Liquidity Management in a Cross-Border Context

Speech by

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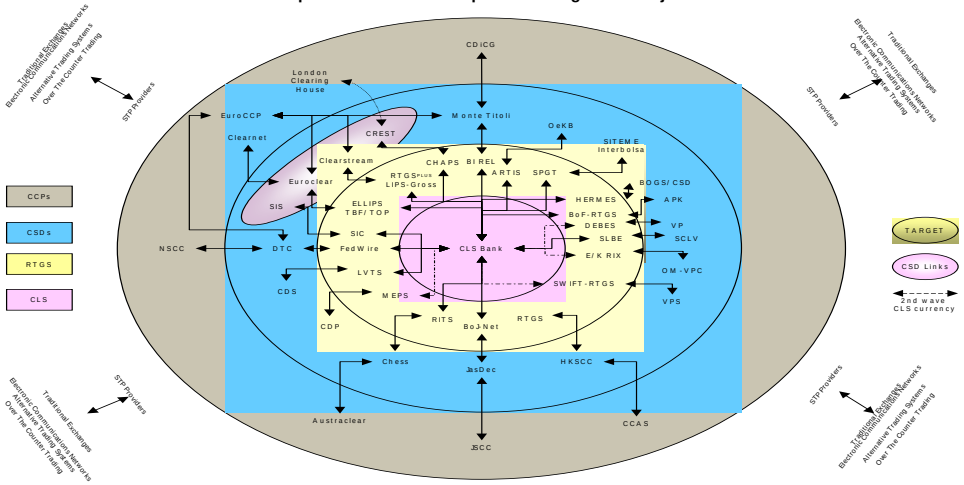
This will be a short and high-level journey through the issues, specifically designed to get some debate going. There are very few occasions in the life of a financial institution where business is conducted without the need to make or receive a payment. The payment systems, domestically and internationally, are the lifeblood of banking. Or to put it another way, they provide the plumbing system for business and commerce, and this is especially true for international business. As you know, plumbing systems can be generally ignored, as they manage very successfully without human intervention. However, if they come under pressure, or indeed break, they can be very unpleasant indeed. And it is against this rather colourful analogy that I make this presentation today.

When I put up this slide I usually have to assure the audience that this is an illustration of today's market, not some Orwellian view of something to come in a few years' time. And it is a very simplified version of the global plumbing system, and indeed it should be overlaid by all the many thousands of users, the custodial links and of course SWIFT in the majority of cases.

The simple version of plumbing in major markets



For simplicity the many hundreds of users, SWIFT and custodial links are not shown. Even so, the result is a complex web of linked real-time settlement systems.

It may be difficult to see exactly what it's describing. But I would emphasise that, although I put CLS in the middle of this, I'm not apportioning any blame to CLS for anything that's going along. It's merely a recognition of the unique linking of RTGS systems on a global basis to achieve real-time PVP. So, going from the centre, you've got CLS, then you've got the RTGS systems it connects to. Going outwards there is the CSDs and the ICSDs, and on the very outside the central counterparties. As you can see from my diagram, by linking together national RTGS systems in real time, connected to all these other players in the market, we have a very complex web of linked real-time settlement systems. All in all, we can say there is a potential for "domestic problems go on world tour".

Traditionally financial institutions have operated against a background of domestic clearing, both for securities and payments. And they were in silos, and in many cases those domestic silos were even segregated between payments and securities, until they came together at the end of the day for final settlement.

Of course these arrangements did have the benefit of keeping domestic problems within a small community. As most problems in these systems are operational rather than credit issues, it meant that the market continued when there was an interruption to service, because they had confidence that those central players would put it back together again fairly quickly and we could all get on with life without concerning ourselves.

Increasingly in today's world, and certainly in tomorrow's, a little local difficulty can be very quickly turned into a world event. This can happen through the real-time connections illustrated, and these connections are being made to achieve real-time DVP and PVP, which are a benefit to the whole system.

It's a common and rational action for individual firms to take avoiding action in this sort of connected world if they don't understand what's going on. In a domestic environment, you carried on as normal because you had trust and confidence. But in this globally connected world, you don't know what's caused the interruption to service. The individual actions of one participant are, quite understandably, usually sub-optimal for the system as a whole. So what is essentially my view, is the global

communication bridge. As previously described, a local problem is handled with a large degree of confidence. Most participants will understand what the issues are: who is addressing the problem, what are the communication channels for those issues, and subsequently what is the expected outcome, and the final resolution of the particular problem. With an international problem, of course, there is nothing like the same degree of knowledge of what's going on. What is the exact problem? Where is it? Who is doing something about it? Do I have to do something about it? Do I have to contact someone? And when is it likely to be resolved? These are just a few of the questions that are likely to be raised in this scenario. And therefore, the creation of a standing committee to coordinate action and communication in times of significant stress would normally be beneficial to the public and private sector alike. Because, of course, the stability of payment and settlement platforms is essential to the participants and benefits everyone.

During Y2K a global communication bridge was put into place to facilitate discussion, communication and resolution of any major issues that might have arisen during that period of time. And it was put to sleep two months after the date itself. In today's connected world we need a similar facility.

We will look now at the global demand for liquidity. And of course, the previous slide did speak of the need for communication and clarity during an incident, and that of course in itself would go an awful long way to prevent a liquidity gridlock before it started to impact or bite on the international community.

I now look at the ever-increasing demand placed on liquidity in global markets. The adoption of RTGS systems in most leading currencies, of real-time delivery versus payment (DvP) increasing in the securities market and of real-time payment versus payment (PvP) in CLS terms all imply an increased demand for liquidity to conduct payments.

