

Report of the Financial System Council

## Measures for Ensuring the Stability of the Payment and Settlement Functions of Financial Institutions (Executive Summary)

### 1. Preface

It is desirable for the entire financial system to become efficient through further serious efforts by financial institutions to improve their financial and managerial base under appropriate pressure. From this viewpoint, it is appropriate for the deposit insurance system to return to a partial coverage system to protect small depositors, i.e. lift the current blanket deposit protection system.

Based on the Prime Minister's instructions, the Project Team has examined whether the payment and settlement network is sufficiently solid as a social infrastructure, and what measures are necessary for ensuring the stability of the payment and settlement functions of financial institutions.

### 2. Current state and future agenda for ensuring the stability of the financial payment and settlement functions

#### (1) Principal consideration in ensuring the stability of the payment and settlement functions

- It is indispensable in the interest of the public to ensure the stability of the payment and settlement functions performed by financial institutions, as most of the payments and settlements in our economy are conducted through this channel.
- In Japan, the mainstream of payments and settlements are made through direct debits from accounts opened with financial institutions and account transfers between financial institutions. This is very different from other major countries in which the cheque is used as the principal means of payment and settlement. There is a large difference among countries with regard to the approach to the issue of the stability of the payment and settlement functions, depending on legislation regarding the protection of deposits and the resolution procedure for failed financial institutions.

- Therefore, it is necessary to consider the appropriate measures in light of the situation in Japan, not necessarily modelled after the examples of other countries.

(2) Measures hitherto taken and the current agenda for ensuring the stability of the payment and settlement functions

Measures to reduce payment and settlement risks of financial institutions and systemic risks within the financial system.

On-site inspections and off-site supervision by the FSA, and examinations by the BOJ have been implemented for individual financial institutions.

Measures have been implemented to reduce systemic risks in the payment and settlement systems. It is expected that the development of a new system in the bill clearing system and the domestic money transfer system will reduce the risks of financial institutions and contribute to the smooth completion of payments and settlements in the event of a failure of a financial institution.

Measures to minimise the risk in the event of a failure of a financial institution

- Prompt procedures to wind down failed financial institutions have been implemented with an amendment of the Deposit Insurance Law in 2000.
- The status of the system for sorting depositor identification data has been inspected during on-site inspection; however, there is room for improvement with respect to data processing in this regard.

### 3. New measures for ensuring the stability of the payment and settlement functions

(1) Basic conditions of the new measures

- In order to ensure the stability of the payment and settlement functions in the event of a failure of a financial institution, it is essential to provide for early detection and prompt correction of the situation in the troubled financial institution, and to rapidly implement the procedure for winding it down. Such action will minimise the effect on the orderly functioning of the institution, including the payment and settlement functions.
- The stability of the payment and settlement functions should be achieved basically through ensuring the soundness of the financial institutions. Therefore, the following measures to ensure the stability of the payment and settlement functions should be designed as measures to prepare for a case in which the soundness of the financial institution is impaired in an exceptional circumstance.

- Based on the above, the basic conditions for the measures to ensure the stability of the payment and settlement functions should be to provide for a safe and secure means of payment and settlement other than cash, and to make it accessible to everyone, as a safety net for payments and settlements involving financial institutions.

(2) Framework of the measures

- After the termination of the blanket deposit protection system, there can be cases in which payment and settlements cannot be conducted in the event of a failure of a financial institution. There can also be cases in which payment and settlement transactions cannot be completed for transactions in process, even if the resolution procedure for failed financial institutions is promptly accomplished.
- In order to address such concerns, a type of deposit should be provided as a safe and secure means of payment and settlement, which is a deposit to be protected fully in the event of a failure of a financial institution (“payment and settlement deposit”). It is also necessary to prepare measures to ensure the completion of payment and settlement transactions in process.

(3) Provide a safe means of payment and settlement

The “payment and settlement deposit” as a safe means of payment and settlement

It is appropriate to make the “payment and settlement deposit” widely available, as a deposit to be used exclusively, in principle, for payment and settlement.

