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**Policy Response to
Issues in Central Bank Payment Services**

by

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My intention today is to broaden our perspective on payments system risk, including relating risk issues to monetary policy considerations. I'd like to view payments system risk in the context of the appropriate role of risk management in a free enterprise economy with an optimum monetary policy aiming at price level stability. In doing so, I'll consider the payments system not just from a national, but from a global standpoint, and as part of a world monetary system. I'll also focus attention on the future to try to glimpse how financial risk can best be managed in an effective international payments and monetary system. In sum, my aim is to tie into a package my thoughts on various issues for promoting a global monetary regime characterized by enhanced stability, reduced uncertainty, and competitive efficiency.

The appropriate scope for private risk management

For some time the U.S. payments system has been a vehicle for extending intraday credit. Fedwire has made final credits to the account of receiving banks without insuring that paying bank accounts are sufficient to cover the payment. Each morning the System opens with anywhere from \$35 to \$40 billion of bank deposits with Federal Reserve Banks. During a typical day, payments of more than \$1 trillion are made over Fedwire. These transfers result in total peak daylight overdrafts of about \$100 billion, which of course are offset by intraday excess credit balances at other banks. Federal Reserve Banks are major unsecured intraday creditors. Taxpayers, not shareholders, face the risk of loss from daylight overdrafts in depository institutions' accounts with the Federal Reserve. Thus, the public sector assumes the primary

risk, while correspondent and other banks in turn blithely deal out this intraday credit to payment system participants.

Let's step back from the current arrangements for a minute and go back to basics. A capitalist, free market system is characterized by a private profit and loss system. This mechanism provides incentives and signals that direct the allocation of the nation's resources. Apart from limited areas of governmental responsibility, such as protecting individual and property rights, ensuring national defense and maintaining macroeconomic stability, the private market mechanism is a superior risk management system; by incorporating risks into the price of credit and equity, it provides incentives for market participants to reduce total risk. In a dynamic economic environment, the future is unpredictable and managers must use their judgment to augment their capital through accurate assessments of the outlook for their firm and industry. A major part of this management job at financial intermediaries is assessing the financial prospects of their borrowers.

In fact, evaluating and managing risks is an essential aspect of the managerial role in nearly all lines of business. Those correctly discerning future conditions are rewarded, while those making poor judgments suffer losses and are weeded out of the managerial and ownership ranks. It is not unusual for enterprises to fail when ill considered initiatives weakly backed by thin equity margins encounter unlucky outcomes. No moral condemnation applies to these failures; the impersonal market system has signalled that too many firms are supplying too many resources to this endeavor. Less wise managers with too little capital consequently are eliminated.

Stockholders, creditors and managers learn from mistakes. Managers and investors chastened by experience have the chance to get up, dust themselves off, and try again, though with a diminished personal capital base or with a diminished reputation that limits their access to the capital and money markets. Meanwhile, lenders stung by defaults learn to assess risks more critically and to modify their lending terms and conditions. Examples of this process in the 1980s can be drawn from experience with agricultural, commercial and real estate lending and from heightened concerns about developing country lending and "event risk" in the corporate bond market.

Private risk management in the payments system

The payments system, too, should be designed to run on these principles of responsible risk taking. It should be possible for an individual depository institution to fail without bringing the whole payments system to a halt or involving the federal safety net. Under these circumstances, counterparties would have a powerful incentive to assess the riskiness of the firms with which they do business. In extending intraday loans, creditors would be more inclined to establish credit limits and charge risk premiums in line with the riskiness of their borrowers. Nothing concentrates the mind so much as having one's own money at stake, unless, as Samuel Johnson suggested, it is the prospect of being hanged in a fortnight.

Settlement finality, with collateralized loss sharing arrangements, such as CHIPS is planning, is a necessary step in the right direction for the U.S. payments system. But even more important is the development of a private intraday market for federal funds. In this

market various participants would be evaluated carefully and face differential risk premiums and credit limits. With these arrangements in place, the failure of a single participant on a network would not hold the financial system, in general, or the payments system, in particular, hostage to an unwind of payments. The failure of one institution no longer would be likely to endanger the solvency of its intraday creditors. The potential for systemic disruptions would be reduced by having a credit-risk premium established by a full-fledged intraday funds market. I believe systemic risk would be lower than would be the case with the Federal Reserve in effect setting a ceiling on the private intraday rate through a low administered fee on its own overdrafts. With reduced private reliance on a low cost daylight overdraft facility, settlement finality of netting groups will encourage better risk management through market discipline in the payments system generally.