We sorted out the credit risk side of it, but what about the liquidity impact, and of course the operational risk of connecting these together? Besides, collateral requirements are not limited to payment systems. There are increasing collateral requirements in low value payment systems, commercial transactions, derivatives exposure and many clearing houses. We've moved away from the very comfortable

world that we lived in not many years ago, to one where people are very aware of the credit issues around nearly everything we do.

In a number of cases in the private sector has been accused of “crying wolf”. It has been argued that there is not really an intraday liquidity problem today. For some cases we can plead guilty as charged. We’re not addressing today’s problem, we’re looking to prevent tomorrow’s issue, and like many, I would argue that prevention is much better than trying to fix a very sick patient. Of course it maybe too late when the patient is very ill.

Additional liquidity needs arise in part from a change in the payments paradigm. No longer is the value date the key driver to achieve settlement algorithms in real-time. It’s increasingly the specific time on the value date which rules our payment day. A simple definition of liquidity used by many people is “meeting your commitments as they fall due at reasonable cost” becomes more complicated in the new real-time environment. Failure to do just that, in intraday payment obligations, becomes immediate and very public. It has a reputation, regulatory and a financial impact on the firm and the market within which you operate.

Looking at liquidity tools which are around the place for specific systems. One can name, through-put guidelines, liquidity re-cycling arrangements, the EBA’s cross-system swap, the inside/outside swap at CLS or liquidity Provider Schemes. These work very well, but by their nature, they tackle specific issues and continue the legacy-way of addressing these issues silos or systems. In a connected environment we must increasingly address liquidity simultaneously across a number of different systems, often in several currencies at the same time. We need to move away from managing segregated pools of liquidity, because that is inefficient and costly to all participants, not just those at the core. Continually looking for individual solutions is at best a short-term tactic, but at worst perpetuates the separation of liquidity in system-specific silos or arrangements.

A report by the New York Payments Risk Committee has sought to improve the circulation of liquidity across systems. We call it the CCP, for Cross-border Collateral Pool, although I think it’s time we actually changed the acronym, because to a lot of

people in this room CCP is a central counterparty. But the CCP it is at the moment. It builds on existing infrastructure, and on the public and private sector working together.

A lot of people in this room will recognise the CCP, or the foundation of the CCP, in something we built for Y2K. In the preparations for Y2K, I was asked to chair a Group on Liquidity and Collateral Management We came up with a form of the CCP to address any interruptions in liquidity over Y2K.

For those who haven't already seen the CCP report, I won't go into any great detail. Most of you will have seen it, the report is available on the New York Federal Reserve Bank's website under the Payments Risk Committee logo, and you can download it. It's an interesting 120 page read. There are basically three variations described in the report, which, as it says here, are the cash , collateral and guarantee models, but in essence they all achieve the same. I would say that the collateral model is the one that is gaining more appeal, because it aligns more closely to the central bank arrangements that exist today. But the three variations result in a similar solution, the ability to mobilise excess liquidity or eligible collateral in one financial centre to obtain intraday liquidity in another centre, and reverse that during the same business day.

It is interesting that one of the main recommendations within the overall report was that central banks should consider accepting a wider range of international securities within their normal operations. I was very gratified to see that only yesterday the ECB put out a discussion document, a consultation if you will. One of the considerations is whether to take G10 securities within their operations.

With RTGS systems looking to extend their operating hours, to extend simultaneous coverage of overseas RTGS systems, it is crucial that intraday liquidity can be managed in times of stress over an ever-increasing settlement day. I would emphasise that we are not just looking at central banks for the solution. We are continuing to work on solutions to be implemented by the private sector alone.

It was considerations on responses to periods of stress that led to the CCP report, though the facilities requested may also be provided in everyday situations. From one end of this spectrum, the public sector normally has a standing facility in times of extreme crisis in the market, 9/11 if you will, or a situation equivalent to that. From the other end, something that could be used every day, in normal market conditions. For me, it's where on that same demand curve we can meet to agree on a solution to benefit all participants and enhance the efficiency of the global payments and settlements platform.

It is worth repeating my earlier comment: we're not looking for a solution for a critical problem today but rather to agree on a long-term strategic solution, for the ever-increasing demands on intraday liquidity and collateral around the marketplace, not just in payment systems. Of course, it is possible to segregate liquidity in national currencies, in domestic silos, in specific systems. However, the clear danger with holding an ever-increasing amount of collateral, is that payment system liquidity will create false markets in the underlying collateral that we're providing, and all participants in those systems will face rising costs. From everything I see, the demand on intraday liquidity and collateral will increase, not just for payment systems but for all other credit-related issues. However availability of intraday liquidity is not unlimited. A cross-border collateral pool would enhance the efficiency of the global payments and settlements environment for the benefit of all participants, not just those at the centre. It will also retain the primacy of central bank money in the global payment and settlement marketplace.

Finally, a few words on the way forward. In the early stages of the task force's work, the production of the report was seen as the final delivery. However, it quickly became apparent that it would be only the end of the beginning. The report was not something to be just posted on a website and left. The task force will remain in place for some time to come. A series of meetings has been arranged for infrastructure providers to meet with representatives of the task force and discuss how we can take this forward and enhance the debate. These meetings will take place over the next three or four weeks, and will be with the likes of Euroclear, Clearstream, S.W.I.F.T. and the DTCC.

There is a strong emphasis in the report to continue exploring private sector only solutions, individually or through various groupings. The Payments Risk Committee and the task force will continue to engage the public and private sector in debate to achieve adoption of these recommendations. However, to coin a phrase from the exploration of space “we are not alone.” We, the private sector, cannot address this issue on our own. The public and private sector engage in the same payment and settlement systems, and central bank money is the core means of settlement for the vast majority of high-value systems. It would therefore seem that we should work together to adopt a solution for the benefit of all participants.

Thank you very much.