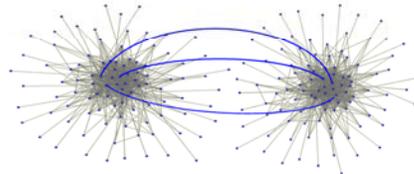




# Congestion and Cascades in Coupled Payment Systems



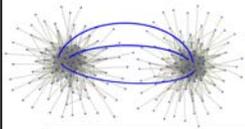
Fabien Renault<sup>1</sup>  
Morten L. Bech<sup>2</sup>  
Walt Beyeler<sup>3</sup>  
Robert J. Glass<sup>3</sup>  
Kimmo Soramäki<sup>4</sup>

<sup>1</sup>Banque de France  
<sup>2</sup>Federal Reserve Bank of New York  
<sup>3</sup>Sandia National Laboratories  
<sup>4</sup>ECB, Helsinki University of Technology

Joint Bank of England / ECB Conference on  
“Payments and monetary and financial stability”  
Frankfurt 12 November 2007

The views expressed in this presentation are those of the authors and do not necessarily reflect those of their respective institutions

**Speaker: Fabien**



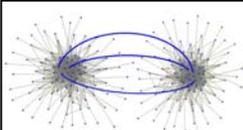
# Overview

---

- Motivation
- Single RTGS model
- Coupled RTGS model
- Correlation between the 2 RTGS systems
- FX settlement risk under non-PvP
- Queuing under non-PvP and PvP
- Conclusion

2

**Speaker: Fabien**



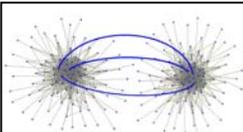
# Motivation

---

- The 2001 Group of Ten "*Report on Consolidation in the Financial Sector*" (the Ferguson report) noted a possible increased interdependence between the different systems due to:
  - The emergence of global institutions that participate to many systems
  - The emergence of global service providers offering services to many systems
  - The development of DvP procedures linking RTGS and SSS
  - The development of CLS
- The report suggested that these trends might accentuate the role of payment and settlement systems in the transmission of disruptions across the financial system.
- To complement this previous work, the CPSS (Committee on Payment and Settlement Systems) commissioned a working group to:
  - describe the different interdependencies existing among the payment and settlement systems of CPSS countries
  - analyze the risk implications of the different interdependencies

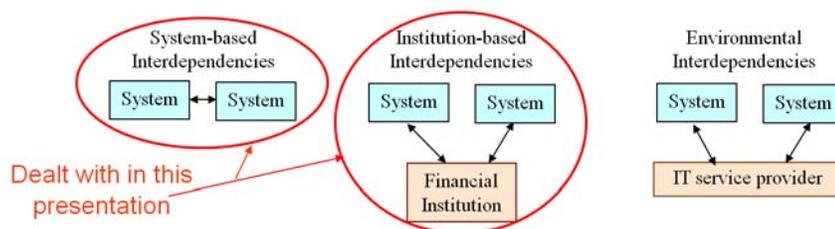
3

**Speaker: Fabien**



# Motivation

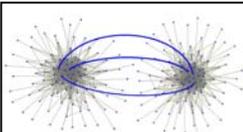
- Could a modeling approach provide any useful additional information to the regulators ?
- So far, payment and settlement system modeling has been mainly limited to a single system, with a few exceptions
- We model the interactions between 2 RTGSs
- Our model include two forms of interdependencies, as observed by the Working Group



