



## **The Launching of Lesotho Wire System: Prospects for the economy**

***The Central Bank of Lesotho (CBL) has embarked upon the modernisation of the country's payment and settlement system as a way of strengthening the financial infrastructure and maintaining financial stability...***

### **Background**

One of the functions of the Central Bank is to promote a safe and efficient payment system. It is in this regard that the CBL is spearheading the reform of the payment system in Lesotho. The establishment of a Real Time Gross Settlement (RTGS) system has been identified as the catalyst towards the modernisation of both the banking and financial markets practices. RTGS is a centralised system in which inter-bank payments instructions are settled in real time throughout the business day. Transfers are settled individually without the netting of debits against credits as is the case in a traditional net settlement system. This means that banks can settle their payments amongst themselves immediately and irrevocably. The intra-day fund transfer feature of RTGS system reduces the following risks:

- **Payment system risk:** With funds available to cover the claim, the time to process the settlement is minimised, since the primary source of risks in inter-bank funds transfers is eliminated.
- **Credit risk:** The final funds transfers take place in real time; the payment is intertwined with delivery such that one takes place with ignition of the other. This ensures that the system is safeguarded against credit risk, which makes it very beneficial in financial deepening.
- **Systemic risk:** Since settlement takes place in real time, intra-day inter-bank exposures are substantially reduced. This minimises chances of banks having to absorb liquidity shortfalls in the event of any participating institution failing to settle its obligations. The RTGS limits the damage to just the immediate counter parties of a transaction as opposed to the risk spreading to the entire system.

The introduction of RTGS system involved more than implementing the software and hardware. It involved reengineering the core of the financial system in the sense that it has to interact and finally integrate with other systems. For example, it would interact with the net clearing systems by way of delivery versus payment and foreign exchange systems by way of payment versus payment.

### **The Traditional National Payment System**

CBL acts as the monitoring and controlling authority of the local clearing house. The clearing house/system operates a manual payment system, dealing with paper-based instruments, such as, cash, cheques, money and postal orders to effect payments. Participants at clearing house are drawn from the Commercial Banks as per the Financial Institution Act 1999. Management of the Clearing and Settlement Committee is made up of the Governor and Chief Executives of Commercial Banks. CBL acts as the settlement agent of the clearing and settlement system through Commercial Banks' settlement accounts.

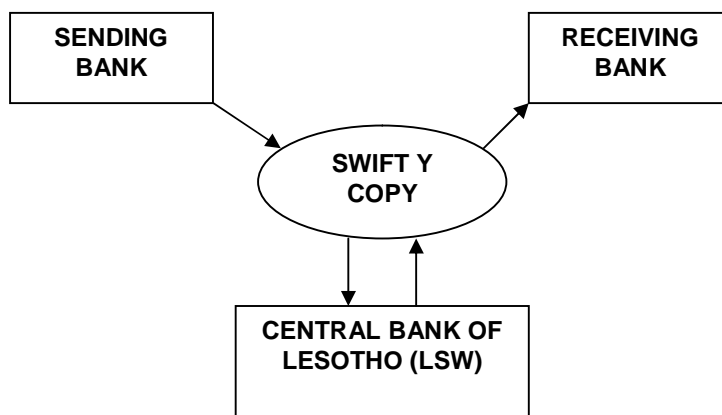
In a situation where a bank is not able to settle due to liquidity shortfall, CBL, through its Lombard Credit Facility, provides overnight liquidity boost. However, banks are required to provide the 91-days securities as collateral for this lending. Without RTGS, all debits and credits for one bank are netted out and a settlement figure is derived, and settled at a later stage. As a result, the following problems are encountered;

- a. If one of the banks fails to settle its dues, this may potentially spill-over and spread to the whole industry, and other banks ultimately fail to settle their obligations.
- b. Development projects are often put into jeopardy as suppliers and or contractors decide to slow down implementation until they receive the payments. They become victims of payment delays.
- c. With government, suppliers often quote higher prices in anticipation of payments delays upon completion of assigned tasks.

### Lesotho Wire System

With Lesotho Wire System, most payments originate from trade in various markets where a customer, following a trade agreement, instructs payment. Once the instruction has been received and accepted by a bank, the bank assumes responsibility for driving the payment to finality and irrevocable transfer of value. Banks initiate payment by verifying certain aspects of the payment instruction and determine the processing path to be followed through the inter-bank funds transfer processes. The payment mechanism in Lesotho Wire system can be depicted by the following:

Figure 1



The clearing process entails the exchange of payment instructions between banks. If the paying bank and the beneficiary bank are not the same institution, inter-bank settlement is required. The sending bank sends the payment message on behalf of its customer (payer) through the SWIFT<sup>1</sup> network called Y Copy. This is accomplished by posting entries across the accounts of the banks held at the Central Bank, resulting in final and irrevocable inter-bank settlement of the amount concerned. Banks complete their accounting processes and provide payment finality to customers upon receipt of confirmation that settlement has been successfully performed by the CBL. The cycle is completed once the beneficiary customer receives notification that the transfer of value has taken place, either explicitly or implicitly. The end-to-end payment process is part of the focus of the payment system reform initiative.

Lesotho Wire System draws its capabilities from the following characteristics:

- Only banks, including the Central Bank, are participants in the RTGS.
- Assets used for settlement are claims on the Central Bank with little or no credit and liquidity risks. This implies that sufficient funds are available, either as account balances or resulting from collateralised credit extension by CBL, in terms of its monetary policy.
- Finality on payment/settlement instructions is received through the system.

