

## IBOS ASSOCIATION

### SWIFT STANDARDS RELEASE 2009

#### Overview of impact on operational processing and correspondent relationships

20<sup>th</sup> January 2009

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#### **The Wolfsberg Group and transparency of cover payments**

The most eye-catching component of SRG2009 is its incorporation of the recommendations on "Core Payments & Transparency" i.e. the outcome of the Wolfsberg Group's review. The recommendation is that the main contents of an MT103 need to be copied into a 202 or 205 cover payment.

Despite the push towards "serial" payments after 9/11, the "cover" payment model can still be justified if it is a "direct" payment **order**, with indirect delivery of **value**.

This applies to almost any scenario in which a bank is making a payment in a non-functional currency, and is so important to there being a range of payment routings between A and B (i.e. to there being consumer choice), that the rumours of its demise appear to have been exaggerated.

The issue for the regulators has been that the 202 or 205 covering a direct payment order has contained very little of the detail of the underlying payment. In consequence the 202/205 may have passed FATF filtering checks where the direct payment order would not have done.

In order to reverse this, 2009 SWIFT Standards Release introduces a new type of 202/205, tagged as "202 COV" or "205 COV" respectively, in which there are numerous new fields corresponding to fields in MT103.

The cost/effort of adoption by the industry could be huge if banks decide to address these changes on a "worst case scenario" basis. At any rate there will be a large cost for non-SWIFT based clearing systems like CHIPS and Fedwire to carry the requisite details in their own interbank messages.

Right now it is far from clear that banks regard SRG2009 as introducing a major new challenge. There is an unresolved conflict between this stance and the perception in the Wolfsberg Group (and the politicians that expressed opinions that gave rise to its formation) that there is a major risk loophole which needs to be plugged.

#### **Mandatory or not?**

Since the 202/205 COV message will be introduced in SWIFT's 2009 Standards Release Guide, it is mandatory as far as SWIFT is concerned for banks to be able to generate them, and to be able to receive and process them.

It is not so clear, however, to what extent financial regulators will make banks coming under their supervision transmit a 202/205 COV for all MT103s that are not serial payments: it would take a regulator audit to discover any failings in that regard.

Were there to be a failing, it could conceivably be attributable to a correspondent being unable or refusing to take a 202 COV i.e. the correspondent takes the view that, since it is not obliged to take an interest in the other bank's business, it will not bother to ask for 202 COV.

The correspondent's view will depend on whether the regulators for a certain currency (e.g. the Bank of England for GBP) will insist that all cover payments in GBP are done as 202 COV and

not as 202. A correspondent in that currency centre processing a 202 may not become aware that the message should have been a 202 COV

Applied to the Euro area, this last point is troublesome, because FATF rules are applied at a country level, whether the currency's regulator is the ECB. It would not be good if Euro could be moved via 202 in one country, but via 202 COV in another.

At any rate SWIFT would not have the facility to NACK a 202 because it should have been done as a 202 COV.

So there are outstanding issues around the legal compulsion to use 202 COV, both for sending banks and for correspondents.

### **Operational impact**

At a simple level all 202 COV does is to cause the copying over of main details of a payment message into its cover payment message.

However, it has more profound implications when it comes to considering whether beneficiary banks will act on MT103s that passed their own filtering upon receipt, without checking to see whether the MT202 COV arrived.

The guiding principle of cover payments up to now was the trust that the receiver of the 103 puts in the sender's undertaking to deliver good value to the receiver's SSI. Receivers would categorise that undertaking dependent upon its source, most obviously into:

- (a) We pay away as soon as we get the 103 from that bank = IBOS
- (b) We wait to see the cover from that bank

It has been assumed that major banks regard one another as trustworthy and where necessary apply for a credit limit or even a policy exemption for those banks' payments such that the MT103 can be processed upon receipt.

202 COV disrupts this logic chain by introducing an element over which the receiver has no control, and upon which they cannot make an informed decision, namely the FATF procedures of the correspondents involved. It is not a credit decision. The receiver could only take a view on the regulatory regime of the country of the currency being transferred if they felt it was sufficiently similar to the one in their own country as to render almost impossible a blocking of a cover payment where the 103 received did pass their own filter.

The risk if it goes wrong is that the MT103 was processed but the cover was blocked: it may be blocked in a suspense account or worse. The working hypothesis, within IBOS at any rate at the date of writing, is that this will be an unacceptable risk and that banks will in all cases switch to the policy of waiting to see the cover before paying on MT103 payments, however much trust they have in the sending banks.

### **First stage remedies**

Clearly the Sending Bank has to be encouraged send the MT202 to its relevant correspondent simultaneously with the dispatch of the MT103 to the Receiving Bank.

The Sending Bank should also inform itself of and ensure compliance with the STP requirements of its correspondent, such that the MT202 results in an STP payment through to the Receiving Bank or its correspondent as long as all filters are passed .

Where the overriding policy of the Receiving Bank is to wait to see the cover payment arrive before processing the MT103 from the Sending Bank, the Receiving Bank must ensure that it is in a position to identify the MT202/cover payment proceeds as soon as they are made available to it, and that the MT103 is then processed immediately.

These demands could result in a major upswing in banks obtaining real-time reporting on the nostro accounts in in-scope currencies.