- Real data will not be available at individual level... need for generated data

4

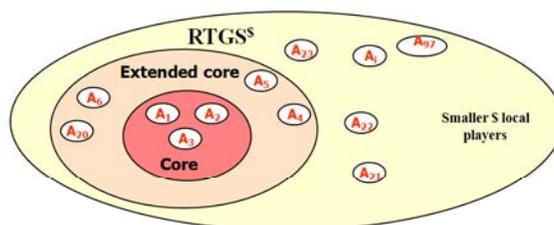
**Speaker: Fabien**



# Single RTGS model

## Model description

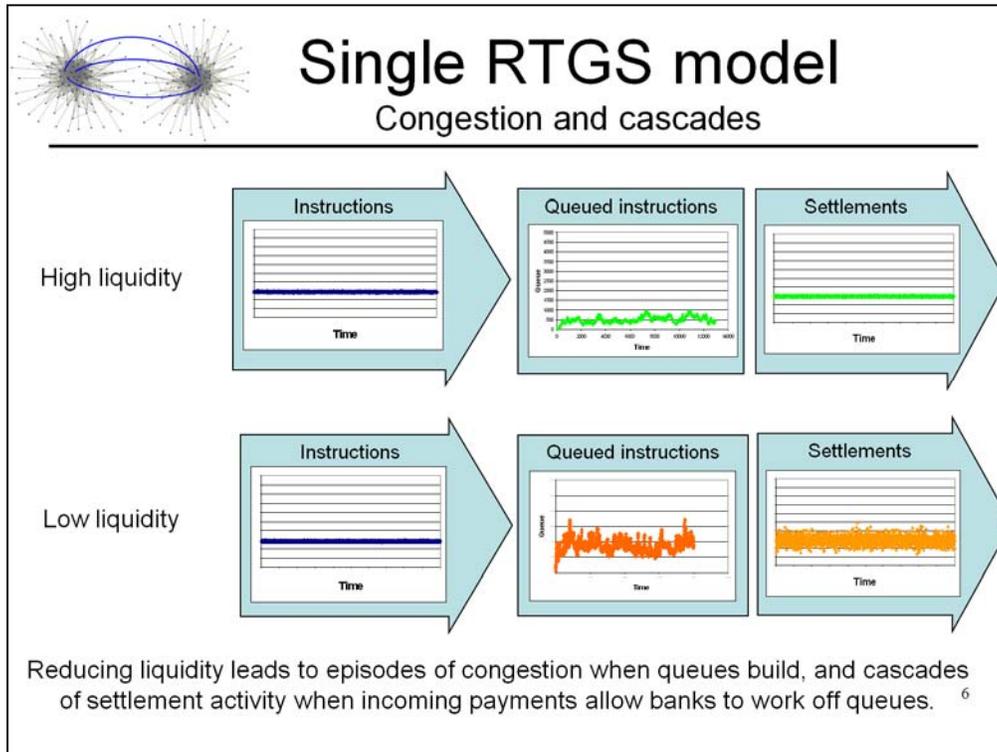
- RTGS<sup>s</sup> is a "virtual" RTGS
- The value of all payments is taken equal to 1
- Many participating banks of different sizes (initial balance at the CB, volumes emitted and received, number of counterparties...)



- The structure of the network (scale-free with an average of 12 counterparties per bank) was chosen in order to mimic the structure of the core of FedWire
- Payments are generated randomly between a bank and one of its counterparties, according to an intensity varying Poisson process
- Payments are settled immediately if the paying bank has sufficient liquidity, else they are queued until the paying bank receives some liquidity

5

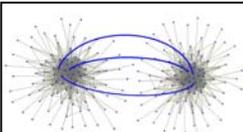
**Speaker: Fabien**



**Speaker: Robert**

Lowering liquidity couples processing across banks. Payments loose correlation with input because their timing becomes determined by internal dynamics of the system.

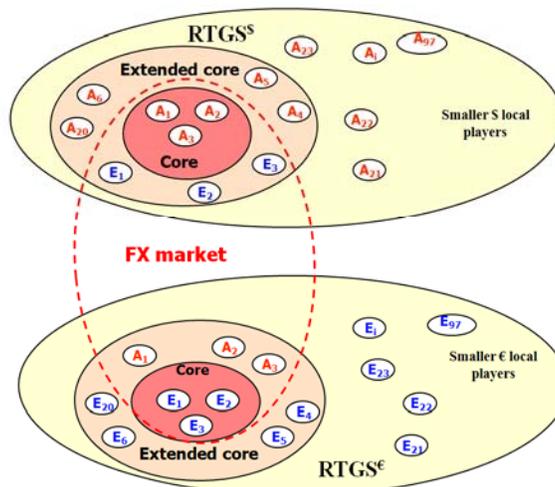
NOTE: we would see increasing correlation of payment activity between neighboring banks as correlation with instructions declines. This is akin to reaction function.



