencies. Second, and related to that, it is through being the marginal provider of liquidity to the banking system that monetary policy operations work. Finally, and more broadly, in a market economy almost all economic transactions involve, ultimately, the use of a payment system to transfer value. So, the failure of a major high value payment system such as CHAPS in the UK – where daily values exceed £160 billion – would disrupt monetary policy, as well as the financial system, and involve real economic costs. That is why the Bank is so closely involved in these issues.

What are our policy objectives specifically in relation to payment systems? First and foremost we are concerned to prevent the payment system being a channel through which problems in one part of the market, or in one particular institution, spill over into a more general systemic problem. For example, if banks give credit to their customers for incoming payments before they have received final funds from the sending bank, then if the sending bank fails, the receiving bank is in turn left high and dry. So we are keen to promote the recognition, measurement, and the means of controlling and reducing all forms of settlement risk – whether credit, liquidity or operational – which might give rise to wider systemic risk.

But as well as addressing risk in payment systems, we need also to bear in mind the effectiveness of the UK financial system. There is little point in providing an absolutely safe payment system if banks find it inefficient or prohibitively expensive to use and therefore opt for other, less safe alternatives. For this reason, the Bank, in common with other EU central banks, provides settlement banks with intra-day liquidity against high quality collateral to ensure that payments flow smoothly through the RTGS system, avoiding gridlock. And we work closely with the system operators, and with the main users of payment systems in the UK, to ensure that the systems continue to meet the market's needs.

Overall, I think we are making progress in achieving these objectives. In the UK – and indeed globally – standards are steadily rising. Most major countries now have Real Time Gross Settlement (RTGS) for their key high value interbank payment systems. In CHAPS, the UK has a high value payment system which is both highly secure and which we believe offers its users an effective and competitive service. Looking wider, the EU, of course, has the TARGET system, linking together the 15 national RTGS systems and the European Central Bank. The risk reducing benefits of RTGS make it our preferred payment system model. But even in other systems which are not RTGS – chiefly the major "net" end of day settlement systems (such as the Euro Banking Association's new Euro1 system) – the residual risks are well recognised and highly circumscribed.

But, despite the great progress made in the last decade since the Lamfalussy Report, we cannot rest on our laurels. There remain weaknesses in some parts of the international infrastructure and we need to continue to refine and encourage best practice. Indeed a Task Force on Payment Systems Principles and Practices – chaired by John Trundle from the Bank- has recently been set up by the G10 central banks to identify core principles relevant to all countries. These principles are intended to reduce risk, particularly systemic risk, and to support and strengthen efficiency in payment systems. As well as reaffirming the Lamfalussy principles in this wider context, this work will also address other issues, such as: the need for prompt final settlement, preferably across the books of the Central Bank; the governance of systems; and the role of Central Bank oversight in promoting systemic stability. But although this work goes wider than the original Lamfalussy principles, I do not expect much change to the philosophy underlying them, for instance that:

- the legal basis of payment systems should be well founded in all relevant jurisdictions;
- the rules and procedures of such systems should make it absolutely clear where risks lie;
- systems should be secure and reliable operationally, with adequate contingency arrangements;
- access should be fair and open; and
- there should be clearly defined procedures for the management of the particular risks arising.

I will now move on from payment systems to settlement systems. In fact, though they raise distinct issues of their own, settlement systems often effectively incorporate a payment system within them. So the reasons why the Bank and other Central Banks are interested in securities settlement systems are broadly the same as for payment systems. The values passing through these systems, and their central place in the financial markets infrastructure, mean that they are of systemic significance.

I would like briefly to focus on the issue in this area which at the moment is perhaps of greatest interest to us and other Central Banks – the introduction of 'full' Delivery versus Payment ("DVP") . Here there is a need to make further progress, both domestically and internationally.

Currently in the UK, users of CGO and CREST have, in the assured payment mechanism, effective DVP. Sellers can fulfil their side of bargains safe in the knowledge they are protected from their counterparty's failure by the 'assurance' of their settlement bank. But is that enough? We believe not. While I would hesitate to call it a weak link, given the strength of the banks involved, this mechanism does nevertheless rest on the soundness of the settlement banks. Failure of one – however unlikely – could cause severe disruption to users of the system as well as, given the huge values involved, to other parts of the financial system.

The solution to this concern has long been recognised. It was set out as long ago as 1992, when the Parkinson report of the G10 Central Banks highlighted the benefits of securities and cash legs settling simultaneously, and with immediate finality, across the books of the settlement system and Central Bank respectively. With RTGS in high value payments already in place, and the integration of gilts settlement into CREST likely to be completed early next year, in the UK we are now in a position where we can realistically contemplate linking the two and moving to 'full' DVP for settlement of UK securities, including gilts and equities. This is one of the Bank's key objectives in the financial stability area, and it is shared by CREST, the settlement banks and the major players in the securities markets.

I would now just like to touch on recent developments in foreign exchange settlement. It is now three years since the Allsopp Report revealed that the scale and duration of interbank exposures relating to the settlement of foreign exchange transactions – so-called "Herstatt risk" – was much greater than had previously been supposed. Indeed, the report found that the amount at risk to a single counterparty could exceed a bank's capital. Now Central Bankers are not generally keen on "one strike and you're out" arrangements, so in the intervening period we have worked hard to improve the understanding, monitoring and control of Herstatt risk. Furthermore, new infrastructure developments, such as the CLS Bank (which plans to go live in the second half of next year) will further reduce the scope for systemic threats to arise through foreign exchange settlement. But we are not there yet, and the Bank remains keen to see further progress in this area.

Finally, it is impossible to cover financial stability issues relating to the infrastructure of the financial system without talking about Year 2000 risks. A great deal has already been done – by banks, and other financial services firms, and by infrastructure providers – to make sure that the critical computer systems are ready for the millennium date change. The preparedness of individual firms is being monitored by the FSA. But as far as the UK payment systems are concerned the responsibility for reporting on preparations lies with the Bank. And we are working closely with the FSA, APACS, the BBA, the card schemes and individual banks to make sure these sectors are ready and the Millennium weekend goes smoothly.

I am confident that the key systems will work. In my judgement the main risks in financial markets actually arise from individual firms being excessively cautious in anticipating problems in their counterparties. It is not quite right to say that the only thing we have to fear is fear itself. But we at the Bank have now turned our attention to how to deal with these so called "shadow effects" of Year 2000 – the risk that the understandable caution of individual firms leads in aggregate to market problems that rebound on all firms.

This is at least partly an issue of confidence. And to that extent it can be addressed by financial sector players being as open as possible with each other about their preparations. Tomorrow, the Bank and the

FSA are jointly hosting a symposium on Year 2000 issues in the financial sector, at which all these issues will be discussed. The main message I would like to underline here is that the key market players – including the Bank itself – have done as much as is possible to ensure that all the key systems will function smoothly on 1 January.

Ladies and Gentlemen, let me end by wishing you a successful conference. SWIFT is a key part of the financial market infrastructure, and the systems it supports remain a central area of interest for the Bank. The Bank's monetary policy decisions are – quite rightly – the subject of great publicity and intensive scrutiny. Ensuring financial stability may be a less glamorous aspect of our public policy work. But it is no less a fundamental part of Central Banking, and it will remain a core area of the Bank of England's work.