

Payment system oversight – a contribution to the stability of the financial system and the efficiency of payment operations

Overseeing payment systems is one of the Bundesbank's fundamental tasks and makes an important contribution to maintaining and strengthening the stability of the financial system. Whereas the term "oversight" is a comparatively recent concept, tasks which come under this heading have been carried out by the Bundesbank for many years. Two key goals of oversight are to ensure that payment systems are safe and efficient. This article considers the importance of oversight and explain its objectives in detail. It also describes the principles underlying the Bundesbank's oversight policy. In carrying out its oversight function, the Bundesbank traditionally takes a market-oriented, cooperative approach. This approach has proved effective in the past and will also continue to be used in the future within the framework of the Eurosystem's common oversight policy. The Bundesbank's activities range from monitoring compliance with international oversight standards, observing developments in the payment field and maintaining contacts with market participants to cooperating with other central banks and banking supervisors. The article concludes by mapping out the main lines of the Bundesbank's future oversight activities.

A payment system is used to transfer financial assets between banks, enterprises, households and government. On the one hand, it is

the two-way flow of payments accompanying the exchange of goods and services in the real economy and, on the other, it serves to transfer claims and pay off liabilities as well as facilitating the monetary settlement of transfers of and shifts in financial assets such as securities and foreign currency. Central banks have a particular interest in payment systems for several reasons: they provide accounts and central bank money for the settlement of payments, many central banks offer their own market infrastructure for settling payments, and monetary policy requires a well-functioning payment system.

Legal basis for payment system oversight

*Legal basis
in Germany...*

The Bundesbank's responsibility for payment system oversight is laid down by section 3 of the Bundesbank Act. The Act states that, *inter alia*, the Bundesbank "shall arrange for the execution of domestic and cross-border payments and shall contribute to the stability of payment and clearing systems". In actual fact the "oversight" function in the sense of the Bundesbank Act is interpreted as covering the entire field of payment operations and not just payment systems or instruments. The Bundesbank's oversight activities embrace all aspects of payments, including regulatory issues.

*... and at the
European level*

For the European System of Central Banks (ESCB), of which the Bundesbank is an integral part, the Treaty establishing the European Community (EC Treaty) and the Statute of the European System of Central Banks and of the European Central Bank (ECB) (Statute) apply

in addition. Pursuant to Article 105 (2) of the EC Treaty and Article 3 of the Statute, the ESCB is to promote the smooth operation of payment systems. Article 22 of the Statute states that "the ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries".

Payment systems and the stability of the financial sector

Payment systems constitute an important part of the financial sector infrastructure. The creation of a single money market and an efficient allocation of liquidity within a currency area require efficient, safe and high-availability systems. In the ESCB, the TARGET¹ network, including the German component RTGS^{plus}, is the system which meets this important requirement for implementing single monetary policy and for settling payments safely.

Payment systems – an important part of the financial infrastructure

The default of one or more participants in a payment system or a malfunctioning of the system itself may have a negative impact on other participants and, in an extreme case, may endanger the stability of the entire financial system (domino effect). Payment systems can consequently be conduits of crises in the financial sector and bring such problems to light. Net systems – systems entailing the mutual netting of claims without immediate fi-

Risks arising from payment operations...

¹ Trans-European Automated Real-Time Gross Settlement Express Transfer system, which links up the ESCB's various individual Real-Time Gross Settlement (RTGS) systems.

nality of the individual payments and without the associated intra-day provision of central bank liquidity – are particularly prone to financial risks. They also pose problems for banks' liquidity management, since incoming payments in the course of the day are not simultaneously associated with transfers of central bank liquidity. If these risks are not countered, the default of a participant that cannot meet its settlement obligations and the unwinding of its payments may result in considerable liquidity and credit problems for other participants. In gross settlement systems, by contrast, payments are only executed after it has been verified that sufficient cover is available and the originator's account has been debited, so that the payment recipient has immediate and final access to the credited amount and is subject to neither credit risks nor liquidity risks if settlement has been effected in central bank money. In addition to the systemic, credit and liquidity risk, payment operations are also subject to operational and legal risk. Disruptions to payment systems may also seriously damage the image of the currency concerned and have devastating consequences for the real economy.

