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DEVELOPMENTS IN THE DOLLAR PAYMENTS SYSTEM

Remarks by

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Good afternoon ladies and gentlemen. We have had a very interesting series of presentations today. The main focus of my concluding talk this afternoon will be on the Federal Reserve's public policy objectives for the dollar payment system and some of the Federal Reserve's recent policy initiatives in this area. First, however, I would like to make a few remarks about the Federal Reserve's broad central banking responsibilities and objectives.

The past two decades have posed extraordinary challenges not only for the Federal Reserve but also for central banks in other industrialized countries. These challenges have included worldwide inflationary impulses in the 1970s, and their aftermath; an international debt crisis that threatened financial institutions in both developed and developing countries; a worldwide stock market crash of historic dimensions; and the prospect of rekindled inflation, followed by recession and a credit contraction. Today we have moved in the United States toward sustainable real growth coupled with a low level of inflation. It is imperative that the hard won gains in stabilizing the U.S. economy, along with its financial institutions, not be lost. Other industrialized countries are also moving, at different rates, toward this same objective.

It is against this backdrop that I would like to address recent discussions in the United States involving the public benefits of the broad central banking role of the Federal Reserve. Throughout the difficulties of the past 20 years, the

Federal Reserve has played an important role both in stabilizing monetary conditions and in helping to ensure the stability of the institutional framework for trade and finance. Conceptually, the multiple responsibilities of the Federal Reserve are sometimes separated, for simplicity, into monetary policy, banking supervision, and payment system functions. In practice these responsibilities are closely intertwined, and the same broad public policy objectives animate all three central banking functions. These policy objectives are well known and aim at undergirding the financial system through prudent banking and market practices, sound institutional arrangements, and stable monetary conditions. The ultimate goal of all these objectives is to encourage steady, non-inflationary growth and rising standards of living.

Consideration of the role of the Federal Reserve requires special attention to international factors. The prominent international use of the dollar, the importance of U.S. financial institutions in international markets, and the role of the United States as a leading international financial center, all argue strongly for maintaining a practical, well tested central banking system that is attuned to major international developments. These developments include changes in worldwide macro-economic conditions and policies, along with closely linked changes in the financial condition of major monetary institutions. Moreover, the day-in and day-out give and take of the policy process calls for well informed policy management, particularly because rapid,

global communications have helped create complex, worldwide institutional and market linkages. Informed and effective policy development and implementation in the "real world" is only possible for a central banking organization with everyday "hands-on" involvement in all facets of central banking, including monetary policy, banking supervision, and the payment system.

The Federal Reserve's responsibilities in the payment system arena vividly illustrate the interrelated nature of the functions of a central bank. As their name implies, central banks occupy a unique position and perform a special banking function for the financial system. At a minimum, this role involves the provision of accounts and risk-free central bank money balances to eligible financial institutions, and also typically involves the provision of key interbank payment and settlement services. These deceptively simple arrangements are at the heart of the monetary infrastructure of modern economies.

Central banks generally provide oversight for a nation's payment system. This oversight responsibility builds on a combination of the account relationships central banks have with commercial banking organizations and the "hands on" supervisory role of central banks vis-a-vis these organizations. In the case of the Federal Reserve, account relationships are the point of operational contact to critical interbank money settlements in the domestic and international financial system. In addition, account relationships provide daily information on key money

flows within the banking system. Supervisory activities provide an early warning system for potential major institutional problems in the payment system and also provide important tools for helping to resolve or manage these problems.

In times of financial stress, in particular, supervisory authority arms a central bank with important information and credibility, and in certain cases legal authority, needed to help resolve complex problems that can arise in the payment system. Without supervisory tools, a central bank must rely solely on its account relationships, and possibly credit powers, to obtain information and resolve payment system problems. I do not believe, as a practical matter, that sufficiently vital and timely information about major monetary institutions in the payment system would be available to the Federal Reserve based solely on account and credit relationships.

Let me now focus more specifically on payment system policy. Although there may be somewhat different public policy objectives for payment systems in different countries, two themes increasingly dominate all others. First, payment systems must contribute to the stability of financial markets and the banking system during times of financial stress. This theme is an integral part of the general central banking policy objectives that I noted above. Most importantly, payment systems should be designed and used so that they do not amplify financial problems originating in other quarters, but rather help dampen the effects of these problems and bolster confidence in the financial system.

