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To: Members of the Executive Board

From: The Secretary

Subject: Payment Systems, Monetary Policy, and the Role of the Central Bank - Appendix VI

The attached glossary (Appendix VI) provides supplementary material to the paper on payment systems, monetary policy, and the role of the central bank, which was circulated as SM/96/225 on August 20, 1996.

Mr. Omotunde Johnson (ext. 38574), Mr. Destresse (ext. 34221), or Mr. N. Roberts (ext. 36386) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

Payment Systems, Monetary Policy, and the Role of the Central Bank

GLOSSARY 1/

Prepared by the Monetary and Exchange Affairs Department
(In consultation with other Departments)

Approved by Manuel Guitián

August 16, 1996

1/ Most of the terms included in this appendix are based on definitions contained in *Payment Systems in the Group of Ten Countries*, prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten Countries, BIS, Basle, December 1993. The glossary explains technical terms as commonly used by central banks (mainly G-10 and EU).

Glossary of Major Terms Used in Main Paper and Appendices I-V

Automated clearinghouse (ACH): an electronic clearing system in which payment orders are exchanged among financial institutions, primarily via magnetic media or telecommunication networks, and handled by a data-processing center. See also clearing.

Automated teller machine (ATM): electro-mechanical device that permits authorized users, typically using machine-readable plastic cards, to withdraw cash from their accounts and/or access other services, such as balance inquiries, transfer of funds or acceptance of deposits. ATMs may be operated either on-line with real-time access to an authorization database or off-line.

Availability schedule: A schedule applied to accounting entries made as part of payments processing that specifies when financial institutions should release funds from the account of a payer and make funds available to the account of a payee.

Batch: the transmission or processing of a group of payment orders, and/or securities transfer instructions, as a set, at discrete intervals of time.

Bilateral net credit limit: the maximum net credit that a participant in a clearing arrangement is willing to have as a net credit position vis-a-vis another participant. See also caps.

Bilateral net settlement system: a settlement system in which participants' bilateral net settlement positions are settled between every bilateral combination of participants.

Bilateral netting: an arrangement between two parties to net their bilateral obligations. The obligations covered by the arrangement may arise from financial contracts, transfers or both. See netting, multilateral netting, net settlement.

Book-entry system: an accounting system that permits the transfer of claims (e.g., securities) without the physical movement of paper documents or certificates. See also dematerialization.

Caps: for risk management purposes, the quantitative limits placed on the positions (debit or credit positions, which may be either net or gross) that participants in a funds or securities transfer system can incur during the business day. Caps may be set by participants on credit extended bilaterally to other participants in a system, e.g., bilateral credit limits, or by the system operator or by the body governing the transfer system on the aggregate net debit a participant may incur on the system,

e.g., sender net debit limits. Sender net debit limits may be either collateralized or uncollateralized.

Central bank credit (liquidity) facility: a standing credit facility that can be drawn upon by certain designated account holders (e.g., banks) at the central bank. In some cases, the facility can be used automatically at the initiative of the account holder, while in other cases the central bank may retain some degree of discretion. The loans typically take the form either of advances or overdrafts on an account holder's current account, which may be secured by a pledge of securities (also known as lombard loans in some European countries), or of traditional rediscounting of bills.

Central securities depository: a facility for holding securities that enables securities transactions to be processed by book entry. Physical securities may be immobilized by the depository or securities may be dematerialized (i.e., so that they exist only as electronic records). In addition to safekeeping, a central securities depository may incorporate comparison, clearing and settlement functions.

Centralized queuing: see queuing.

Check: a written order from one party (the drawer) to another (the drawee, normally a bank) requiring the drawee to pay a specified sum on demand to the drawer or to a third party specified by the drawer. Widely used for settling debts and withdrawing money from banks.

Clearing/Clearance: clearing is the process of transmitting, reconciling and in some cases confirming payment orders or security transfer instructions prior to settlement, possibly including netting of instructions and the establishment of final positions for settlement. In the context of securities markets this process is often referred to as clearance. Sometimes the terms are used (imprecisely) to include settlement.