Securities clearing and settlement systems likewise influence the smooth settlement of payments in many ways. The monetary settlement of individual payments and balances, which in these systems arise from, for example, purchasing securities on the stock market, is executed via the Bundesbank and therefore has a direct impact on banks' central bank liquidity. Smoothly functioning securities settlement systems are also necessary to enable banks to transfer securities as col-

lateral to the Bundesbank quickly and efficiently. This collateral serves to increase central bank liquidity in two respects. Firstly, it can be used as collateral for intra-day credit which has been guaranteed by the Bundesbank in the interests of efficient payment settlements. Secondly, the collateral can be deployed in the framework of monetary policy operations with the Eurosystem.

The threats to the financial sector, real economy and the currency posed by risks arising from payment operations and securities settlement must be limited by implementing suitable measures. With this particular goal in mind, the central banks have drawn up various oversight standards. In addition, measures were taken at an early stage to reduce risk, such as the introduction of gross settlement systems or the widespread use of central bank money as the monetary settlement medium in securities trading, for example in overnight processing by Clearstream Frankfurt. This increased use of central bank money not only accords with the aim of reducing risk but also makes banks' use of liquidity more efficient. Whenever a payment transaction or positions are settled in central bank money, the latter is available to the recipient for all further transactions.

... must be limited by suitable measures

Standards and principles governing oversight activities

Various standards and principles apply to payment operations and securities settlement. One of the tasks of payment system oversight is to monitor the relevant systems to ensure

International oversight standards and principles

Risks in payment systems

Credit risk

The risk that a party within the system will be unable fully to meet its financial obligations within the system either when due or at any time in the future.

Liquidity risk

The risk that a party within the system will have insufficient funds to meet financial obligations within the system as and when expected, although it may be able to do so at some time in the future.

Legal risk

The risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks.

Operational risk

The risk that operational factors such as technical malfunctions or operational mistakes will cause or exacerbate credit or liquidity risks.

Systemic risk

The risk that the inability of one of the participants to meet its obligations, or a disruption in the system itself, could result in the inability of other system participants or of financial institutions in other parts of the financial system to meet their obligations as they become due. Such a failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the system or of financial markets.

Source: BIS, *Core Principles for Systemically Important Payment Systems*, January 2001.

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that they comply with these standards and principles. As an integral part of the ESCB and a member of the Committee on Payment and Settlement Systems (CPSS) of the G10 central banks, the Bundesbank is actively involved in developing international standards and principles. These rules may be referred to as "soft law" because they do not have the status of law and are neither universally applicable nor legally binding.

The "Core Principles for Systemically Important Payment Systems", which were approved by the governors of the G10 central banks in January 2001, are of particular importance. They date back to a report published in 1990 by the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (known as the "Lamfalussy Standards"), which were originally drawn up for cross-border and multi-currency netting and settlement systems but which are used much more generally in practice. The ten "Core Principles" relate to legal certainty, the management of financial risks, security and operational reliability, and criteria for participation. Additional principles that were not among the "Lamfalussy Standards" are the minimum requirements for efficiency, for assets used for settlement and for the governance arrangements. In addition, the publication also contains statements on the responsibilities of the central bank in applying the "Core Principles". With regard to the oversight of payment systems in the euro area, the Governing Council of the ECB decided to adopt the "Core Principles" of the CPSS as minimum requirements for payment system oversight in the Eurosystem.

*European
standards*

In June 2003 the Eurosystem additionally adopted a set of "Oversight standards for euro retail payment systems" which are based on the "Core Principles" of the CPSS. They contain indicators for classifying retail payment systems with a correspondingly differentiated catalogue of requirements. They distinguish between retail systems of systemic importance, those which are of prominent importance, and all other systems. Whereas the first type of system has to fulfil all ten "Core Principles", important systems need to observe only six of the "Core Principles" (I, II, VII-X). Other systems, where necessary, have to meet other requirements (such as for electronic money (e-money)) or particular national regulations.

*Minimum
requirements
for e-money*

In the "Report on electronic money" published in 1998, the Eurosystem defined its minimum requirements for the issuance and design of e-money. The minimum requirements relate primarily to oversight and security aspects as well as to the redeemability of e-money in central bank money. The report on e-money is supplemented by the security objectives defined for the Eurosystem in connection with e-money ("Electronic Money System Security Objectives" report, 2003).