# Coupled RTGS model

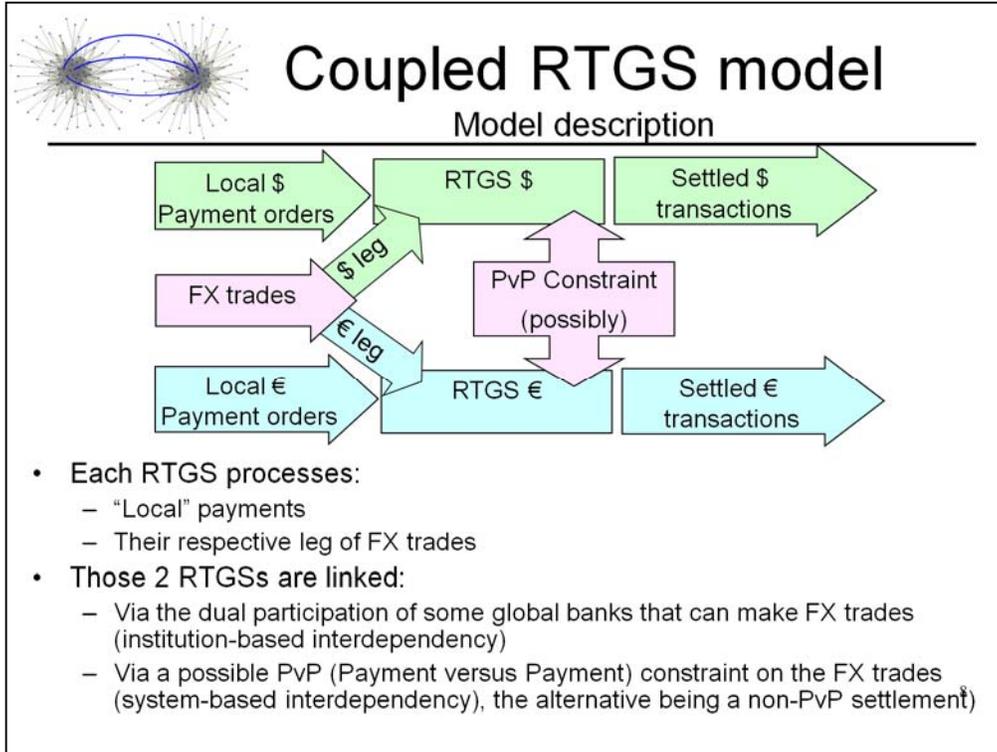
## Model description

- RTGS<sup>\$</sup> and RTGS<sup>€</sup> are two distinct RTGSs with two different currencies: \$ and €
- RTGS<sup>\$</sup> and RTGS<sup>€</sup> are similar in structure
- 6 “global banks”:
  - The 3 top banks in RTGS<sup>\$</sup>: A<sub>1</sub>, A<sub>2</sub> and A<sub>3</sub> which are also in the top 20 of RTGS<sup>€</sup>
  - The 3 top banks in RTGS<sup>€</sup>: E<sub>1</sub>, E<sub>2</sub> and E<sub>3</sub> which are also in the top 20 of RTGS<sup>\$</sup>
- The 6 “global banks” make FX trades (at constant exchange rate) between themselves
- FX trades are generated randomly between the global banks according to a model similar to the local payments generation model

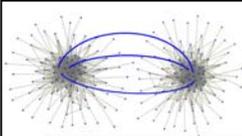


7

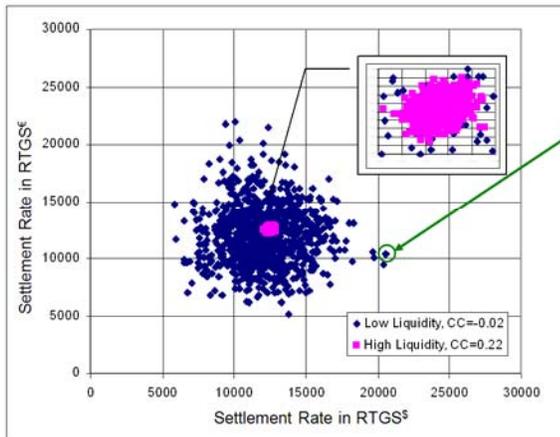
Speaker: Fabien



**Speaker: Fabien**



## Correlation between the two RTGS non-PvP case



Period of very high settlement rate in RTGS\$ and relatively low settlement rate in RTGS€

- The two systems are said to be “correlated” if statistically, a period of high settlement rate in one system corresponds to a period of high settlement rate in the other system
- High liquidity: some degree of correlation (0.22)
- Low liquidity: no correlation at all (-0.02)

Result of two simulations (low liquidity in both systems and high liquidity in both systems, non-PvP).