Clearinghouse: a central location or central processing mechanism through which financial institutions agree to exchange payment instructions or other financial obligations (e.g., securities). The institutions settle for items exchanged at a designated time based on the rules and procedures of the clearinghouse. In some cases, the clearinghouse may assume significant counterparty, financial or risk management responsibilities for the clearing system. See clearing/clearance, clearing system.

Clearing system: a set of procedures whereby financial institutions present and exchange data and/or documents relating to funds or securities transfers to other financial institutions at a single location (clearinghouse). The procedures often also include a mechanism for the calculation of participants' bilateral and/or multilateral net positions with a view to facilitating the settlement of their obligations on a net or a net net basis. See also netting.

Confirmation: a particular connotation of this widely used term is the process whereby a market participant notifies its counterparties or customers of the details of a trade and, typically, allows them time to affirm or to question in trade.

Correspondent banking: an arrangement under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services to those respondent banks. Such arrangements may also be known as agency relationships in some domestic contexts. In international banking, balances held for a foreign respondent bank may be used to settle foreign exchange transactions. Reciprocal correspondent banking relationships may involve the use of so-called nostro and vostro accounts to settle foreign exchange transactions.

Counterparty: the opposite party to a financial transaction, such as a securities trade or swap agreement.

Credit caps: see caps.

Credit card: card indicating that the holder has been granted a line of credit. It enables him to make purchases and/or draw cash up to a prearranged ceiling; the credit granted can be settled in full by the end of a specified period or can be settled in part, with the balance taken as extended credit. Interest is charged on the amount of any extended credit and the holder is sometimes charged an annual fee. Merchants also usually pay a fee when their customers make payments by credit card.

Credit card company: a company that owns the trademark of a particular credit card, and may also provide a number of marketing, processing or other services to the members using the card services.

Credit risk/exposure: the risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter. In exchange-for-value systems, the risk is generally defined to include replacement cost risk and principal risk.

Credit transfer: a payment order or possibly a sequence of payment orders made for the purpose of placing funds at the disposal of the beneficiary. Both the payment instructions and the funds described therein move from the bank of the payer/originator to the bank of the beneficiary, possibly via several other banks as intermediaries and/or more than one credit transfer system.

Credit transfer system (or giro system): a system through which payment instructions and the funds described therein may be transmitted for the purpose of effecting credit transfers.

Cross-currency settlement risk (or Herstatt risk): see principal risk.

Cross-system net debit cap: the maximum cap that a participant in a clearing arrangement can have with respect to other participants across all networks. See also caps.

Custody: the safekeeping and administration of securities and financial instruments on behalf of others.

Daylight credit (or daylight overdraft, daylight exposure, intraday credit): credit extended for a period of less than one business day; in a credit transfer system with end-of-day final settlement, daylight credit is tacitly extended by a receiving institution if it accepts and acts on a payment order even though it will not receive final funds until the end of the business day.

Debit caps: see caps.

Debit card: card enabling the holder to have his purchases directly charged to funds on his account at a deposit-taking institution (may sometimes be combined with another function, e.g., that of a cash card or check guarantee card).

Debit transfer system (or debit collection system): a funds transfer system in which debit collection orders made or authorized by the payer move from the bank of the payee to the bank of the payer and result in a charge (debit) to the account of the payer; for example, check-based systems are typical debit transfer systems.

Decentralized queuing: see queuing.

Default: failure to complete a funds or securities transfer according to its terms for reasons that are not technical or temporary, usually as a result of bankruptcy. Default is usually distinguished from a "failed transaction".

Delayed net settlement system (DNS): a net settlement system where the settlement is delayed. See net settlement system.

Delivery: final transfer of a security or financial instrument.

Delivery-versus-payment system (or DVP, delivery-against-payment): a mechanism in an exchange-for-value settlement that ensures that the final transfer of one asset occurs if and only if the final transfer of (an)other asset(s) occurs. Assets could include monetary assets (such as foreign exchange), securities or other financial instruments. See also final transfer.

