
Chapter I

Overview

1.1. The Payments System provides the arteries or highways for conducting trade, commerce and other forms of economic activities in any country. An efficient payments system functions as a lubricant speeding up the liquidity flow in the economy and creating a momentum for economic growth. The payments process is a vital aspect of financial intermediation; it enables the creation and transfer of liquidity among different economic agents. A smooth, well functioning payments system not only ensures efficient utilisation of scarce resources but also eliminates systemic risks.

1.2. The payments system assumes importance in the context of domestic financial sector reforms and global financial integration. The time value of money flows has increased sharply in view of the competing demands on the financial sector. Efficient, low cost cross-border payments flow helps to promote international trade in goods and services. Foreign investments (direct and portfolio) are encouraged by the availability of an efficient payments system. For these reasons, an efficient and technologically advanced payments and settlement system performs a vital infrastructural function in the economy. Central banks have, therefore, been taking measures to set up such an infrastructural set up.

1.3. Use of money for settlement of payment obligations has a very long history. Use of non-cash exchange through barter preceded the introduction of money. Barter, however, co-exists with monetised economy in some underdeveloped agricultural societies even now. But currency or cash, is the most readily accepted medium of exchange in all modern societies because it is the legal tender and helps to bring about irrevocable settlement.

1.4. There are, however, certain disadvantages associated with the use of cash. Holding cash does not fetch any return-the interest foregone because of cash holding is a cost to the holder of cash. Besides, the holder of cash bears some insurance costs in terms of the premia that is paid to cover any loss/theft. Moreover, carrying of large quantities of cash to make large-value payments is a security risk and also involves transportation costs.

1.5. The requirements of a modern economy in regard to settlement of transactions are diverse and variegated and the needs of manufacturing, trade, and commerce activities involve large value payments over vast geographic distances. External trade with the rest of the world involves payments in different currencies. Payments can no longer be completed by simple cash transfer in such cases. Therefore, there arises the need for additional forms of payments, which can be facilitated with improved financial intermediation and expansion of financial instruments. Cheques and other paper based instruments and to some extent electronic instruments have become important modes of payment in recent times in most countries because of growing financial intermediation.

1.6. Individuals, business entities or governments issue cheques or other forms of order on their banks in discharge of their payment obligations. The recipients of these orders would then get the funds embodied in these payment instruments through their own banks. As the number of banks grew over time, the volume of instruments exchanged among them increased substantially. Consequently, as also to have an orderly means of transfer of payment instructions among banks at a location or centre, a common set of practices and mechanisms of exchange had to be evolved. When instruments presented by customers of banks become payable at outside locations, special collection arrangements are set in motion to collect the funds. If the collecting bank has a branch at the relevant outside location, there would be no problem, but, if the collecting bank does not have a branch at the outside location, it will have to enter into correspondent banking relationship with another bank at the said outside location for the purpose of collecting funds.

1.7. The payment instruments which are routed through financial intermediaries involve book entries at various levels to transfer funds from one party to the other. The range of intermediation varies to take care of different situations. This may, for instance, consist of instructions to intermediaries to move goods coinciding with the movement of funds as in the case of a Letter of Credit. Or, the instruction could be for payment of specified sums of money to the bearer of a payment instrument, as in the case of a bearer cheque. In some cases, the payment instruments are negotiable in the sense that they can be transferred from person to person in lieu of cash. In yet other cases, both the ultimate beneficiary and the destination could be pre-determined. In all these cases, banks play a crucial part in conveying, transmitting and carrying out the instructions embodied in the payment instruments. While doing so, these intermediaries have to settle among themselves the monetary claims arising from the execution of payment instructions. Thus, whenever non-cash payment instruments are involved, they are accompanied by a chain of related fund transfers as well as a stream of book entries and messages. Banks in turn need an intermediate agency such as the clearing house where these instruments can be exchanged and where the financial claims on one another can be settled through a settlement bank, which is usually the Central Bank of the country.

1.8. Clearing Houses facilitate the exchange of instruments and processing of payment instructions at a central point among the participating banks. Clearing Houses-manual and paper based in many advanced countries have gradually extended their range of activities to include automated (ACH) and electronic means for settlement of payment transactions. Such an evolution is also seen in emerging economies.

1.9. Banks, as crucial intermediaries in the payments stream, provide deposit accounts to non bank agents (i.e. individuals, firms/corporate bodies) which are considered as liquid assets and facilitate payments transactions. Banks provide credit facilities so that such payments can be effected with lower working balances. Moreover, they act as conduit through which domestic and international capital markets provide resources to the commercial sector.