The observed settlement rate in both systems is sampled over several “time windows”

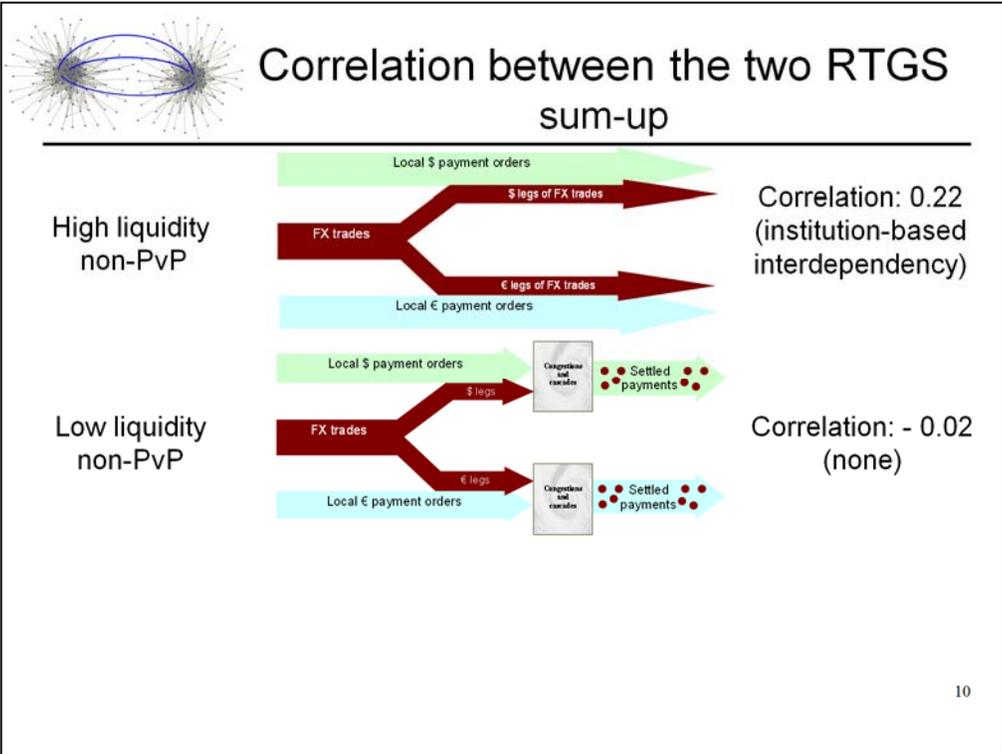
9

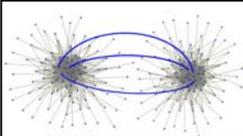
### Speaker: Walter

This is the settlement rate for the entire system, not just FX

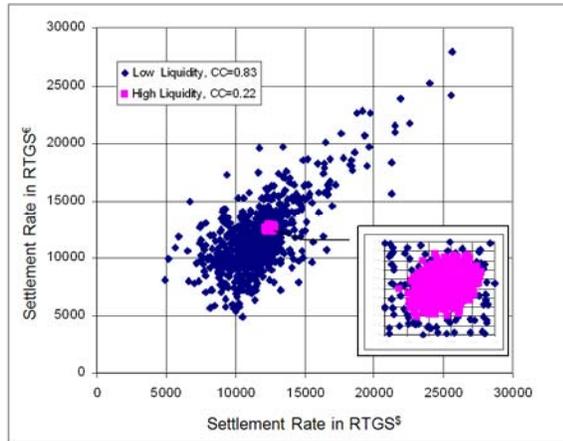
We’re showing settlement rates in the two systems measured over 1000 small time windows using different networks in each system

The systems are correlated only because their response is correlated to the input which is identical in each system...





## Correlation between the two RTGS PvP case



- High liquidity: same degree of correlation as in the non-PvP case (0.22)
- Low liquidity: high degree of correlation (0.83). A settlement cascade in one RTGS can settle an FX transaction and thus propagate to the other RTGS

Result of two simulations (low liquidity in both systems and high liquidity in both systems, PvP).