Dematerialization: the elimination of physical certificates or documents of title that represent ownership of securities so that securities exist only as accounting records.

Direct debit: a pre-authorized debit on the payer's bank account initiated by the payee.

Direct participant/member: the term generally denotes participants in a funds or securities transfer system that directly exchange transfer orders with other participants in the system. In some systems direct participants also exchange orders on behalf of indirect participants. Depending on the system, direct participants may or may not also be settling participants. In the EU context this term has a specific meaning: it refers to participants in a transfer system that are responsible to the settlement institution (or to all other participants) for the settlement of their own payments, those of their customers and those of indirect participants on whose behalf they are settling. See participant/members, indirect participant/member, settling participant/member.

Draft: a written order from one party (the drawer) to another (the drawee) to pay a party identified on the order (payee) or to bearer a specified sum, either on demand (sight draft) or on a specified date (time draft). See also check.

EFTPOS: see point of sale (POS).

Electronic data interchange (EDI): the electronic exchange between commercial entities (in some cases also public administrations), in a standard format, of data relating to a number of message categories, such as orders, invoices, customs documents, remittance advices and payments. EDI messages are sent through public data transmission networks or banking system channels. Any movement of funds initiated by EDI is reflected in payment instructions flowing through the banking system. EDIFACT, a United Nations body, has established standards for electronic data interchange.

Failed transaction: a transaction (e.g., a funds or securities transfer) that does not settle on time, usually for technical or temporary reasons.

Final (finality): irrevocable and unconditional.

Final settlement: settlement that is irrevocable and unconditional.

Final transfer: an irrevocable and unconditional transfer that effects a discharge of the obligation to make the transfer. The terms "delivery" and "payment" are each defined to include a final transfer.

Float: the effect of a time difference between the crediting of a payee's account and the debiting of a payer's account as a result of a payment transaction. There can be several types of float, depending on (i) whether it occurs at the level of the relationship between commercial banks and their customers (customer float), or between the central bank and commercial banks (central bank float, interbank float, or bank float); and on (ii) the nature of both the payment instrument and the clearing process.

Giro system: see credit transfer system.

Gridlock: a situation that can arise in a funds or securities transfer system in which the failure of some transfer instructions to be executed (because the necessary funds or securities balances are unavailable) prevents a substantial number of other instructions from other participants from being executed. See also failed transaction, queuing, systemic risk.

Gross-settlement system: a transfer system in which the settlement of funds or securities transfers occurs individually on an order-by-order basis according to the rules and procedures of the system, i.e., without netting debits against credits. See real-time gross settlement, net settlement system.

Haircut: the difference between the market value of a security and its collateral value. Haircuts are taken by a lender of funds in order to protect the lender, should the need arise to liquidate the collateral, from losses owing to declines in the market value of the security.

Herstatt risk: see principal risk.

Indirect participant/member: refers to a funds or securities transfer system in which there is a tiering arrangement. Indirect participants are distinguished from direct participants by their inability to perform some of the system activities (e.g., input of transfer orders, settlement) performed by direct participants. Indirect participants, therefore, require the services of direct participants to perform those activities on their behalf. In the EU context the term refers more specifically to participants in a transfer system that are responsible only to their direct participants for settling the payments input to the system. See direct participant/member and settling participant/member.

Interbank funds transfer system (IFTS): a funds transfer system in which most (or all) direct participants are financial institutions, particularly banks and other credit institutions.

Intraday credit: see daylight credit.

Irrevocable and unconditional transfer: a transfer that cannot be revoked by the transferor and is unconditional.

Issuer: the entity that is obligated on a security or other financial instrument. For example, a corporation or government having the authority to issue and sell a security; a bank that approves a letter of credit. Sometimes used to refer to a financial institution that issues credit or debit cards.

Lamfalussy standards: six minimum standards for the design and operation of cross-border and multi-currency netting and settlement schemes, which apply equally to domestic interbank net settlement systems. The

standards reflect the concerns the central banks of the Group of Ten countries had in 1990. The standards are named after the chairman of that committee, Mr. Lamfalussy. See Table I in main paper for details.