*Standards for
securities
clearing and
settlement
systems*

The standards for securities clearing and settlement systems were drawn up at the European and international levels with the involvement of the Bundesbank. The standards adopted by the Eurosystem for using these systems for monetary policy transactions within the Eurosystem² are designed for securities settlement systems – also known as central securities depositories (CSDs). These

securities settlement systems are used by monetary policy partners of the Eurosystem to transfer securities to the Bundesbank as collateral. The standards lay down the conditions – from a fairly narrow user perspective – under which CSDs may act as intermediaries in monetary policy transactions. However, they also have positive effects on securities settlement outside of the monetary policy context.

By contrast, the Recommendations for Securities Settlement Systems (November 2001) drawn up by a joint working group of the CPSS and the International Organization of Securities Commissions (IOSCO) were formulated under the broader angle of general oversight and financial market stability. They contain minimum requirements for securities settlement systems in industrial and developing countries. This group is currently working on elaborating minimum standards for central counterparties (CCPs), which act as intermediaries between two counterparties in the cash and forward markets so as to ensure trade anonymity and reduce the risks for market participants. At the European level, a working group of the European System of Central Banks and the Committee of European Securities Regulators (ESCB-CESR Joint Working Group) deals with the ongoing development and subsequent implementation of international recommendations. The group also takes due account of the requirements of the single market and European integration.

² Standards for the use of EU securities settlement systems in ESCB credit operations, January 1998.

Core Principles for systemically important payment systems

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|---|---|
| <p>I The system should have a well founded legal basis under all relevant jurisdictions.</p> <p>II The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.</p> <p>III The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.</p> <p>IV¹ The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.</p> <p>V¹ A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.</p> <p>VI Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.</p> <p>VII The system should ensure a high degree of security and operational reliability and should have contingency arrange-</p> | <p>ments for timely completion of daily processing.</p> <p>VIII The system should provide a means of making payments which is practical for its users and efficient for the economy.</p> <p>IX The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.</p> <p>X The system's governance arrangements should be effective, accountable and transparent.</p> |
|---|---|
- Responsibilities of the central bank in applying the Core Principles**
- | |
|---|
| <p>A The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.</p> <p>B The central bank should ensure that the systems it operates comply with the Core Principles.</p> <p>C The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.</p> <p>D The central bank, in promoting payment system safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.</p> |
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Source: BIS, *Core Principles for Systemically Important Payment Systems*, January 2001. — ¹ Systems should seek to exceed the minima included in these two Core Principles.

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IMF standards

The "Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles" published by the International Monetary Fund (IMF) defines requirements for, *inter alia*, public authorities which exercise an oversight function. The Code emphasises that oversight activities are to be governed by the principle of transparency with regard to their role and underlying principles.

Payment systems and efficiency

*Efficiency is
always cost-
related...*

An efficient payment system requires cost-effective procedures which accord with users' preferences. Payment costs can be reduced through various means. These include replacing paper-based instruments (for example, paper-based credit transfer orders, cheques) by electronic instruments and procedures. The higher the degree of straight-through processing (STP) of payment orders and information from the payer to the beneficiary, the greater the efficiency. Gaps in the media and interfaces between different procedures lead to higher transmission costs but also to longer processing times and an increased risk of errors. In this connection, the Bundesbank has recently been discussing two issues with the banking industry. Firstly, on the subject of a German Automated Clearing House (ACH), it was considered whether the current outsourcing of services to transaction banks should perhaps instead be channelled into a national ACH. Secondly, the Bundesbank is actively endeavouring to replace the current paper-based forms for large-value

cheques by a national electronic imaging procedure.

Besides costs, user preferences also play a role in the efficiency of payment systems. These relate to such things as the safety and comfort of procedures and instruments, the processing time of payments and banks' liquidity management, for which – as mentioned above – the use of central bank money is of particular importance. Therefore, the Bundesbank focuses its attention on banks as users. While the Bundesbank's mandate is not oriented to consumer protection, an increase in efficiency never exclusively benefits the banks but is also in the interests of the banks' customers. Other authorities concern themselves with consumer issues. For example, the European Parliament and Council have issued a regulation on cross-border payments in euro according to which charges for cross-border payments in euro are to match those for domestic euro payments.

