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Remarks by

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Ladies and gentlemen, in the last two days we have covered a lot of ground, and I will keep my remarks short. One of the most intriguing aspects of this conference is that, in some areas, I sense new possibilities to improve international settlement arrangements. This in turn would permit a reduction in risks in the international financial markets. In other areas, we need to increase our efforts.

This morning Dr. Breuer helped sensitize us to the need for stronger settlement arrangements in the international securities markets. Volumes of transactions are growing very rapidly and the settlement arrangements are quite complex. It is easy to give up trying to make progress on cross-border settlement issues because so many financial institutions and regulatory players are potentially involved. However, I believe we must continue to make progress in this area, particularly before problems develop, and not simply to give up because progress is difficult.

Both yesterday and today we have heard that Herstatt risk has grown but that new possibilities exist to improve settlement techniques and reduce risk. I will say a bit more about clearing houses in a moment. First, I would like to reemphasize the point that Herstatt risks may ultimately be reduced by changes in the settlement techniques used in the foreign exchange markets. For example, individual banking organizations may choose to offer their correspondents special settlement services, including delivery-versus-payment facilities. Such facilities may be more

feasible as the hours of operation of national payment systems are lengthened and real-time settlement becomes available in most currencies. Entirely new settlement arrangements may also become possible, as operational barriers are reduced to the use of real-time settlement in the international markets.

The point is that new ideas need to be explored, both within individual banks and among banking organizations. I found it interesting that a number of representatives of the banking industry believe that there must be stronger on-going communications within the banking industry on topics such as the improvement of foreign exchange settlement arrangements.

The majority of today's program for the Symposium has been devoted to a discussion of prospects for applying clearing house methods to OTC derivatives. As you have heard, private market participants and clearing organizations have devoted substantial time and effort to making such arrangements a reality. None of these projects has yet reached fruition, but their efforts already have deepened our understanding of the costs and benefits of such arrangements. As a result, the business case for private market participants to join a clearing house has become clearer and the range of unresolved public policy questions has narrowed.

One thing that has become apparent is that the start-up costs for a clearing house are quite substantial. These include the costs of hardware, software, and communications systems, including the creation of back-up facilities to ensure operational reliability. Legal costs also can be considerable,

especially if the clearing house involves cross-border participants or settlements. The existence of these start-up costs requires potential participants to examine carefully and critically the potential benefits of a clearing house. Moreover, the fixed nature of these costs implies that the clearing house must attract a critical mass of participants to be economically viable. This can be especially challenging when some participants perceive smaller net benefits than others, often because the status quo entails competitive advantages. The business case also tends to be obscured by the lack of reliable information on levels of activity in OTC markets. In this regard, I am struck by the important role that the cooperative development of a data base on foreign exchange activity has played in supporting the business case for the Multinet project.

Progress also has been made in clarifying the public policy issues raised by clearing house proposals. In this regard, I think we have seen evidence today that the Lamfalussy Report has provided a useful framework for discussion of the public policy implications of foreign exchange clearing houses. The central conclusion of the Lamfalussy Report was that netting arrangements have the potential to reduce systemic risk, provided that the arrangements are properly designed and operated. Such netting arrangements clearly include clearing houses for foreign exchange contracts or other financial instruments. In order to help ensure that systemic risks are properly controlled, the Lamfalussy Report set out broad minimum standards that are

applicable to the design and operation of clearing houses. The Report stressed, however, that the responsibility for developing new netting arrangements and for ensuring their sound operation rests with the private sector, not with central banks. This emphasis reflected both concern about moral hazard and a realization that the private sector was best equipped to determine how to design netting systems that meet the standards. As the presentations today suggest, in practice the best design may vary from product to product and from market to market.

While the work that has been undertaken seems to confirm the value of the Lamfalussy standards, it has also highlighted areas in which public policymakers need to do more work. Perhaps the most important work involves the legal enforceability of netting agreements. Although substantial progress has been made in some legal jurisdictions, in others considerable legal uncertainty persists. I believe the most effective step that could be taken to promote enforceability would be to promptly implement the proposal that the Basle Supervisors released last year to recognize bilateral netting for capital adequacy purposes. This would create incentives for progress in all jurisdictions. Further work also is needed to clarify the application of capital requirements to clearing house arrangements for derivatives. I recognize that it has been difficult to reach conclusions without concrete proposals to analyze, but concrete proposals seem imminent and their analysis should be expedited.

With the proper incentives in place, I am confident we can look forward to further progress in reducing costs and risks in the clearance and settlement of OTC derivatives. As we have heard today, for interest rate products that progress may well be incremental. Bilateral collateral arrangements already are spreading and a centralized collateral management service may be the next logical development. But as market activity continues to expand, collateral costs and increasingly stringent counterparty credit limits may prompt more serious consideration of proposals to introduce true clearing houses. At each step, market participants, operating within the broad guidelines of the Lamfalussy standards, will ensure that the benefits of risk reduction exceed the costs.

Finally, on behalf of the Federal Reserve, I would like to thank all of you for joining us at our International Symposium. I trust that the program has raised important issues and will continue to stimulate thought and discussion, as well as action, within the international banking community. I wish everyone a safe journey home and a pleasant weekend. Our Symposium is now adjourned.