

Central Bank moves to Real Time Settlements - Landmark in Payment Reforms

The Central Bank of Sri Lanka (CBSL) creates history today when it launches the Real Time Gross Settlements (RTGS) system. Sri Lanka is the first country in the South Asian region to implement the RTGS and Scripless Securities Settlement System (SSSS). The SSSS module is to be implemented shortly.

"If we are to become a financial hub in the region, then it is vital for the country to have an efficient and upto date payments system," says Governor of the CBSL, Mr. A.S. Jayawardena.

This RTGS/SSSS is a key element of the financial infrastructure which will facilitate the money market, forex market and Government securities market transactions. This real time payment system will enable value transfers to take place throughout the day and make these transfer mechanisms smooth, safe and speedy. Consequently, both, local and foreign investors will benefit from this innovation.

The previous payments and settlement system, which was in use until today, did not conform to international best practice which emphasises on safe and secured payments and settlements and the reduction of the gap between payments and settlement. Therefore, the decision to introduce this system will ensure the smooth value transfers in money and Government securities markets in a safe and secured manner, thereby eliminating risks involved in payments and settlements.

Large Value Cheques

Presently, all commercial banks and primary dealers maintain current accounts with the CBSL and are issued cheque books for large value payments. These large value cheques

are cleared by the CBSL across the current accounts of commercial banks and primary dealers. In settling these accounts, the CBSL ensures that every bank maintains cash balances to cover the statutory reserve requirement on a weekly average basis, amounting to ten percent of its defined deposit liabilities.

There were many weaknesses in this system. Although the CBSL settled the accounts of the participants at the end of day, they are unable to draw funds on the same day. They could do so one day after the transaction day (t+1). Accordingly, they credit and debit their customers' accounts either on t+2 or t+3. This type of clearing was also very tedious which involved a number of officers working after hours to finalise settlements. Although the CBSL settled accounts of banks and primary dealers at the end of the day, there was no legal assurance of the finality of the transaction. The finalisation of the transaction could have been debated in a court of law as there was no definite time involved in the settlement.

Although the volume of large value cheques cleared in this manner are small, the value of such cheques is about Rs.20 billion a day. With the introduction of the RTGS system, the efficiency in real time cheque clearing is likely to enhance money market and forex market transactions.

"In the past, cheques, large payments and drafts were usually made and settled in the usual leisurely manner," said the Governor. But, with these changing and demanding times, exchange rates fluctuate every minute, instant payments are initiated, and interest rates change constantly. As a result, most developed countries have

introduced systems where settlement risks are eliminated. "If everyone plays by these rules, then we will have a very efficient payment settlement system," he emphasised.

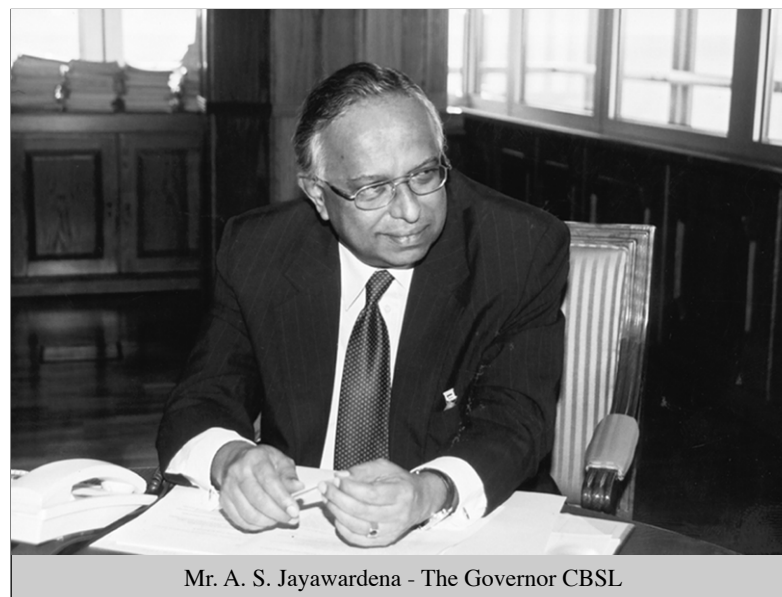
Previous Risks

Previously, there were many risks involved in end of day settlements. Firstly, credit risk was likely with

provides a solution to ensure that the payment system is not interrupted.