With such arrangements in place on private payments networks, private credit judgments about counterparties also would do more to promote a more efficient payments system than would the Federal Reserve's steps to manage its own intraday exposure to risk, even under the proposals the Board has put out for comment. For example, these proposals envision a 25-basis-point administered price on intraday Fedwire overdrafts above a deductible. I believe that while administered pricing will reduce the Federal Reserve's exposure to risk, a "moral hazard problem" still will remain. With all borrowers charged the same price, riskier institutions, who would tend to face higher risk premiums than other borrowers in private intraday credit markets, would be more

inclined to turn to the Federal Reserve for intraday credit at the administered price. And I'm not thinking here of the clearly identifiable problem institutions for whom collateral would continue to be required and for whom even collateralized overdrafts would stay quite limited. All this suggests to me that ultimately the private sector should be the source of intraday credit in the normal course of events. Only in emergency situations should the Federal Reserve extend intraday credit, and even then it should require collateral, and charge a rate above the equilibrium market rate for weaker private credits.

A long-run plan for the payments system

These considerations led me to propose a long-run policy under which routine daylight overdrafts at the Federal Reserve would be eliminated. Any intraday reserve inadequacy would have to be covered by a collateralized discount window loan made at an administered rate normally at a premium above market rates. At the same time, the Federal Reserve would pay a below-market interest rate on excess reserves held overnight. This rate would both encourage holdings of larger reserve balances and provide some opportunity cost for funds made available in a 24-hour federal funds market.

Under my proposal, the Federal Reserve would cease to supply unsecured intraday credit. Hence, the moral hazard problem facing the Federal Reserve under an administered pricing arrangement simply would not arise. By requiring collateral and assessing a penalty discount rate, the Federal Reserve would reduce the likelihood that poor credit risks, rationed out of private markets, would turn instead to it for credit.

This proposal would lead to an efficient determination of interest rates and quantities of intraday credit supplied through private competitive markets. Scarce reserves would be more efficiently rationed throughout the day by lower hourly rates in underutilized periods and premium rates for concentrated-payment periods such as just prior to Fedwire closing. Market forces would determine the timing of transmitting payments and the resources that should be allocated to the payments system, as well as the appropriate scope of netting payments flows. For example, those receiving payments could accept the credit risk of participating in a netting scheme or adjust down their asking price so as to offset the higher cost to the sender of transferring earlier-in-the-day final funds via Fedwire. After intraday funds are trading at a market clearing rate, final payments will have a time value early in the day that will increase the demand for Fedwire final settlements, thereby reducing total payments system risk. Thus, the market price for intraday credit would vary flexibly, though within certain limits, to reflect the changing scarcity of supply relative to demand.

Implementation of the plan would imply that the market interest rate on federal funds with a 24-hour term would equal the sum of the market-determined interest rate on intraday funds and the administered overnight rate paid by the Federal Reserve on excess reserves. Therefore, interest rates on funds with 24-hour and intraday terms would be directly related. But the volatility of these rates would be constrained by the difference between the administered rates on discount window borrowings and on excess reserves.

Excess reserve holdings undoubtedly would increase substantially, even with the payment of a rate on excess reserves below the 24-hour federal funds rate. Federal Reserve revenues, hence, could rise somewhat if the proposal were implemented, as the Reserve Banks paid less on extra excess reserves than the return on the additions to their portfolio of securities. The size of the revenue increase would depend upon the spread between the return on the added securities and the rate paid on new excess reserves, less, of course, the cost of beginning to pay interest on the existing level of excess reserves.

Under the plan, the discount window would be open to all eligible depository institutions able to provide sufficient collateral. Today's "administrative pressure" related to the extension of Federal Reserve credit would end, as would the costs associated with this practice, both for the Federal Reserve and for depository institutions.

I recognize that the plan could not be fully implemented until the processing capabilities at the Reserve Banks and depository institutions permit DI's to send and receive payments at specified times within the day. The necessary hardware and software developmental process will take time. I believe that the Board's current proposals are a desirable first step to encourage the development of that infrastructure. Therefore, I support with my colleagues the Board's proposals as an improvement relative to the situation today, and, at the same time, want it to be understood that future modifications to the payments system risk reduction program are necessary to ensure the development of an intraday federal funds market. Until additional steps are taken, the payment system will continue to have an unacceptably high exposure to risk, with

the Federal Reserve facing an undue likelihood of a "last resort" scenario arising from a payments system problem.