The observed settlement rate in both systems is sampled over several "time windows"

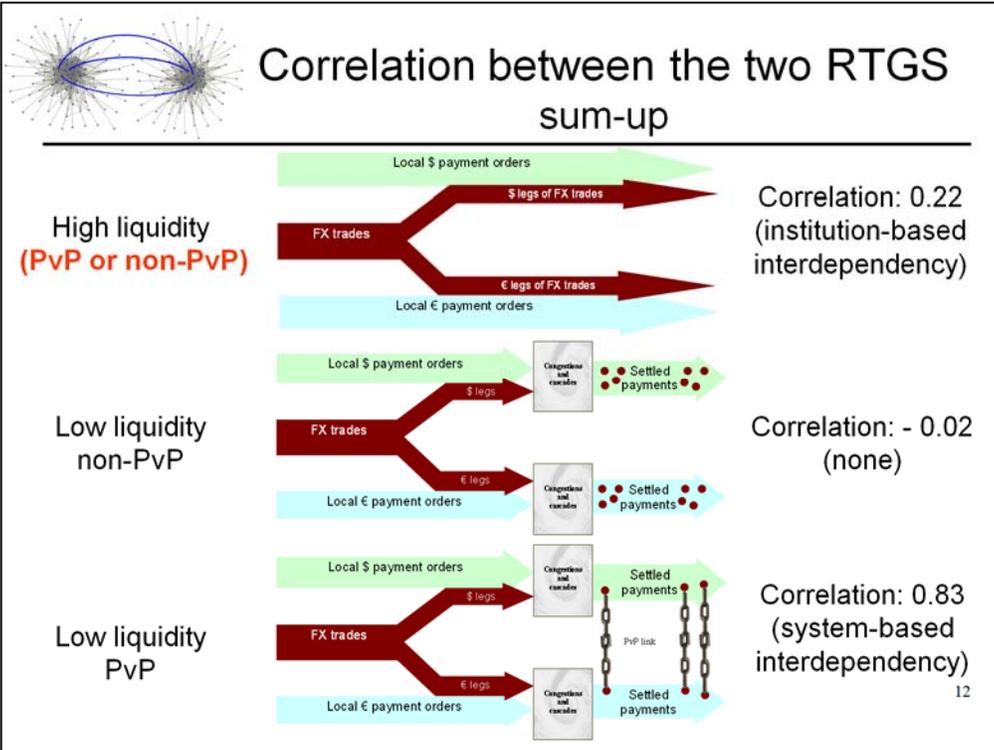
11

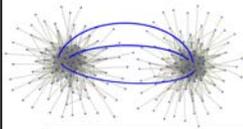
### Speaker: Walter

Note scale change from 25000 for FoP up to 35000 for PvP here

We're showing settlement rates in the two systems measured over 1000 small time windows using different networks in each system

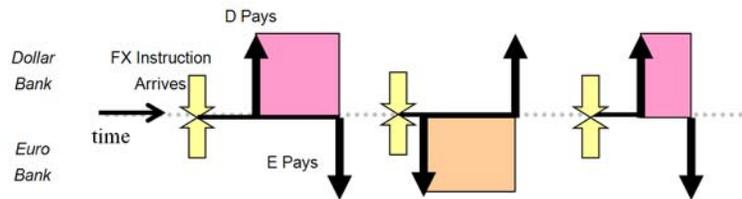
Red arrows points out the correlated high settlement rates (cascades) in each system triggered by PvP payments, there are also corresponding periods of correlated low settlement rates





## Exposure of Banks in case of non-PvP

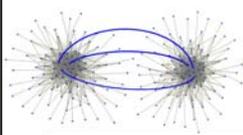
Non-PvP Creates Exposure due to Differences in Settlement Times



Settlement times may differ due to:

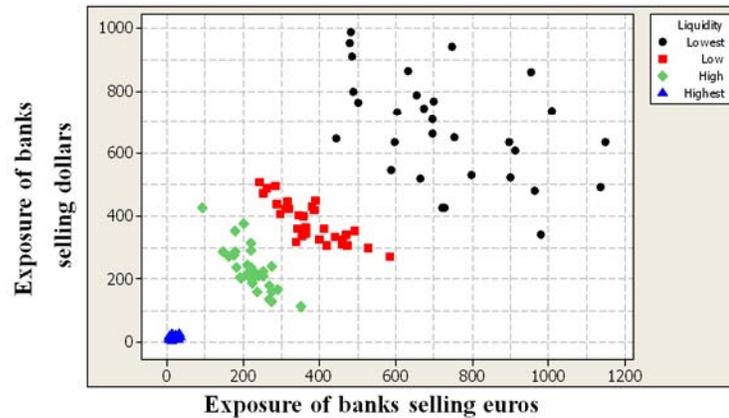
- structural differences (e.g. time zone differences or topology).
- Liquidity differences

**Speaker: Walter**



# Exposures and liquidity

Same level of liquidity and no priority for FX payments



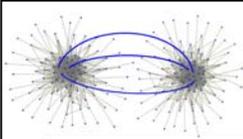
14

**Speaker: Morten**

We here show exposures between the € selling banks and the \$ selling banks, when both RTGSs have the same level of liquidity and with a no priority for FX payments.