*... and
preference-
related*

Account needs to be taken in the context of payment systems of particular aspects concerning the efficient allocation of resources that arise from the network structure of payment systems. The utility of a payment system or payment instrument for the participant increases with its extensiveness and acceptance. Owing to this positive network externality, it is advantageous to choose coordinated procedures for payment systems since compatible, interoperable elements broaden the potential user base and thus boost its usage.

*Network
structure
of payment
systems...*

CPSS-IOSCO recommendations for securities settlement systems

1 Legal framework

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

2 Trade confirmation

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

3. Settlement cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

4 Central counterparties (CCPs)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

5 Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

6 Central securities depositories (CSDs)

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

7 Delivery versus payment (DVP)

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

8 Timing of settlement finality

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

9 CSD risk controls to address participants' failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

10 Cash settlement assets

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Source: BIS, *Recommendations for Securities Settlement Systems*, November 2001.

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11 Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

12 Protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

13 Governance

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

14 Access

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

15 Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

16 Communication procedures and standards

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

17 Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

18 Regulation and oversight

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

19 Risks in cross-border links

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

*... makes
common
technical
standards
meaningful...*

An important instrument for achieving this aim is the development of common technical and organisational standards and the actual implementation of existing payment system standards. Without such standards it would be necessary to insert conversion links into the payment processing chain, which would normally result in a lower level of efficiency for both the customer and the banking industry. Technical standards can arise from market processes, develop from cooperative ventures between private and sometimes public players or be laid down by institutional standard setters. In their role as a catalyst, central banks can promote coordination or can themselves set standards and, for example, further develop the systems they operate accordingly. However, only standard setters which have practical market experience and/or work closely with market participants are likely to be in a position to develop and implement the best possible standards.

The Bundesbank has traditionally been involved in Germany with the development of technical standards for payment systems and participates, for example, in the corresponding bodies of the Central Credit Committee (CCC). The "Automation" task force of the Business Management Committee draws up agreements for standardising interbank payments in Germany. The agreements are based on the consent of all the parties involved and are legally binding for all banks which are affiliated to the various national federations of the banking industry that were signatories to the agreement. After they have been signed, the agreements are reported to the Federal Cartel Office because they reverse the prin-

ciple of no collusion among competitors. If no objections are made within three months after being reported, the agreements become final and absolute in law.

To a certain extent, the same conditions prevail in payment systems as in natural monopolies: across-the-board returns to scale and high sunk costs (such as the initial investment in constructing a payment system or developing technical standards). High sunk costs and the need for a critical mass of participants in the payment network constitute entry barriers in the markets concerned and stop potential competitors from entering the market. The Bundesbank has countered this problem through its competitively neutral provision of payment services to all banks, thereby enabling every institution to directly participate in payment operations and at the same time ensuring a nationwide coverage permitting all institutions to access the payment systems. Moreover, the creation and application of common technical standards and procedures has not led to monopolistic structures in Germany but instead has fostered keen competition among banks with regard to operating hours, prices, running times and additional services, which has had positive consequences for consumers.

Path dependency, ie the impact of past decisions on future decisions, plays a major role in the efficiency of payment systems. There is a danger that structures which have become inefficient as a result of changes in the operational setting will remain in place simply because changing the system and the standards would be too expensive. These costs are

*... without
resulting in
monopolies*

*Path
dependency*

weighed up against the benefits of changing the standard, which are rather limited until a critical mass of users of the new standard has been reached. Introducing innovations is additionally hampered by increased uncertainty surrounding the assessment of new procedures and by a lack of knowledge about alternative options. Hence a new procedure with greater long-term efficiency may fail to replace an older procedure that is less efficient in the long term. This problem can be overcome through a coordinated approach, such as a joint changeover to a new standard. For example, one of the objectives that the Bundesbank has persistently pursued is to continue reducing the use of traditional cheques which, compared with alternative payment methods such as paperless credit transfers or direct debits, have considerable efficiency deficits.

Single currency area requires changes to national structures

The single currency and growing economic integration have highlighted the aforementioned coordination problems at the European level. Even payment system structures which have achieved high levels of efficiency at a national level exhibit inefficiencies in the international environment because of a lack of compatibility. This applies particularly to the European retail payment system which is still fragmented, whereas the large-value payment system is already more harmonised.³ The Bundesbank therefore supports and, through collaboration with the German banking industry, is involved in efforts to establish consistent European standards. These are likely to yield efficiency gains in the long term vis-à-vis the proven national standards.