<sup>1</sup> SWIFT is Society for World-Wide Inter-bank Financial Telecommunication

- The CBL has access to the actual position of all banks in real-time.
- Banks are able to access their accounts at the CBL in real-time, which reflects their actual position in relation to other banks.
- Notifications to banks include sufficient information to pass entries in their books on a straight-through-processing (STP) basis.

The financial obligations resulting from the clearing of various payment streams are settled through RTGS.

### **Participation and Access Criteria**

Participants in Lesotho Wire System are the financial institutions and CBL, which acts as both the system provider and a participant on behalf of the Government of Lesotho. CBL oversees participation in the payment system, in terms of the legal framework as guided by the rule book of Lesotho Wire System. The Bank ensures that participants conform to the rules and regulations of participation, which are supported by well defined roles and participation criteria for different stakeholders. This means that a level playing field exists for all payment system service providers.

Other than the above mentioned participants, the rule book provides for access of the following entities to participate in the system;

- Foreign Banks, duly supervised in another country,
- Foreign Central Banks and
- Operators of domestic and foreign payments systems, clearing houses and securities settlement systems.

### **The Outlook**

The system serves as a base for the envisaged automated clearing house, which is expected to follow at a later stage. This will among others;

- Facilitate the inter-bank settlement and inter-bank clearing process, which is expected to enable other payment instruments.
- It has potential to promote the use of preferred payment instruments over traditional ones, and allow sufficient time for that change from traditional payments.
- The system will support establishment of a payment solution through the utilisation of mobile phone technology in order to compete with cash and attract the unbanked community.
- Establish debit card payment streams as backbone of the future retail payment instruments. This will encourage distribution of point of sale devices and merchant acceptance, and hence, international usage.

### **Conclusions**

Lesotho Wire system carries along with it, safe, speedy, affordable, accessible and efficient funds transfer mechanism. This forms the basis for development of inter-bank money market development in the economy as it may be cheaper for banks to place their funds with one another rather than the settlement accounts with CBL. It minimises various risks associated with payment and clearing systems, and for this reason, improves credit rating of the country. Fraudulent payments are minimised and managed in the payment system through proper design of payment instruments' security features, as well as system procedures. The system also conforms to international standards and principles governing settlements. Thus, participants and various stakeholders must fully do their roles to support the initiative so as to realise full benefits.

**Table 1. Monetary and Financial Indicators+**

	May	June	July
<b>1. Interest rates (Percent Per Annum)</b>			
1.1 Prime Lending rate	11.50	12.00	12.25
1.2 Prime Lending rate in RSA	10.50	11.00	11.50
1.3 Savings Deposit Rate	1.24	1.24	1.32
1.4 Interest rate Margin( 1.1 – 1.3)	10.26	10.76	10.93
1.5 Treasury Bill Yield (91-day)	7.10	6.90	6.90
<b>2. Monetary Indicators (Million Maloti)</b>			
2.1 Broad Money (M2)	2613.74	2703.98	2997.94
2.2 Net Claims on Government by the Banking System	-1471.58	-1283.97	-1793.79
2.3 Net Foreign Assets – Banking System	5129.82	5075.67	5840.59
2.4 CBL Net Foreign Assets	3827.23	3700.5	4323.58
2.5 Domestic Credit	-651.42	-461.92	-948.09
2.6 Reserve Money	379.52	438.80	379.03
<b>3. Spot Loti/US\$ Exchange Rate (monthly average)</b>	6.3178	6.9904	7.0769
<b>4. Inflation</b>	6.7	6.6	6.4
<b>5. External Sector (Million Maloti)</b>	<b>2005</b>	<b>2006</b>	
	<b>QIV</b>	<b>QI</b>	<b>QII</b>
4.1 Current Account Balance (Excl. LHWP)	-51.90	26.67	215.48
4.2 Capital and Financial Account Balance (Excl. LHWP)	102.73	99.88	-229.39
4.3 Reserves Assets	-86.9	-177.17	-441.12

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.

**Table 2. Selected Economic Indicators**

	2003	2004	2005	2006*
<b>1. Output Growth( Percent)</b>				
1.1 Gross Domestic Product – GDP	2.7	4.0	2.7	4.8
1.2 Gross Domestic Product Excluding LHWP	4.3	4.5	3.2	5.1
1.3 Gross National Product – GNI	6.0	6.1	3.4	5.7
1.4 Per capita –GNI	3.7	3.9	2.2	4.4
<b>2. Sectoral Growth Rates</b>				
2.1 Agriculture	0.3	13.5	20.0	10.7
2.2 Manufacturing	5.7	2.1	-8.0	1.2
2.3 Construction	-4.9	-4.4	2.5	2.8
2.4 Services	6.1	2.6	3.5	2.8
<b>3. External Sector – Percent of GNI Excluding LHWP</b>				
3.1 Imports of Goods	84.0	84.5	69.5	77.7
3.2 Current Account	-6.3	-1.2	-1.0	8.6
3.3 Capital and Financial Account	3.9	1.5	2.0	2.3
3.4 Official Reserves (Months of Imports)	5.6	5.2	6.4	7.1
<b>4. Government Budget Balance (Percent of GDP)</b>	-0.4	5.6	4.4	9.3

\* Preliminary estimates