

Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee



Electronic Processing of Debit Instruments

Decision Note

Romanian Banking Association Board & Regulation & Licensing Department and Payments Department, National Bank of Romania

Purpose of the note:

- 1) To enable RBA Board members and NBR to provide a preliminary assessment on the main features of the implementation plan for electronic processing of debit instruments proposed by the SPI project working group¹;
- 2) to enable NBR to validate the list of regulatory changes needed for the implementation of the electronic solution, as prepared by the SPI working group.

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1. Background

Clearing of debit instruments (DIs) is currently paper-based and is carried out through 42 local clearing houses. In order to speed up the processing of the debit instruments, the banking community has adopted an intermediary solution that allows centralized clearing at Transfond, where the physical exchange of paper-based DIs takes place, while the final migration to an electronic solution is designed.

The SPI Committee approved on September 14th, 2006 the undertaking of the SPI Project on technical and regulatory requirements for improving clearing and settlement of checks, drafts and promissory notes through their electronic processing. The project working group presented in December 2006 a comprehensive summary document presenting a solution for the electronic processing of DIs and a proposal for the preparation of the necessary regulatory amendments.

The SPI Committee decided that the plan conceived by the project working group (see Appendix 2), including the proposed regulatory changes for implementing the electronic processing of debit instruments, be vetted and endorsed by the RBA Board and NBR.

2. Description of the solution on the electronic processing of DIs

The proposed electronic processing of debit instruments means that paper-based instruments received by the beneficiaries' banks are truncated (their images are captured) at a local, regional or central level. The debit payment instructions and the DI's captured images are electronically submitted to the paying banks' units designated to be the SENT single points of access. The paying banks validate the payment based on the DI captured images and the payment instructions are cleared in SENT, with final settlement of the resulting net position in ReGIS.

The main difference brought by the electronic solution compared to the intermediary solution is that banks will exchange scanned images instead of paper – DIs and will validate payments based on these images. This will result in an increase in the efficiency of DIs processing, in terms of reducing the processing costs and the duration of the settlement period (to maximum 3 banking days).

The main phases of the proposed electronic processing of DIs (DI truncation, transmission of the electronic payment messages, electronic presentation in SENT, payment validation, clearing of DIs and settlement) are illustrated in Appendix 1.

3. Issues to be assessed and approved

The following issues should be assessed and approved by the RBA Board and NBR in order to ensure a coordinated approach in implementing the electronic solution for DI processing:

- Cost of installing the electronic processing infrastructure;
- implementation risks;
- regulatory requirements;
- next steps in project design and implementation.

3.1. Implementation costs of the electronic processing system for DIs

The implementation of the electronic processing of DIs will result in the following additional **costs** for banks:

- one-off IT investment, whose value depends on the truncation solution and on the volume of DIs processed;
- other implementation costs (e.g, preparing the internal procedures and staff training, etc).

At the same time, the automation of the major part of the operations will generate additional **benefits** for banks consisting mainly in savings in respect of:

- personnel and other operational costs (mail, archiving, etc);
- commissions payable by banks to Transfond.

Based on a preliminary Regulatory Impact Assessment analysis performed by Convergence and partially on Roland Berger data, the one-off IT costs borne by banks to implement the proposed solution were estimated at about RON 11 million for all the banks (as weighted average it has been estimated that each bank faces 288,000 RON for IT investments, based on data offered by Transfond). The annual benefits were appraised to RON 105 million per year, most of which come from staff savings (RON 96 million per year) and the remaining from possible reduction in Transfond's commissions (RON 9 million per year). As for Transfond, the implementation of the electronic solution will entail a IT one-off investment of RON 700.000 and will bring annual savings of almost RON 2 million by eliminating the annual average losses generated by the paper-based business.

The implementation of the electronic processing of DIs also sets out provisions that transfer part of such cost-effective measures to DIs end-users, by reducing the maximum settlement period to 3 banking days. The estimated amount transferred to end-users resulting from the reduction in the maximum settlement period with 3 banking days, as compared to the interim solution (6 banking days), could entail benefits of about either RON 48 million (assuming that companies are paying 3 days less interest for the credit lines/overdrafts financing their activity by receiving DIs' value earlier) or RON 13 million/year (if computed on interest received for current accounts, supposing that the total amount received earlier is maintained in the current accounts).

In a conservative approach and taking into account all the above mentioned benefits and costs (including also the potential decrease in the banks' income or increase in the interest costs due to the shortening in the settlement period), the net benefit for the banking system from the investment in DI electronic processing could be estimated at RON 46/81 million per year.