I am, of course, not proposing that Fedwire no longer be used to transmit funds or securities, but rather that the unsecured daylight overdrafts in reserve or clearing accounts now associated with its operation be eliminated. Indeed, with the globalization of financial markets and the inevitable development of continuous 24-hour trading in spot and futures contracts, I would like to see the Fedwire network operating on a 24-hour basis. One cost-effective approach to a 24-hour Fedwire operation would be to offer an "overnight" service at one of the Reserve Banks. Any depository institution with a reserve or clearing account with any Reserve Bank, including foreign banks with branches or agencies in the United States, could use the service. At the close of business, DI's could transfer balances into a special overnight, non-interest-bearing clearing account. Balances in the account would not satisfy reserve requirements. Transfers of funds originating in overseas markets could be processed through these accounts, but no overdrafts would be allowed. The next morning, at the opening of business, banks could transfer funds from their special accounts back to their regular reserve or clearing accounts.

In this manner, U.S. and foreign banks would be able to make final payments in dollars 24 hours a day, thereby avoiding the temporal risk associated with current and proposed offshore large-dollar payment networks. International financial markets could operate more smoothly around the clock. By facilitating final dollar transactions, a 24-hour

Fedwire would help maintain the dollar as the currency of choice for many international payments.

Unfortunately, under current circumstances, the demand for this 24-hour service would be limited to the security advantage of receiving final payments. Not until funds have an intraday time value will receivers have an additional reason to press for payment in final funds rather than wait for end-of-day net settlement on private networks. With money having an intraday value, receivers could relend the proceeds to others. Only after an intraday federal funds market exists around the globe will these funds have a time value sufficient to increase significantly the demand for 24-hour Fedwire services.

Toward a more stable international monetary system

As long as current payments system risk exposure continues, it is imperative that additional macro-risk exposure be reduced. This brings me to the larger issue of promoting a stable international monetary system. The Federal Reserve can best contribute to this outcome by ensuring domestic price stability--by which I mean a trend in the producer price index that is flat over the long run. More precisely, the Federal Reserve should choose some base, such as January 1986, from which it would make a commitment to hold the PPI within 10 percent of that base as a fundamental price rule.

Price stability in the United States would give other countries the option of following the dollar by semi-pegging, using the dollar, with its stable purchasing power, as an anchor. Although doing so would mean trading off some domestic monetary policy independence, this would not represent much of a conflict if they too would give a high priority

to long-run price stability. Those countries who choose an inflationary or deflationary policy could allow their currencies to float. In any case, the United States, recognizing its reserve currency role, would not gear its monetary policy primarily to the exchange value of the dollar; instead, it would pursue price stability through maintaining a low managed rate of monetary expansion consistent with the PPI target level. Of course, exchange rate disturbances could affect prices even for a reserve currency and could not be ignored; progress toward price stability may at times be efficiently achieved by exchange rate stabilization efforts which are accompanied or followed by reinforcing policy changes.

By making price stability the priority goal for the Federal Reserve, we would make monetary conditions a less important concern to our citizens. I need not elaborate on the benefits of price stability to the U.S. economy in terms of low nominal interest rates and diminished macroeconomic uncertainty. To be sure, microeconomic uncertainty will remain and some companies will continue to go out of business, as I noted earlier. Some will succumb--as they should--to the discipline of the market system, and will not be bailed out by debt finance that is artificially stimulated by an inflationary monetary policy. It is not the Federal Reserve's place to use inflationary monetary expansion to try to take the loss out of our profit and loss system. Attempts to forestall failures of individual financial institutions or other firms in a healthy overall economy can only produce a built-in inflationary bias.

It goes without saying that deflation also must be avoided. Deflation is a macroeconomic policy failure that, by distorting operations of the marketplace, would reinforce private microeconomic mistakes. The Federal Reserve certainly must guard against a downward spiral of economic activity such as that accompanying the great monetary contraction in the 1930s.

Monitoring money growth--and in today's environment that means mainly M2--can keep the Federal Reserve from accommodating either inflationary or deflationary impulses. You see, I do not advocate maintaining a preestablished M2 growth rate when commodity or foreign exchange auction markets indicate a shift in the demand for money. Instead, I believe prices in sensitive auction markets can add information about the current thrust of monetary policy and can in fact aid in achieving an appropriate rate of money growth. The economic outcome would then be more stable than if money growth were strictly targeted without the aid of these auction market signals.

Conclusion

In conclusion, we need to work toward a global monetary regime anchored by stable goods prices in terms of dollars, the main reserve currency. The Federal Reserve can play its role by ensuring low average monetary expansion over time, with short-run money growth adjusted from time to time in response to signals from sensitive auction prices. The Federal Reserve's role in the payments system would be to step out of the way of the development of an intraday federal funds market, which would also facilitate payments 24 hours a day over Fedwire, without extending unsecured credit having inevitable moral hazard problems. A

private market for intraday credit, subject to the discipline of market forces, can operate efficiently, with demand for early-in-the-day settlement finality encouraged by the intraday time value of money.