Second, payment systems must be efficient. They must operate dependably at low cost and encourage innovative financial and payment practices. Efficiency over the long run requires investments in new technologies today that provide the flexibility to adapt to changing markets tomorrow. It is part of a central bank's responsibilities to encourage constructive innovations, both in the systems it operates and in discussions with banking organizations that operate private systems.

I would like to mention three specific areas where the Federal Reserve has recently taken payment system initiatives: the announcement of expanded Fedwire operating hours beginning in 1997, the recent adoption of Regulation EE dealing with financial netting, and the charging of fees for daylight overdrafts. The first initiative --expanded Fedwire hours-- should be viewed in the context of efforts to find new ways to reduce settlement risk in the foreign exchange markets, also known as Herstatt risk. Despite enormous increases in the volume of foreign exchange trading, foreign exchange contracts are settled today, in many important respects, as they were at the time of the now famous closure of Bankhaus Herstatt in 1974. For example, in the case of contracts involving European currencies, these currencies are paid out hours before contra-payments in dollars are made and settled in New York. In the case of yen-dollar contracts, yen payments are often made and settled as much as 18 hours before dollar contra-payments are finally settled.

I believe that the international banking community must take up the challenge of developing new technologies and settlement practices that will help solve one of the oldest problems in the international financial system. Attention to Herstatt risk should be an important part of the operational planning of individual banking organizations and clearing groups. The issue should also be highlighted in discussions both within the banking community and between banking organizations and central banks.

To be sure, very important steps have been taken since 1974 by the New York Clearing House to strengthen the CHIPS payment system, which is often used today to settle the dollar leg of foreign exchange transactions. These steps have included the "same-day" settlement of payments, enhanced risk controls, and settlement support arrangements. Yet large time gaps between the settlements of different international currencies remain, in part because of central bank operational policies, and more needs to be done to reduce these gaps.

Last month the Federal Reserve announced that beginning in 1997 the operating day for Fedwire will be expanded from the current 10 hours to 18 hours. Specifically, the Fedwire funds transfer service will operate from 12:30 a.m. until 6:30 p.m. Eastern time. (The current operating hours are from 8:30 a.m. until 6:30 p.m.) A specific date for the new Fedwire operating schedule will be announced at least one year in advance.

For the time being, no changes are being made in the operating hours of the Fedwire securities transfer system. The

Federal Reserve staff, however, is working on the design of new features for that system that might allow longer operating hours without imposing significant, unwanted operating costs on users of the system. It is expected that new features for the securities system will be proposed for public comment this year.

I would like to emphasize several key points about the Federal Reserve's decision to expand Fedwire operating hours. First, the primary impetus behind this decision is the potential public benefit to the United States and the international financial system from expanding the opportunities for banking organizations to settle their obligations in central bank money in a timely fashion. The Fedwire system is the ultimate system for making "instantaneous" and irrevocable, electronic interbank funds transfers in the U.S. dollar. The Federal Reserve believes strongly that concrete actions need to be taken that will remove operational barriers to private-sector efforts to employ the Fedwire as a tool, along with new technologies and settlement techniques, to help reduce Herstatt and other settlement risks. Some of these techniques may eventually involve settlements using delivery-versus-payment principles.

Second, the financial industry has strongly urged the Federal Reserve to establish clear longer term operational goals for Fedwire so that the industry can plan effectively their settlement practices, payment services, and technology strategies. The Federal Reserve understands that the financial industry has a very important need to make careful and rational

technology decisions, particularly over the next few years that promise to be a time of continuing change. Thus, the Federal Reserve's announcement of a clear decision for substantially expanded Fedwire operating hours, but with a three-year lead time, should be seen as a positive step to help simplify strategic planning.

Third, central banks in other countries may wish to review the operating hours of their Fedwire-like payment systems to increase the period of time these operating hours overlap with the newly announced Fedwire hours. Further increases in the overlap of payment system hours may provide even more flexibility to banking organizations as they review their current operations.