Relationship between safety and efficiency

In large-value payment systems the safety aspect is more to the fore, whereas in retail payment systems the focus is on the efficiency aspect. To a large extent these two objectives of payment system oversight are compatible with one another because users have preferences for a specific safety level of the payment systems or instruments. Only systems which satisfy the users' preferences and are widely accepted can also be efficient in the long run in that, given the aforementioned network structure, a critical mass of users must be reached so as to achieve the corresponding returns to scale and operate profitable systems. Owing to a lack of transparency, however, systems with high risks might also be retained. Central banks can sharpen risk awareness in this context and encourage a changeover to procedures with greater safety and efficiency. The Bundesbank achieved this by developing Euro Access Frankfurt (EAF) from a net system to a hybrid system and then later changing to the gross settlement system RTGS^{plus}. A high liquidity efficiency was attained in addition by using liquidity-saving elements and giving banks the opportunity to manage payment flows.

Matching aims

However, the two aims of safety and efficiency are not fully compatible, also in the light of externalities in risk mitigation. For example, problems experienced by an individual

Conflicting aims

³ Large-value payment systems primarily process financial market transactions, commercial payments from enterprises and urgent payments. Retail payments notably include payments incurred in everyday life (salaries, rents, purchases etc).

system participant result in costs for other system participants. Moreover, disruptions in payment operations lead to problems in other areas, such as the currency and the real economy. These external costs are not, however, factored into the cost/benefit considerations of individual participants. All in all, there is a danger that participants in payment systems may be less interested in safe systems than is macroeconomically desirable.

Oversight function exercised by the Bundesbank

*Role of the
Eurosysteem
in payment
system
oversight*

The Bundesbank acts under the regulations of the Eurosystem, which oversees the payment and settlement systems in the euro area. This task also embraces the central banks' own systems. The "Statement on the role of the Eurosystem in the field of payment systems oversight" published in 2000 explained in detail the goals of oversight and outlined the organisational distribution of duties within the Eurosystem. According to this statement the Governing Council of the ECB defines the fundamental political stance of the Eurosystem's oversight policy. The implementation of this stance is based on the principle of decentralisation and is usually the responsibility of the national central bank (NCB) of the country in which the system concerned is legally registered. In the case of cross-border systems, this NCB has the leading oversight role and cooperates with the other NCBs concerned. Systems which do not have a clear national anchoring are normally overseen by the NCB of the country in which the system is legally registered. The Governing

Council of the ECB can, however, transfer the leading oversight function for such latter systems to the ECB; this was the case for the EURO1 system of the Euro Banking Association (EBA), which is registered in France but largely operates according to German law.

The German payment system infrastructure is characterised by the coexistence of payment systems and other settlement procedures. There are currently two payment systems as defined in the EU Directive on Settlement Finality in Payment and Securities Settlement Systems (Settlement Finality Directive). Both systems are operated by the Bundesbank. Large-value payments are handled by RTGS^{plus} and retail payments by the Retail Payment System (RPS). In connection with the Bundesbank's own systems, responsibilities for oversight and for operation are segregated. This internal organisational structure meets the minimum requirements of the Governing Council of the ECB and of the IMF.

*Objects of
payment
system
oversight*

RTGS^{plus} is of systemic importance for the financial system and is checked for compliance with the "Core Principles" in the context of payment system oversight. Given its market share in Germany of just over 15%, RPS is classified as an "other system". As a result, the European oversight standards do not apply to it. RPS is nevertheless subject to oversight – as are the bilateral clearing arrangements between commercial banks' central offices and their principal payment offices or the respective internal payment networks of the cooperative and savings banks, which make up the remaining 85% of interbank settlements in the retail payment sector. The

Bundesbank oversees not only the payment systems but also the payment instruments; in this connection electronic cards and internet usage have acquired considerable importance. Among other things, the Bundesbank is looking at the design of the smart card (*Geld-Karte*) scheme, the e-money system operated by the German banking industry. The security aspects of this smart card are being analysed in cooperation with the Federal Office for Security in Information Technology (BSI).

The Bundesbank also makes its infrastructure available in the area of securities settlements. The Electronic Securities Settlement (ESS) system is an electronic interface between Clearstream Banking Frankfurt AG and the Bundesbank for transmitting data for the monetary settlement of securities transactions. This procedure is also subject to oversight.

