

Norges Bank's oversight and supervision of the payment system

The Norges Bank Act from 1985 gave Norges Bank responsibility for promoting an efficient payment system. In keeping with the increased focus on risk in the payment system, both nationally and internationally, Norges Bank's work on payment system issues has also changed. The Payment Systems Act of 1999, which gives Norges Bank responsibility for authorisation and supervision of interbank systems, is important for the central bank's work in this area. The recommendations concerning payment systems from the Bank for International Settlements (BIS) also state that central banks should publicly disclose their role and their most important policies with respect to payment systems. In order to explicitly define our objectives for and roles in the payment system and in line with the recommendations from the BIS, Norges Bank makes public the basis for its oversight and supervision of the payment system.

Background

The payment system is an important part of a country's economic and financial infrastructure. Smoothly functioning payment systems make it possible to execute safe and timely payment transactions. The payment system handles different kinds of payment transactions - for the settlement of goods and services purchases, capital transfers, securities and foreign exchange trading, etc., and these transactions are made by private customers, banks, enterprises and government agencies. These transactions result in claims between the payers' and payees' banks, and these claims are settled through the banks' accounts in Norges Bank. Banks and the central bank are thus the core of the payment system. Banks' accounts in Norges Bank provide the link between the payment system and monetary policy since the central bank's key interest rates are the sight deposit and overnight lending rates in Norges Bank.

The payment system is also essential to financial stability. Banks' participation in the payment system exposes them to different kinds of settlement risk: credit risk is the risk of losses due to the failure of another bank to meet its obligations, while liquidity risk is the risk of losses due to the failure of a counterparty to meet obligations in part or in full at the agreed time. Legal risk arises when the legal framework is unclear and payment transfers are not executed as expected, resulting in unexpected exposure to other market participants and thus potential losses. Operational risk is tied to inadequate procedures, malfunctions in computer systems, breach of rules, etc.

One bank's risk may be the source of more comprehensive systemic risk if the payment system is organised in such a way that problems at one bank spread to another bank, thus threatening financial stability. Systemic risk is the reason that central banks are concerned about how the payment system is organised. A significant precondition for financial stability is that payment and settlement systems are designed and function in such a way that participating banks can handle settlement risk and that one bank's problems do not spread to other

banks. International efforts to reduce payment system risk have been in process for more than fifteen years. The Norwegian authorities and the financial services industry have followed these developments closely with a view to ensuring that the Norwegian payment system is robust and efficient compared with systems in other countries.

Norges Bank's responsibilities with regard to the payment system

Norges Bank is responsible for promoting robust and efficient payment systems and financial markets, thereby contributing to financial stability. Oversight of the payment system is based on the Bank's formal responsibility as laid down in the Norges Bank Act. According to the first paragraph of Section 1, Norges Bank shall "...promote an efficient payment system domestically as well as vis-à-vis other countries." Based on this, Norges Bank worked with the banks for many years to develop a common payment system infrastructure in Norway in order to reduce overall costs. This, combined with the introduction of prices for payment services that have encouraged customers to use the least expensive services when appropriate, has led to substantial efficiency gains. Today, this work is being continued by the banking industry's own organisations with less direct participation from Norges Bank. For more than fifteen years, however, Norges Bank has followed developments in the Norwegian payment system by means of its Annual Report on Payment Systems. Today, this publication is the primary source of information about this important aspect of the financial infrastructure. Norges Bank will continue this work in order to provide a key reference for market participants, consumers and government agencies, both in Norway and abroad.

The efforts to establish a coordinated infrastructure have resulted in extensive advantages for its users, although technological developments may gradually

permit small-scale solutions to give the same cost advantages, thus facilitating more extensive competition. When new payment solutions are introduced and new participants enter the market, Norges Bank will place emphasis on the systems' ability to communicate with each other in order to maintain the efficiency of the payment system as a whole. Norges Bank is also of the opinion that banks should play a key role in developing new payment solutions even though other market participants may offer some niche products. Cross-border payments normally take longer to complete and cost considerably more than domestic payments. Norges Bank will try to ensure that Norway complies with the EU Commission's recommendations and regulations in a flexible and expedient manner.

The Payment Systems Act of 1999 gives Norges Bank responsibility for authorisation and supervision of interbank systems which comprise systems for interbank clearing and settlement. The Act reflects the increasing recognition in the 1980s and 1990s of the payment systems' significance for financial stability. The Act underpins the banking industry's responsibility to design stable, robust systems in close cooperation with Norges Bank as the ultimate settlement agent in the Norwegian clearing and settlement system. However, as a last resort the Act also authorises direct intervention by Norges Bank in systemically important interbank systems. Norwegian interbank systems' size and function vary considerably. Therefore, Norges Bank may grant exemptions to the authorisation requirement for systems that have no significant effect on financial stability.

According to the Act, responsibility for the payment system is divided between Norges Bank and the Banking, Insurance and Securities Commission, which is responsible for customer-related aspects of the payment system (systems for payment services). The two institutions have identified their "target groups" and clarified the division of responsibility and work. It is often difficult to make a clear distinction between the two parts of the payment system, and the two institutions exchange information regularly about their ongoing activities. Norges Bank's primary focus will be on monitoring the efficiency of the payment system as a whole, including the customer-related parts. It must be stressed that malfunctions in the customer-related parts of the payment system may also have considerable systemic consequences and spillover effects, which substantiate the need for continuous oversight. The Banking, Insurance and Securities Commission is also responsible for approving securities settlement systems. As settlement bank for the cash leg of securities settlements, Norges Bank will regularly evaluate the significance of these transactions for financial stability.