3.2. Regulatory requirements

The main legal and regulatory proposals that must be drafted and promoted for approval are the following:

- proposal for the amendment of the Cheque Law;
- proposal for the amendment of the Bill of Exchange & Promissory Note Law;
- proposal for the amendment of the Technical Norms accompanying the Cheque Law and the Bill of Exchange & Promissory Note Law (Technical Norm 9/1994, Technical Norm 10/1994);
- a draft for the amendment of the SENT System Rules;
- amendment or repeal proposal relating to certain National Bank of Romania's regulations (i.e. Regulation 10/1994).

In the interest of quick implementation, the regulatory design work could be initiated outside the NBR under close NBR oversight. In this respect, the NBR could designate an external counsel that will review the legal and regulatory preparatory work conducted by market stakeholders, before it starts its own internal review and decision-making process.

The proposed amendments of the two laws regulating DIs are to be finalized by the end of March 2007. The secondary regulations amendments should be presented for approval by June 2007.

3.3. Implementation risks of the electronic processing system for DIs

The planning and follow up of the implementation of the electronic processing of DIs should address all the risk factors that could ensure the smooth implementation: a) the uncoordinated approach of the banks, NBR and Transfond; b) the transition to the new solution; c) the lack of correlation between the technical specifications and the secondary regulations, d) the late enactment of the regulations..

a) The implementation of the electronic solution needs a careful planning and coordination. Based on the technical requirements, banks, Transfond and NBR could appreciate the time needed to adjust the IT software applications and to procure the necessary devices. The implementation plan to be presented by the project working group has to cover all the necessary steps, including the testing period and the transition period from the paper-based to electronic processing.

- b) A possible challenge for the banks is to ensure the minimization of the inconveniences caused by the technical works for the implementation of the electronic solution and by the transition period. The works and the tests have to be planned and carried out so that the current bank activities are not disrupted.
- c) The correlation between the technical requirements and specifications with the regulations should be ensured by the project working group's composition and by the work in parallel in the two sub-sections of the project under the project management team's continuous monitoring.
- d) In order to avoid delays in implementation, the authorities should be committed to ensuring the timely enactment of the regulations proposed by the project working group, duly vetted by external independent counsel and NBR Legal Department . This should be facilitated by the technical agreement reached among the project working group members where the authorities are represented.

In addition, the electronic processing of DIs itself could bring an increase in the operational risks due to the validation of DIs based on the scanned images (i.e. fraud risk). This risk could be mitigated through the adoption of high and uniform standards for the quality of the images.

On the other hand, the operational risks entailed by the manual processing of DIs are reduced, such as handling and mailing risks (especially in case of local truncation) and risks of non-reporting/delayed reporting of the payment incidents.

3.4. Other issues: administrative elimination of checks

The large portion of DIs transactions in the large banks' business, the imperfect replacement option and the still considerable demand for DIs are supporting the idea of maintaining checks.

While some counter-arguments exist in favor of eliminating the checks (i.e., the reduced portion of DIs transactions in some banks' business), in the consumers' opinion, as expressed by NACP, the elimination of checks could cause significant problems due to the difficulties to replace the commercial loans facilitated by checks with bank loans (for SMEs).

3.5. Next Steps

RBA Board and NBR are invited to send to the PMG and the SPI Secretariat detailed considerations about their views on the project design and implementation strategy. The PMG will take these considerations into account as it prepares the next operational phase.

We seek RBA Board views particularly in respect of issues summarized in paragraphs 3.1, 3.3 and 3.4.

We seek NBR views particularly in respect of issues summarized in paragraph 3.2, 3.3 and 3.4.

We would appreciate receiving a response by no later February 28, 2007.

Upon receipt of the RBA Board and NBR views, the next operational stage of the project will start with the objective to prepare the technical and functional specifications and the proposals for amending the legal and regulatory framework.

Therefore, the project working group will be enlarged and subdivided in to two subgroups:

- one sub-group to deal with the technical specifications (experts with economic and technical backgrounds);
- another other sub-group to deal with drafting up the proposals for laws and regulations (experts with legal and economic backgrounds).

The proposed amendments of the two laws regulating DIs are to be finalized by the end of March 2007.

The deliverables on the functional and technical specifications, as well as on the secondary regulations amendments will be presented for approval by June 2007.

Appendix 1: DI processing scheme

Appendix 2: PWG Technical Proposal