Fourth, I would emphasize that the use of Fedwire during expanded operating hours will be entirely voluntary. The service will be available, but any banking organizations that do not find it in their business interest to use the service will not have to expand their own banking hours. Indeed, our analysis indicates that there are no burdens placed on banks, including reserve maintenance burdens, from choosing not to use Fedwire during expanded hours of operation. This is especially important to the many thousands of smaller institutions that use the Fedwire service, but may not find it useful to expand their own banking hours. Finally, the Federal Reserve staff will continue to be available to discuss with the private sector new approaches to reducing Herstatt and other settlement risks.

In addition to the Fedwire initiative, the Federal Reserve continues to support other steps aimed at helping the private sector to devise new means to help reduce settlement risk. For example, the Federal Reserve has supported the work of the international central banking community to develop common minimum standards --the Lamfalussy standards-- that should guide the design of new multilateral clearing arrangements, such as those for interbank foreign exchange contracts. These types of arrangements, if soundly designed, offer the possibility of reducing and better controlling settlement risk. Great care must be exercised in the design of these systems, however, because they also have the potential to concentrate settlement risk at a single point in a pivotal international institution. We will hear more about these projects tomorrow.

In a second area of payment system initiatives, the Federal Reserve recently issued Regulation EE, which became effective on March 7. The regulation was authorized by the Federal Deposit Insurance Corporation Improvement Act, and aims at strengthening the legal foundation for financial "netting contracts" that have increasingly been used in the foreign exchange, swaps, and other "over-the-counter" markets. In using these netting contracts, parties agree that they will pay or receive net amounts due on a series of financial contracts or payment orders, rather than the gross amounts due on each obligation. The new regulation establishes relatively simple generic tests that will permit financial institutions, which are acting as market-makers, to

enter into netting contracts that will be valid under federal law, even in the event of bankruptcy. The goal of Regulation EE is to enhance efficiency and reduce systemic risks in major financial markets through the reduction of legal uncertainty.

In a third area of payment system initiatives, the Federal Reserve will begin charging fees for daylight overdrafts incurred by banking organizations in their reserve and clearing accounts, beginning in mid-April. The aim of this policy, along with related programs to control daylight overdrafts, is not to impose new costs on the banking industry, but to reduce risk in the payment system. These efforts have already been a catalyst for changes in the measurement and control of risk. One of the latest and most impressive efforts has been undertaken under the aegis of the Public Securities Association. In recent experiments to expedite the daily processing of settlements for repurchase agreements involving government securities, major securities dealers have been able to reduce the average daily aggregate value of the banking system's daylight overdrafts by as much as one third. I look forward to even greater progress as more financial firms become engaged in efforts to manage and control their use of daylight credit, as we approach mid-April.

Overall, the Federal Reserve is monitoring closely the significant efforts now being undertaken to reduce and better manage the use of daylight credit. These efforts and their results will be studied carefully as the Board evaluates the

potential impact of further increases in daylight overdraft fees, which are currently scheduled to take effect in 1995 and 1996.

I would also like to take a moment to mention the situation with consumer payments, particularly since this topic is often neglected at international conferences. Although the large-value payment systems in major countries carry 80 to 90 percent of the value of all payments, small-value, consumer-oriented payment systems carry 80 to 90 percent of the number of all payments. A large proportion of these small payments is still made using paper checks or paper vouchers.

At the same time that we continue to use paper-based payment methods, new technologies for information processing and communications are developing at a very rapid rate. I believe it is time that we redouble our efforts to improve the efficiency of consumer payment systems, both within and between countries. Significant steps are likely to include new mechanisms for the collection and processing of paper instruments, to the extent consumers continue to rely on traditional payment methods.

More fundamentally, we need to continue to find means of making payments electronically in ways that are cost effective and acceptable to consumers and businesses so that we can improve the efficiency of the payment system. In the longer term, I would not rule out the possibility that entirely new payment systems and technologies may be developed, as the full impact of new communications technologies and advanced consumer electronics begin to be felt.

In conclusion, I believe that we have new opportunities to help reduce risk and improve efficiency in the payment system. Much has been done, and much is being done. However, much more needs to be done. A vast array of new technologies has created an ever-more tightly interdependent world financial system. These same technologies can and should be used to help provide modern, safe, and effective mechanisms, around the world, for settling domestic and international transactions and ensuring the integrity of globally expanding daily flows of money.