The Payment Systems Act is based on international recommendations, primarily from the Bank for International Settlements (BIS) and the European

Central Bank (ECB). The Act is in line with the BIS recommendations, Core Principles for Systemically Important Payment Systems, which currently provides the international standard for payment systems. The BIS report from the Committee on Payment and Settlement Systems presents ten core principles with which systemically important payment systems should comply. The principles focus on limiting legal, credit, liquidity and operational risk, as well as on the system's cost effectiveness and access criteria. The BIS has also made four recommendations about how central banks should exercise their responsibility in this area, with regard to both overriding objectives and the application of the ten core principles throughout the payment system. The EEA Directive on Settlement Finality has been incorporated into Norwegian law with the passage of the Payment Systems Act. Thus, legal protection may be established for payments that are part of the assets of a bank that has initiated insolvency proceedings.

The purpose of the Payment Systems Act is to help ensure that the systems are organised in such a way that they promote financial stability. However, Norges Bank shall not control in detail the systems nor take over the operator's responsibility for system operations. As long as the Payment Systems Act's requirements are satisfied, operators themselves determine how the system shall be developed and operated. The general background material for the Payment Systems Act makes it clear that the Act is a supplement to and not a replacement of the industry's own regulation of the systems. In exercising its supervisory authority, Norges Bank emphasises that it is the banks' responsibility to give due consideration to both risk and efficiency when they operate interbank systems. Norges Bank's ongoing supervision of the interbank systems that are subject to authorisation will take the form of meetings with the licensees, where such factors are discussed in more detail, and will also include an annual report about system participation and turnover. In addition, all significant changes with regard to ownership, organisation and operating conditions shall be reported to Norges Bank before the changes are made.

In line with the BIS recommendations, Norges Bank, by virtue of its role as the ultimate settlement bank, contributes to ensuring the execution of payment settlements: banks' accounts in Norges Bank ensure them settlement without underlying credit risk, and Norges Bank provides liquidity to banks through collateralised loans, thus ensuring prompt settlement of payment transactions.

Risk in the Norwegian payment system

After the Payment Systems Act entered into force and adjustments were made to satisfy the authorisation requirements, the legal risk associated with the Norwegian Payment System is regarded as very limited. Norges Bank's analyses show that overall credit and liquidity risk is also relatively limited after several years of cooperation between banks and Norges Bank on various measures to reduce the risk in the Norwegian payment system. In Norges Bank's opinion, the key interbank systems in Norway satisfy the BIS recommendations. Therefore, in the future the focus will largely be on risk associated with Norwegian banks' participation in international foreign exchange trading (foreign exchange settlement risk) and operational risk.

The remaining settlement risk is primarily tied to banks' high exposures in connection with foreign exchange trading. This is because settlement in different currencies is executed in different settlement systems, normally at different times. Participants are thus exposed to the risk of an unforeseen loss if foreign currency is paid out before receipt of an incoming payment. The establishment of an international multi-currency settlement bank, CLS – Continuous Linked Settlement, will substantially reduce the settlement risk associated with such transactions. According to plan, Norwegian banks will be able to connect to the system in the third quarter of 2002, and Norwegian krone will be one of the settlement currencies within a year after the system becomes operational. The banking industry and Norges Bank have cooperated closely since 1999 on establishing this solution.

Norges Bank places considerable emphasis on reducing the operational risk in the private clearing and settlement systems. Operational disturbances at banks have demonstrated that there may be considerable vulnerability in this area. It is the responsibility of the system operators to ensure that routines, back-up solutions, expertise and contingency plans are in place to effectively deal with operational risk. The banking industry has commenced work to determine what measures are necessary to reduce this risk. This demonstrates that the banking industry is focusing on the problem and that operational risk is being taken seriously. However, the individual system operators are also expected to evaluate their routines and solutions to find ways to reduce risk. Norges Bank regularly assesses the need for measures in relation to systems that do not focus sufficiently on operational risk, and works closely with the Banking, Insurance and Securities Commission to this end.

Norges Bank's operations in the area of payment systems

Developing and managing Norges Bank's Settlement System (NBO) has allowed Norges Bank to influence the organisation of the payment system, and hence risk and efficiency. Due to the authorisation requirements in the Payment Systems Act, Norges Bank can also establish requirements for and monitor efficiency and risk, also in the bank-operated part of the clearing and settlement system. One consequence of this is that Norges Bank has initiated work to evaluate the organisation of the Norwegian payment system. In connection with this, a fundamental review concerning the central bank's responsibilities and tasks in the payment system has been carried out.

The central bank's primary functions include offering banks settlement in risk-free payment instruments, ie claims on Norges Bank, and ensuring sufficient liquidity in the interbank market to avoid disruptions in clearing and settlement. This is accomplished primarily by providing banks access to loans in Norges Bank with securities holdings as collateral. These fundamentals can be maintained, however, without extensive involvement by Norges Bank in the operations and development of the settlement system. Based on this, Norges Bank has invited the banking industry to participate in a project to analyse alternatives to the present division of responsibility in the Norwegian clearing and settlement system. The aim is to establish an appropriate division of responsibility between the banking sector and Norges Bank that allows Norges Bank to concentrate on its core activities (authorisation and oversight of the interbank systems, provision of liquidity for settlements as well as monetary policy issues connected with the payment system). It is assumed that such a review will reveal coordination gains that over time will reduce overall costs in the clearing and settlement system.

For further reading, we recommend:

Enge, Asbjørn and Bjørn Bakke (2001): "Risk in the Norwegian settlement system 1995-2000" Economic Bulletin 1/2001 pp 20-27

Watne, Kjetil (2001): "Do Norwegian payment systems satisfy the new BIS recommendations?" Economic Bulletin 3/2001 pp 91-98