Large-value funds transfer system (LVTS): interbank funds transfer system through which large-value and high-priority funds transfer are made between participants in the system for their own account or on behalf of their customers. Though as a rule no minimum value is set for the payments they carry, the average size of payments through such systems is relatively large. Large-value funds transfer systems are sometimes called wholesale funds transfer systems.

Liquidity risk: the risk that a counterparty (or participant in a settlement system) will not settle an obligation for full value when due. Liquidity risk does not imply that a counterparty or participant is insolvent since it may be able to settle the required debit obligations at some unspecified time thereafter.

Loss-sharing rule (or loss-sharing agreement): an agreement between participants in a transfer system or clearinghouse arrangement regarding the allocation of any loss arising when one or more participants fail to fulfil their obligation: the arrangement stipulates how the loss will be shared among the parties concerned in the event that the agreement is activated.

Magnetic ink character recognition (MICR): a technique, using special MICR machine-readable characters, by which documents (i.e., checks, credit transfers, direct debits) are read by machines for electronic processing. See optical character recognition (OCR).

Multilateral net settlement position: the sum of the value of all the transfers a participant in a net settlement system has received during a certain period of time less the value of the transfers made by the participant to all other participants. If the sum is positive, the participant is in a multilateral net credit position; if the sum is negative, the participant is in a multilateral net debit position.

Multilateral net settlement system: a settlement system in which each settling participant settles (typically by means of a single payment or receipt) the multilateral net settlement position that results from the transfers made and received by it, for its own account and on behalf of its customers or non-settling participants for which it is acting. See multilateral netting, multilateral net settlement position, settling participant and direct participant.

Multilateral netting: an arrangement among three or more parties to net their obligations. The obligations covered by the arrangement may arise from financial contracts, transfers or both. The multilateral netting of payment obligations normally takes place in the context of a multilateral net settlement system. See bilateral netting, multilateral net settlement position, multilateral net settlement system.

National payments council: a council, usually comprising of the central bank, the commercial banks, and other financial and nonfinancial organizations that actively participate in the payment system. The council discusses strategies and guidelines for the development of the payment system.

Net credit or debit position: a participant's net credit or net debit position in a netting system is the sum of the value of all the transfers it has received up to a particular point in time less the value of all transfers it has sent. If the difference is positive, the participant is in a net credit position; if the difference is negative, the participant is in a net debit position. The net credit or net debit position at settlement time is called the net settlement position. These net positions may be calculated on a bilateral or multilateral basis.

Net debit cap: see caps, net credit or debit position.

Net settlement: the settlement of a number of obligations or transfers between or among counterparties on a net basis. See netting.

Net settlement system: a system to effect net settlement.

Netting: an agreed offsetting of positions or obligations by trading partners or participants. The netting reduces a large number of individual positions or obligations to a smaller number of obligations or positions. Netting may take several forms that have varying degrees of legal enforceability in the event of default of one of the parties. See also bilateral and multilateral netting, novation, substitution.

Novation: satisfaction and discharge of existing contractual obligations by means of their replacements by new obligations (whose effect, for example, is to replace gross- with net-payment obligations). The parties to the new obligations may be the same as to the existing obligations or, in the context of some clearinghouse arrangements, there may additionally be substitution of parties. See substitution.

Off-line: in the context of payment and settlement systems, the term may refer to the transmission of transfer instructions by users, through such means as voice, written or telefaxed instructions, that must subsequently be input into a transfer processing system. The term may also refer to the storage of data by the transfer processing system on media such as magnetic tape or disk such that the user may not have direct and immediate access to the data. See on-line.

On-line: in the context of payment and settlement systems, the term may refer to the transmission of transfer instructions by users, through such electronic means as computer-to-computer interfaces or electronic terminals, that are entered into a transfer processing system by automated means. The term may also refer to the storage of data by the transfer processing system on a computer database such that the user has direct

access to the data (frequently real time) through input/output devices such as terminals. See off-line.