1.10. The payments system has a multiplicity of layers where several levels of intermediation occur in the transfer of funds from one person and/or institution to another. The structure of the Payments System can be visualised as a Pyramid, with linkages among different tiers of the payment intermediaries. At the base of the Pyramid are the non banks (all non-depository corporations including individuals and firms) whose assets are diverse, including bank notes and deposits. The types of payments at the base of the Pyramid include both cash and non-cash modes of payments. Banks are at the intermediate level. The assets of the banks comprise, among others, their reserves with the Central Bank, deposits with the correspondents and claims on the correspondents, and investments in Government and other securities, loans and advances and cash in their vaults. Typically, their liabilities would among others, be made up of deposits from non banks and correspondents and loans from the Central Bank. The Clearing House and the settlement bank are the financial intermediaries who channel the funds flow between the banks. At the apex of the pyramid is the Central Bank of the country (i.e. Reserve Bank of India) which has the settlement accounts of the banks and sustains the payments process.

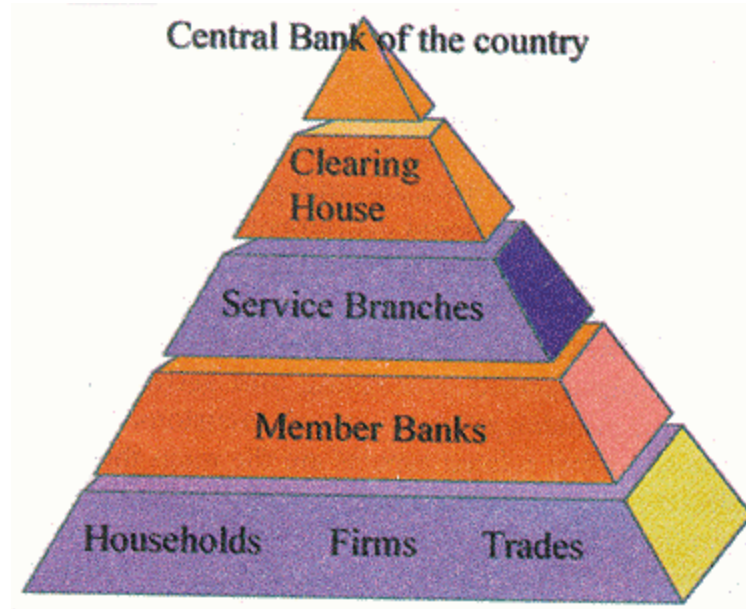


Figure 1.1. Payments System Pyramid

1.11. In the Payments System Pyramid, the Central Bank has a special role to play as the settling bank maintaining settlement accounts for banks. These are used by banks to discharge their obligations amongst themselves. While the settlement account can be maintained with any bank, there is always a risk of default by the settling bank. A failure of a settling bank can have disastrous consequences leading to a possible systemic collapse. Settlement accounts maintained with the Central Bank, on the other hand, provide the basic stability to the settlement process as the Central Banks cannot fail. The involvement of the Central Bank in the settlement process is therefore crucial.

1.12. This monograph is organised in the following way. After giving a brief account of the evolution of payments system in India in Chapter II, the various paper based instruments in vogue in India are discussed in Chapter III. The complexities of the existing paper based payments and settlement systems, Remittance Facilities and Currency Chests and the Uniform Regulations and Rules of Clearing for paper based instruments form the subject matter of Chapter IV. Given the increase in the volume of paper based instruments and the time taken for clearing these instruments, it was inevitable to move towards item-based computerised processing and settlement for improving systemic efficiency as well as customer service. These and other related aspects are the main themes of interest in Chapter V. In the early and mid 90s, a beginning was made in introducing ACH (Automated Clearing House) services such as Electronic Clearing Service (ECS) and Electronic Funds Transfer (EFT). The developments in this regard, including the establishment of a Shared Payment Network System (SPNS) of Automated Teller Machines (ATMs) are highlighted in Chapter VI. For an efficient electronic payments system, a strong and robust telecommunication network is necessary. The efforts made by the Reserve Bank in particular as well as the banking industry in general in setting up a telecommunication network to serve the needs of the industry form the contents of Chapter VII. The final chapter provides a brief idea of the challenges ahead in modernising the Indian payments system.