Definition of the “payment and settlement deposit” (the basic features are determined, and defined by its function)

The “payment and settlement deposit” is defined as a type of deposit meeting the three conditions below;

- Deposit redeemable on demand
- Provides normally required payment and settlement services
- Bearing no interest

(Note) As the “payment and settlement deposit” is defined as a legal concept, the question of which existing deposit categories are to be classified as “payment and settlement deposits” is an issue to be resolved in practice. For instance, the “current deposit” is clearly categorised as a payment and settlement deposit. If an “ordinary deposit” account yields no interest, it is also categorised as a payment and settlement deposit.

### Funding of the full protection

It is appropriate to fund the full protection for the payment and settlement deposit by the deposit insurance premium, and differentiate the rate of the premium from that for other types of deposits.

Ensuring the availability of the payment and settlement deposit in financial institutions

Financial institutions are urged to provide “payment and settlement deposits” to depositors requiring them, in view of the public interest and the network characteristics of payment and settlement. However, it is not appropriate to impose a legal obligation to provide such deposits, since it may hamper the entry of financial institutions with innovative business models.

Financial institutions are also strongly urged to promote the appropriate use of “payment and settlement deposits” in order to minimise the risks of large payment and settlement transactions.

Moral hazard arising from the full protection of “payment and settlement deposits”

Since zero interest incurs costs to the depositor (including opportunity cost), there will be a disincentive for depositors to deposit funds in excess of what is truly necessary for payment and settlement.

A higher insurance premium for the “payment and settlement deposit” can also act as a restraint for financial institutions to collect additional funds through this means at no cost.

- (4) Another option (an alternative scheme to protect “payment and settlement deposits” by a narrow bank account)

This is a scheme using a trust account which separates the “payment and settlement deposit” from other types of deposits, and which limits the investment of funds in this account to that in safe and liquid assets (such as JGBs). The advantage of such a scheme is to enable the provision of a safe means of payment and settlement with lower insurance premium cost. There can be a choice between this scheme and a system of full protection of those deposits under the deposit insurance system.

- (5) Completion of payment and settlement transactions in process

Based on the above, it is possible to complete an ongoing payment and settlement transaction smoothly if the funds are kept in a separate deposit account bearing no interest, since it is fully protected as a “payment and settlement deposit”.

However, some funds for payment and settlement transactions in process, such as those kept as temporary receivables or as a deposit in the name of the financial institution, are not covered by the current deposit insurance system, and cannot be used to complete the payment and settlement transaction in the event of a failure of a financial institution.

Thus, in order to complete such payment and settlement transactions, it is appropriate to clearly segregate the funds for payment and settlement in process, and to take the necessary measures to provide temporary funding such as loans from the Deposit Insurance Corporation.

#### (6) Prompt procedures for the resolution of failed financial institutions

In order to ensure the stability of the payment and settlement functions, it is still important to speed up the procedures for the resolution of failed financial institutions. In order to further provide for a smooth and rapid resolution of failed financial institutions through measures such as an improved sorting system for depositor data, it is appropriate to take the necessary measures.

### 4. Consideration in amending the system

#### (1) Agenda for the future

The need to ensure the stability of the payment and settlement functions is not temporary. However, it is necessary to review the measures above, as necessary, based on the principle of a least costly deposit insurance system.

The scheme mentioned above to ensure the safety of the “payment and settlement deposit” by a trust account is an attractive system which meets the principle of a least costly deposit insurance system. However, given the current earning structure and possible effects on the financial intermediary function of financial institutions in Japan, this alternative scheme should be considered for possible implementation in the medium to longer term.

#### (2) Consideration upon implementation

- Sufficient consideration should be made of the need to develop necessary computer software in financial institutions.
- When making available the payment and settlement deposit, financial institutions must not impose an undue burden on, or require unnecessary procedures with their customers, and consider the convenience of their customers.

- In order to prevent any confusion or concern of depositors, financial institutions must provide adequate explanation to depositors, and the government should actively provide information to the public.

(Note) For many depositors, particularly for individual depositors, it should be made clear once again that deposits are protected under the small deposit protection system up to a ceiling of 10 million-yen for the principal, plus the interest thereon, per depositor even after the lifting of the full protection system.

#### **5. Closing remark**

Concerning the payment and settlement system, measures to further reduce the risks of the domestic money transfer system is under consideration. In addition, measures are in progress to enable a more prompt resolution of failed financial institutions

In addition to such measures, it is anticipated that the stability of the payment and settlement functions in our economy is further reinforced by providing for a safe and secure means of payment and settlement as a safety net.