Optical character recognition (OCR): a technique, using special OCR machine-readable characters, by which documents (e.g., checks, credit transfers, direct debits) are read by machines for electronic processing. See magnetic ink character recognition (MICR).

Overnight money (or day-to-day money): a loan with a maturity of one business day.

Paperless credit transfers: credit transfers that do not involve the exchange of paper documents between banks. Other credit transfers are called paper-based.

Participant/Member: a party who participates in a transfer system. This generic term refers to an institution that is identified by a transfer system (e.g., by a bank identification number) and is allowed to send payment orders directly to the system or which is directly bound by the rules governing the transfer system. See direct participant/member, indirect participant/member.

Payment: the payer's transfer of a monetary claim on a party acceptable to the payee. Typically, claims take the form of banknotes or deposit balances held at a financial institution or at a central bank.

Payment lag: the time-lag between the initiation of the payment order and its final settlement.

Payment order (or payment instruction): an order or message requesting the transfer of funds (in the form of a monetary claim on a party) to the order of the payee. The order may relate either to a credit transfer or to a debit transfer.

Payment system: a payment system consists of a set of instruments, banking procedures and, typically, interbank funds transfer systems that ensure the circulation of money.

PIN (personal identification number): a numeric code that the cardholder may need to quote for verification of identity. In electronic transactions, it is seen as the equivalent of a signature.

Point of sale (POS): this term refers to the use of payment cards at a retail location (point of sale). The payment information is captured either by paper vouchers or by electronic terminals, which, in some cases, are designed also to transmit the information. Where this is so, the arrangement may be referred to as "electronic funds transfer at the point of sale" (EFTPOS).

Position netting: the netting of instructions in respect of obligations between two or more parties that neither satisfies nor discharges those original individual obligations. Also referred to as payment netting in the case of payment instructions.

Prepaid card (or payment card): a card "loaded" with a given value, paid for in advance.

Principal risk: the credit risk that a party will lose the full value involved in a transaction. In the settlement process, this term is typically associated with exchange-for-value transactions when there is a lag between the final settlement of the various legs of a transaction (i.e., the absence of delivery versus payment). Principal risk that arises from the settlement of foreign exchange transactions is sometimes called cross-currency settlement risk or Herstatt risk. See credit risk.

Provisional transfer: a conditional transfer in which one or more parties retain the right by law or agreement to rescind the transfer (e.g., when checks are deposited to a payee's account, the checks may still be dishonored, and the payee's bank may rescind the deposit).

Queuing: An arrangement, generally used in RTGS systems, whereby transfer orders are held until sufficient cover is available. In some cases, cover may include unused credit lines or available collateral. See also caps. Queuing arrangements can be divided into two types: (i) centralized, where the queue is handled by the payment system's central processor, and (ii) decentralized, where queues are handled by the individual banks themselves.

Real-time gross settlement (RTGS): a gross-settlement system in which processing and settlement take place in real time (continuously).

Real-time transmission, processing or settlement: the transmission, processing or settlement of a funds or securities transfer instruction on an individual basis at the time it is initiated.

Receiver finality: analytical rather than operational or legal term used to describe the point at which an unconditional obligation arises on the part of the receiving participant in a transfer system to make final funds available to its beneficiary customer on the value date. See final settlement.

Registration: the listing of ownership of securities in the records of the issuer of its transfer agent/registrar.

Remote participant: a participant in a transfer system that has neither its head office nor any of its branches located in the country where the transfer system is based.

Remote payment: payment carried out through the sending of payment orders or payment instruments (e.g., by mail). Contrast with face-to-face payment.

Replacement cost risk (or market risk, price risk): the risk that a counterparty to an outstanding transaction for completion at a future date will fail to perform on the settlement date. This failure may leave the solvent party with an unhedged or open market position or deny the solvent party unrealized gains on the position. The resulting exposure is the cost of replacing, at current market prices, the original transaction. See also credit risk.

Respondent: see correspondent banking.