*Cooperative
approach
to payment
system
oversight*

Payment system oversight can be carried out by central banks with a varying intensity of intervention. This ranges from a market-oriented approach with very little or no intervention, a cooperative oversight approach in collaboration with market players to a highly regulatory approach. The Bundesbank traditionally uses the first two approaches. In the euro area the ECB has the right to issue regulations (Article 22 of the Statute). It has, however, not yet exercised this right. The successful cooperation between the Bundesbank and the payment system players – particularly through the CCC – has contributed greatly to the high degree of safety and efficiency in German payment systems and rendered regulation largely unnecessary. The fact that it is

itself a payment system operator means that the Bundesbank is able not only to ensure competitively neutral access to the market for all banks but also to directly influence the safety and efficiency of payment systems. The use of moral suasion vis-à-vis market players is another effective instrument for implementing general and technical oversight standards. Another option available to the Bundesbank is informing the general public about any irregularities and risks. Through its participation in various committees of the German CSD, Clearstream Banking Frankfurt AG, which deal with policy and organisational issues, the Bundesbank also helps to ensure that, concerning the financial settlement of securities transactions, the interests of the systems' users and public needs are duly taken into account.

Comprehensive and up-to-date information is a key requirement for oversight activities. The Bundesbank therefore attentively follows and analyses developments in the German payment landscape. The scope of analysis embraces not only publicly accessible media or specifically requested material but also complaints and court rulings in the field of payment systems. Ongoing insights and the expertise which the Bundesbank has gained from developing and operating its own large-value and retail payment systems are likewise of particular importance. The Bundesbank holds meetings directly with market players and associations of the banking industry at various levels. It also participates in relevant events organised by the banking industry and stages its own conferences, seminars and working meetings. Moreover, the Bundes-

Market analysis

bank has set up working groups which in some cases deal with specific subjects, such as crisis management for payment and settlement systems. The Bundesbank also conducts market surveys in order to obtain the information it needs for its oversight activities. It uses this instrument in particular when compiling payment statistics.

The Bundesbank makes use of the insights which it gains from its oversight function in its payment policy activities at the national, European and G10 level as well as in its own publications and other public statements on payment operations, which range thematically from structural to technical issues. The results of its statistical surveys are incorporated, *inter alia*, in payment-related publications of the Bank for International Settlements (*Payment and Settlement Systems in Selected Countries, "BIS Red Book"*) and of the ECB (*Payment and Securities Settlement Systems in the European Union, "ECB Blue Book"*) as well as in the payment statistics for Germany, which can be found on the Bundesbank's website.⁴

*Cooperation
between
payment
system
overseers
and banking
supervisors...*

All enterprises which conduct banking business within the meaning of section 1 (1) of the Banking Act or provide financial services within the meaning of section 1 (1a) of the Banking Act commercially or on a scale which requires a commercially organised business undertaking are subject to the provisions of the Banking Act and therefore to banking supervision. The "execution of cashless payment and clearing operations (giro business)" and "the issuance and administration of electronic money (e-money business)" qualify as

banking business, while "the issuance and administration of credit cards and travellers' cheques (credit card business)" is a financial service. A licence from the Federal Financial Supervisory Authority (BaFin) is required to carry out these business activities. Pursuant to section 6 (2) of the Banking Act, one of BaFin's tasks is to "counteract undesirable developments in the banking and financial services sector which may endanger the safety of the assets entrusted to institutions, impair the proper conduct of banking business or provision of financial services or involve serious disadvantages for the national economy".

Pursuant to section 7 of the Banking Act, the Bundesbank is responsible for the ongoing monitoring of institutions. This specifically includes evaluating the documents submitted by institutions as well as performing and evaluating audits of banking operations. However, the Bundesbank has sole responsibility for payment system oversight. Problems and risks of prudential relevance which come to light during the monitoring and oversight activities are reported to the banking supervisors at the Bundesbank and at BaFin. On the one hand, this cooperation is necessary to ensure that concrete penalties can be imposed wherever negative developments are exposed in the payment processing of one or more banks. On the other hand, the Bundesbank also cooperates with BaFin in areas which equally affect both agencies. One example of this is the oversight of new payment procedures such as e-money systems.