As expected the aggregate exposures increase as liquidity decrease.

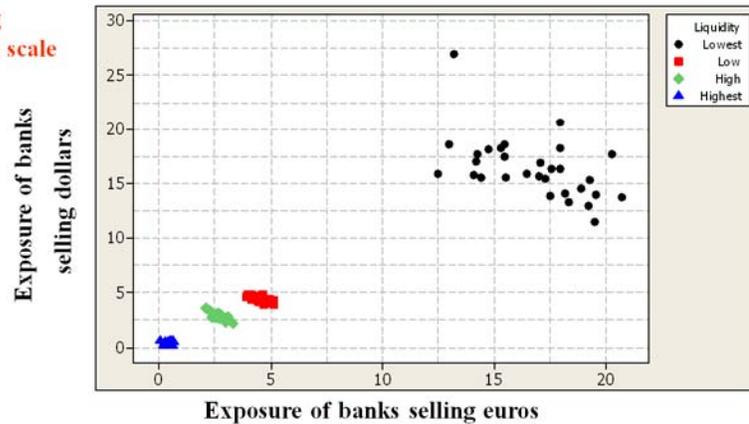
Whether the euro selling banks or the dollar selling banks are



# Prioritizing FX Payments

Same level of liquidity and priority for FX payments

Note big differences in scale

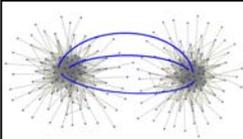


15

**Speaker: Morten**

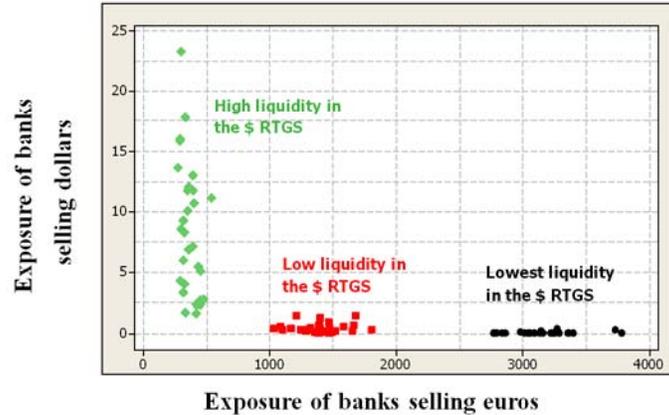
We here show exposures between the € selling banks and the \$ selling banks, when both RTGSs have the same level of liquidity and with a priority for FX payments.

In this particular case the priority for FX payments is sufficient to eliminate most of the exposure. Obviously all other types of payments are queued to a higher degree.



# Exposures and liquidity differentials

## High level of liquidity in RTGS €



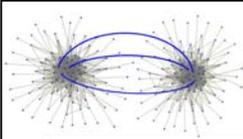
16

**Speaker:** Morten

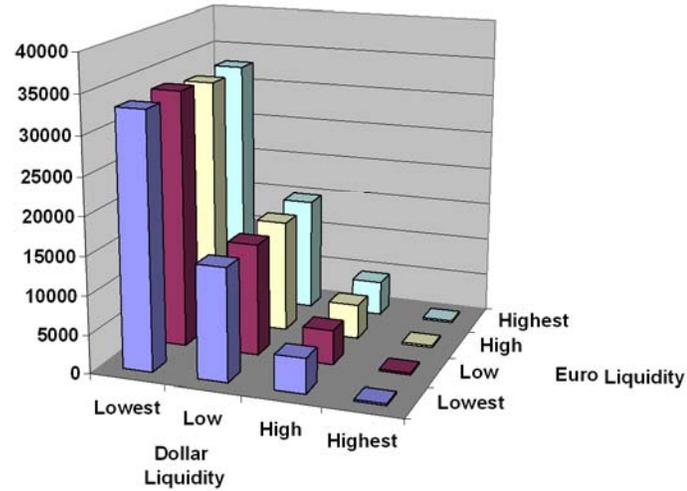
Here we show exposures between the € selling and the \$ selling banks, when euro liquidity is at the highest level and dollar liquidity varies.