With the new RTGS system, as soon as the payment instructions come from the commercial banks directly to the CBSL, the account balances are checked automatically and settled accordingly. If there are no adequate funds, the transaction will

"Governor Jayawardena aims to make Sri Lanka a financial hub"



Mr. A. S. Jayawardena - The Governor CBSL

the event of a bank being placed in liquidation after it had written a large number of cheques which were to have been settled through LankaClear or the large value cheques that were to have been settled by the CBSL. Although this situation has never been experienced here, these risks are real and could happen at any given time. For example, the bankruptcy of a large paying bank would cause a domino effect that would filter through the entire financial sector and eventually the economy, until the CBSL intervenes to sort out the multi-lateral net balances and identify the bilateral transactions of that bank with each of the other banks and

be queued until such time money is available in the relevant bank's account. If, by the end of the day, there are still no funds to make the payment, then the transaction will be made void, thus reducing the potential credit risk relating to that transaction.

The second type of risk is the liquidity risk where a bank may fail to settle due to insolvency, liquidation, temporary liquidity problem or a technical problem. Therefore, there is a risk for the net receiving bank as it might not get its dues in full on the day it should receive its money. If such a risk were to arise, the CBSL will be called

upon to guarantee the payment obligations of the troubled bank and settle the transactions on its behalf. Although these risks have not realised in a small country like Sri Lanka where we know what is happening in the banking sector each day, these risk cannot be ruled out altogether.

Under the new RTGS system, the CBSL will not settle the net paying bank's payments unless there are adequate funds in its account.

Thirdly, systemic risk can occur if a large bank is unable to make its payments and that could have a "knock on effect" on other banks and their customers bringing the whole system to a grinding halt. Under the RTGS system, the CBSL will avoid such a situation by providing an intra day liquidity facility to all banks subject to the availability of collateral.

Introduction of the new SSSS

According to Mr. Jayawardena, investors will benefit vastly in the short and long term with the new SSSS. With Government securities being the biggest capital market in the country with over Rs. 400 billion being traded, the features of the new system will stimulate far more active trading in these securities. The scripless securities will eliminate what was a very cumbersome process. "The moment that extra paper work is eliminated, there will be a saving in cost to the primary dealers," says Mr. Jayawardena. As a result, the primary dealer or the bank can pass down this saving to the benefit of the investor buying Government securities.

Secondly, there is greater security with respect of ownership, where one's securities will not get lost or misplaced or misused. Thirdly, the speed of the settlement which is

instantaneous will enable the investor to maximise his/her investment as decisions can be made without delay. As the system gains recognition and is accepted and trusted, new investors will enter the market and existing investors will participate even more and trade in greater volumes.

Government securities are prime securities that are very much in demand. Presently, the EFP, ETF and NSB have large portfolios of securities that are generally not traded but held until maturity. At the same time, there are some private dealers or commercial banks who want such securities as collateral. With the convenience of scripless securities with SSSS, these large holders of securities can actively trade their securities to generate income. This type of trading can create another repo market outside the CBSL and enhance the transactions in the securities market.

A challenge facing CBSL is determining ways of changing investor's perceptions that there has to be tangible proof of ownership of government securities in the form of actual scrip. They need to be re-educated to trust a system that only sends a confirmation notice of the transaction, followed by monthly statements.

Another important factor is that, if we are to become a financial hub in this part of the world, then we must have a sound, efficient and up to date payment system.

With the introduction of RTGS and SSSS, this country would be considered a far more attractive location for overseas investors to invest their money. That will in turn benefit the country because a significant proportion of GDP comes from the financial services industry.