On top of that banks would have to install the necessary systems and processes to link 202 COV messages received on the nostro to MT103 payments received at their BIC, such that the MT103 can be processed and credited within the GSL timeframes.

### **Exposure to other correspondents**

The above remedies can be regarded as a 'motherhood and apple pie' level of response. What makes the possibility of a delay in processing an MT103 by the Receiving Bank more likely is the exposure of the MT202 COV to delay in the country of the currency:

- the MT202 COV needs to be processed immediately by the sending bank's correspondent – if it passes the FATF checks – and to be passed on to the receiving bank's correspondent with all the detail that is additional under SRG2009
- there is a risk on the first correspondent (the Sending Bank's correspondent) in that their liquidity position in the intervening clearing system means that either the Sending Bank or the clearing house queues the payment
- then there is the risk that the sender's correspondent fails to pass on the extra detail to into the clearing, so that the receiving banks correspondent does not process it

None of these risks exist now where the MT103 Sending Bank is on the Receiving Bank's 'A' list.

### **Exposure to clearing systems**

- it would be an unacceptable risk that the clearing system itself is unable to take in the extra detail and carry it to the receiving bank
- This would mean that the clearing message might fail the AML tests at the Receiving Bank's correspondent
- The recent Payments Market Practice Group output on 202 COV identified this issue but then stated that it would be up to each local community to solve it

The upshot is that there is a series of issues in the base case scenario – where Sending and Receiving Banks use different correspondents.

### **Illustrations**

To illustrate whether MT202 COV could introduce delay, we have set out a diagramme below showing the pinchpoints.

There is a further illustration of how those pinchpoints can be circumvented, if sender and reciver use the same correspondent.

That is feasible for IBOS payments in an IBOS model i.e. a closed one, but would not work if extrapolated to third-party payments to/from any other bank.



### **PMPG guidelines**

The Payments Market Practice Group has issued its v1.3 guidelines on this topic in December 2008, and they downplay the impact of MT202 COV. SWIFT themselves are an important player in PMPG. The guidelines appear to leave a lot of open issues.

Firstly, there is the use of the word 'should' all the time. That can mean it is an opinion based on researching the issue, or it could be an order to banks/clearing system to do what is necessary to make sure MT202 COV does not delay operational processing. But in fact MT202 COV could change the game for the reasons we have laid out in the IBOS papers.

Secondly, PMPG and SWIFT recommend that a correspondent that has blocked a 202 COV should send a 299 to the sending bank, who should then send a 199 to the beneficiary bank. There are no timelines attached to the sending of the 299 or then the 199; the payment could have been waiting for several hours before the 299 is sent. The 299 and 199 often sit in queues or on printers.

There is no guidance, and there probably cannot be, as to how long the beneficiary bank should wait before it **does not get** a 199 in order that it can be comfortable that the cover was not blocked.

Then, when the cover is finally released, should there be another 299 and 199 to tell the sending/receiving banks that the issue which caused the preceding 299 and 199 has been solved? Or should there be periodical status reports by 299/199 like 'still waiting'?

And what should be the contents of the 299/199? A detail of what the payment failed on?

The PMPG guidelines leave too much open.

### **Credit Crisis**

Banks run an 'A' list (pay out on a 103 from that bank without waiting to see cover) and a 'B' list (pay out on that bank's 103 after we confirmed receipt of cover).

The credit crisis is right now causing review of those lists, which holds up payments and is an inevitable contributor to the liquidity squeeze.

A change where a beneficiary bank moves the sending bank onto their 'B' list will not be disclosed to the sending bank. That bank might only find out if the beneficiary customer (who, with intercompany payments, might well be the sending customer as well) raised a complaint to the sending bank that funds were not arriving as quickly as guaranteed.

### **Where are we now?**

Banks are adopting SRG 2009 as is mandatory as SWIFT members. However it is a more complex picture on usage and impact.

Banks do not seem to be contemplating changing their 'A' list/ 'B' list policy structure due to MT202 COV. Instead, the usage of MT202 COV is seen as making it easier for the beneficiary bank to identify the cover on an MT103, possibly allowing payments from 'B' list banks to be processed more quickly.

Banks in FATF countries also appear comfortable that, if they run their AML checks properly at their end, MT202 COV does not make a quantum difference to their risks. The extra risk is that the AML filters of the correspondents see something in the extra information that was not picked up by the sending bank. There is widespread confidence that these will be false positives, and not attributable to major differences in AML checklists.

**Is this a damp squib?**

The PMPG guidelines appear to imply that SRG2009 is nothing much to get concerned about. On the other hand its instigators considered that there was a major need for restructuring the Cover Payments model.

Banks are confident that their own AML lists do not differ greatly from those of their correspondents. Will that confidence prove to be well-founded.

There has so far been no great upswing in demand for real-time nostro reporting. Maybe it is happening but due to Payment Services Directive (and the requirement to put incoming funds at clients' disposal immediately) or due to regulator pressure on control of liquidity.

Or perhaps the financial regulators have not yet made clear to the banks what transactions must be carried out using MT202 COV.

The customer service level that would result if banks waited for MT950 the following day before paying on any MT103 would surely be unacceptable, as would the risk to the bank of paying the MT103 when still unsure of whether the cover had passed AML checks at the correspondents.

The overall position has to become clear some distance before November 2009, one would hope.

RJL/20.1.09