The less liquid the dollar system is the higher is the exposure for the banks selling euros because euros are settled quicker than dollars.

Whether the euro selling banks or the dollar selling banks are



## Queues: non-PvP



17

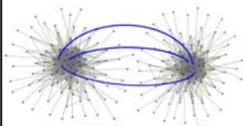
Average queue in dollar RTGS

**Speaker: Morten**

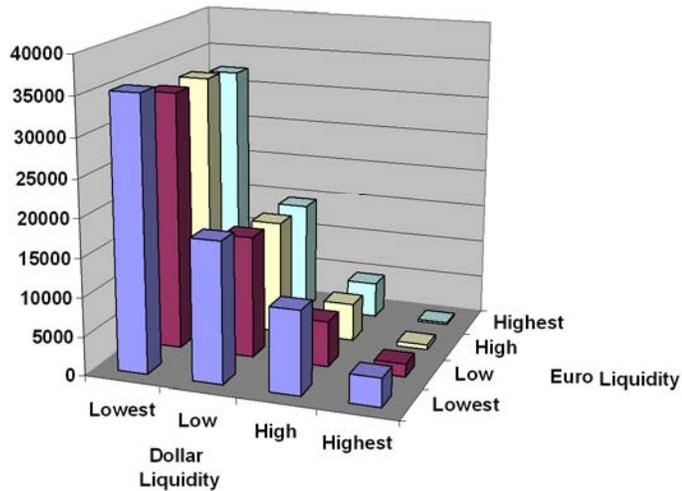
PvP eliminates the FX related exposures but introduces queuing

Here, we show the average

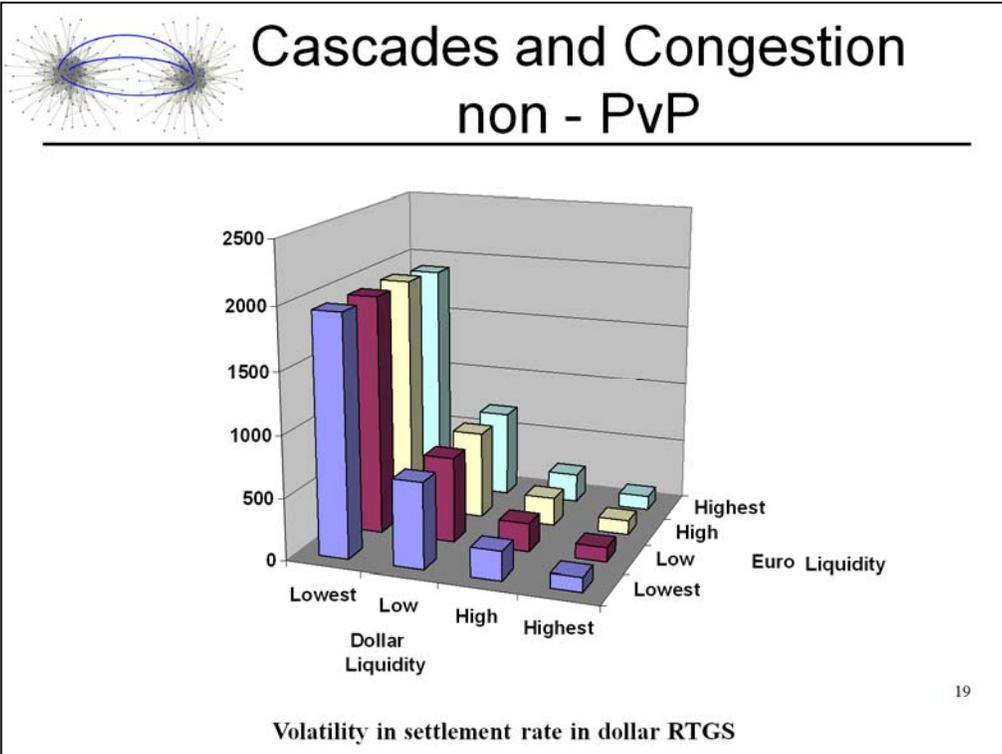
There are more queuing in the two systems when there is a PvP mechanism except when both systems are super liquid.