Retailer's card: a card issued by non-banking institutions, to be used in specified stores. The holder of the card has usually been granted a line of credit.

Retail transfer system: interbank funds transfer system that handles a large volume of payments of relatively low value in such forms as checks, credit transfers, direct debits, ATM transactions and EFT at the point of sale.

Same-day funds: money balances that the recipient has a right to transfer or withdraw from an account on the day of receipt.

Securities depository (book-entry system): see central securities depository.

Sender finality: analytical rather than operational or legal term used to describe the point at which an unconditional obligation arises on the part of the initiating participant in a funds transfer system to make final payment to the receiving participant on the value date. See final settlement.

Settlement: an act that discharges obligations in respect of funds or securities transfers between two or more parties. See gross- and net-settlement system, net settlement, final settlement.

Settlement agent: an institution that manages the settlement process (e.g., the determination of settlement positions, monitoring the exchange of payments, etc.,) for transfer systems or other arrangements that require settlement. See final settlement, settlement, settlement institution(s), multilateral net settlement system.

Settlement finality: see final settlement.

Settlement institution(s): the institution(s) across whose books transfers between participants take place in order to achieve settlement

within a settlement system. See settling participant/member, settlement agent, multilateral net settlement system, bilateral net settlement system.

Settlement lag: in an exchange-for-value process, the time-lag between entering into a trade/bargain and its discharge by the final exchange of a financial asset for payment. See payment lag.

Settling participant/member: in some countries, a settling participant in a funds or securities transfer system delivers and receives funds or securities to/from other settling participants through one or more accounts at the settlement institution for the purpose of settling funds or securities transfers for the system. Other participants require the services of a settling participant in order to settle their positions. Currently in the EU direct participants are by definition also settling participants. See also direct participant/member.

Settlement risk: general term used to designate the risk that settlement in a transfer system will not take place as expected. This risk may comprise both credit and liquidity risk.

Settlement system: a system in which settlement takes place.

Smart card: a plastic transaction card which has a micro-electronic chip embedded into it that allows it to have a memory and computational abilities.

Substitution: the substitution of one party for another in respect of an obligation. In a netting and settlement context the term typically refers to the process of amending a contract between two parties so that a third party is interposed as counterparty to each of the two parties and the original contract between the two parties is satisfied and discharged. See novation.

SWIFT: (Society for Worldwide Interbank Financial Telecommunication): a cooperative organization created and owned by banks that operates a network that facilitates the exchange of payment and other financial messages between financial institutions (including broker-dealers and securities companies) throughout the world. A SWIFT payment message is an instruction to transfer funds; the exchange of funds (settlement) subsequently takes place over a payment system or through correspondent banking relationships.

Systemic risk: the risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets.

Transfer: operationally, the sending (or movement) of funds or securities or of a right relating to funds or securities from one party to another party by (1) conveyance of physical instruments/money; (2) accounting entries on the books of a financial intermediary; or (3) accounting entries processed through a funds and/or securities transfer system. The act of transfer affects the legal rights of the transferor, transferee and possibly third parties in relation to the money balance, security or other financial instrument being transferred.

Transfer system: a generic term covering interbank funds transfer systems and exchange-for-value systems.

Truncation: a procedure in which the physical movement of paper payment instruments (e.g., paid checks or credit transfers) within a bank, between banks or between a bank and its customer is curtailed or eliminated, being replaced, in whole or in part, by electronic records of their content for further processing and transmission.

Unwinding (or settlement unwind): a procedure followed in certain clearing and settlement systems in which transfers of securities or funds are settled on a net basis, at the end of the processing cycle, with all transfers provisional until all participants have discharged their settlement obligations. If a participant fails to settle, some or all of the provisional transfers involving that participant are deleted from the system and the settlement obligations from the remaining transfers are then recalculated. Such a procedure has the effect of transferring liquidity pressures and possibly losses from the failure to settle to other participants, and may, in the extreme, result in significant and unpredictable systemic risks.

Wholesale funds transfer system: see large-value funds transfer system.