⁴ http://www.bundesbank.de/zv/download/zvd_en.pdf

Common and divergent objectives and approaches between banking supervision and payment system oversight

Common features	Divergent features	
	Banking supervision	Payment system oversight
<ul style="list-style-type: none"> – Maintaining financial stability – Protecting customers against counterparty credit risk – Avoiding excessive risks – Enabling sufficient risk transparency for market participants – In particular, monitoring the security and reliability of the transactions effected – International cooperation, which is becoming ever-more important in both areas owing to the greater risks involved in cross-border transactions 	<ul style="list-style-type: none"> – Main objective is the stability of the individual bank – Instructions to individual institutions concerning, among other things, capital and liquidity requirements – Far-reaching powers of intervention including withdrawal of the banking licence – Banking supervision in Germany is carried out by BaFin in cooperation with the Bundesbank 	<ul style="list-style-type: none"> – Main objective is security and efficiency in payment systems – Attempts to limit the negative consequences of default by one or more participants – Works towards establishing risk-adequate structures at system level – Has hardly any powers of intervention and thus uses, among other things, moral suasion. Where necessary, calls in banking supervisors – Payment system oversight in Germany is carried out by the Bundesbank

Deutsche Bundesbank

... is governed in the EU by a "Memorandum of Understanding"

To institutionalise cooperation and the exchange of information, banking supervisors and overseers from the Eurosystem and other EU member states have agreed on a Memorandum of Understanding in the field of EU large-value payment systems, which has been in force since 1 January 2001 and replaced the previous agreement of 1994. The memorandum, which is not legally binding, is based on the consideration that banking supervision and payment system oversight are pursuing a common goal – namely, safeguarding the stability of the financial system. The respective remits of these two agencies changed to some extent at the start of monetary union in that payment system oversight became one of the basic tasks of the Eurosystem, ie the central banks, whereas banking supervision remains the responsibility of national agencies

and not every central bank is responsible for or involved in banking supervision in its own country.

Besides overseeing payment systems in Germany, the Bundesbank is also involved in the oversight of supranational payment systems. The ECB is the leading overseer for the EBA's systems. The Bundesbank is involved in this oversight through its participation in the respective working groups of the ESCB. The same applies to the oversight of the Continuous Linked Settlement (CLS) system, which came into operation in September 2002 for the purpose of settling foreign exchange transactions and which, thanks to its design, largely eliminates FX settlement risk. Primary responsibility for overseeing CLS lies with the Federal Reserve System. The ECB participates

Participation in the oversight of supranational payment systems

in the cooperative oversight with regard to settlements in euro. The Bundesbank is involved in the oversight of CLS both as a member of the Eurosystem, via the ESCB working groups, and as the NCB of the German direct participants. Furthermore, the Bundesbank takes part in a working group of the CPSS of the G10 which supports the Federal Reserve System within the framework of the cooperative oversight of the entire CLS system. Although it is not a payment system, SWIFT⁵ is also monitored as part of payment system oversight. Within the cooperative oversight framework, the G10 central banks – which include the Bundesbank – support the activities of the National Bank of Belgium, which is the leading overseer of SWIFT.

Outlook

On the whole, the Bundesbank has carried out its oversight function, which it has traditionally seen as forming part of its mandate spelled out in section 3 of the Bundesbank Act, successfully and in doing so has made a substantial contribution to the high level of safety and efficiency of the German payment landscape. In this context the cooperative approach to oversight has proved to be both effective and appropriate. In this connection the Bundesbank will further intensify its on-

going dialogue with the banking industry – also by means of bilateral discussions with individual banks – and communicate its objectives in an appropriate and transparent form to both the banking industry and the general public.

The Bundesbank sees important focal points of its future oversight activities in identifying the adjustment requirements of the German structures with regard to establishing a single European payment area and in further developing provisions to cope with emergencies and contingencies in the financial sector (business continuity planning). The Bundesbank will also monitor changes in the value chain of the payment systems, arising, for example, from the involvement of transaction institutions and banks, and the resultant implications for central banks, or the innovative design of electronic payment procedures – without which, for example, the development of e-commerce would be retarded. Finally, the Bundesbank will continue to evaluate the experience of other central banks in connection with payment system oversight with a review to further refining its own oversight activities.

⁵ The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is an important provider of communication services to the international financial system.