# Queues: PVP



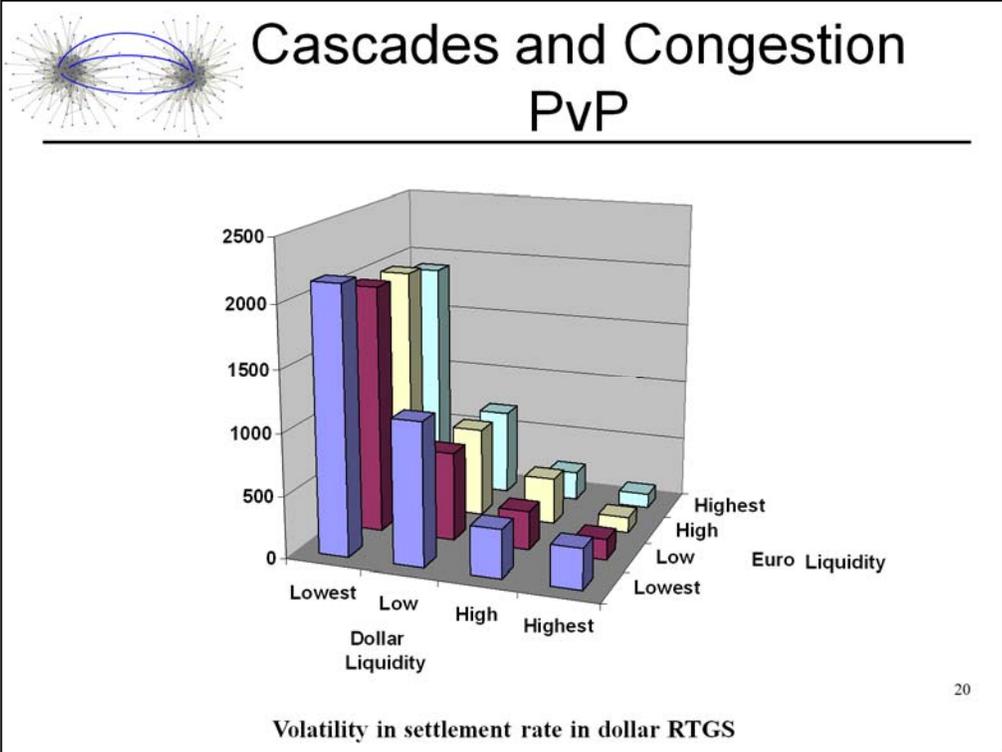
Average queue in dollar RTGS



**Speaker: Morten**

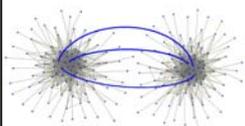
In the case of non-PvP the degree of cascades and Congestion here measured as the variability of the settlement rate is

- 1) Decreasing in the liquidity of the system
- 2) Does not depend on the liquidity of the other system



**Speaker: Morten**

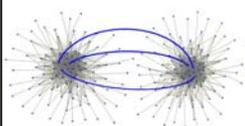
In the case of PvP the degree of cascades and Congestion is higher than non-PvP and the level depends on the liquidity of the other system.



## Conclusions

---

- At high liquidity the common FX drive creates discernable correlation in settlement
- At low liquidity
  - Congestion destroys instruction/settlement correlation in each system,
  - Coupling via PvP *amplifies* the settlement/settlement correlation by coordinating the settlement cascades in the two systems
- Queuing in systems increases and becomes interdependent with PvP
- Congestion and cascades becomes more prevalent with PvP
- Exposure among banks in the two systems
  - Is inversely related to liquidity available.
  - Is reduced by prioritizing FX
- Banks selling the most liquid currency are exposed



## Upcoming Investigations

---

- **Effect of settling FX trades through a net funding mechanism**
  - Decrease of the interdependency ?
  - However, the time critical payments would force the banks to set some liquidity aside...
- **Reaction of the global system to shocks**
  - Contagion of a local shock from one RTGS to another
    - Default of a local player (will the crisis spread out to the other currency zone?)
  - Effects of global shocks
    - Default of a global player
    - Total shut-down of a RTGS
    - Operational problems affecting the FX link
- **Influence of an intraday FX swap market**
  - Reduced queuing in normal operation
  - As a mitigation of a local shock affecting one RTGS (beneficial interdependency)
- **Additional market infrastructures (SSSs, CCPs, ICSDs, DNSs, markets...)**

**Speaker: Fabien**