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Maximizing Customer Service and Productivity
Through Technology

Remarks by

Ernest T. Patrikis, First Vice President
Federal Reserve Bank of New York

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The Federal Reserve's View of the Payments System
in the 21st Century
The Reserve Banks' Wholesale Payments Product Office

It is a pleasure for me to appear here today, at the invitation of a former New York Fed colleague, Elliott McEntee, and to appear for the first time together on the same stage with Tom Melzer and Paul Connolly. I will let you decide whether we are equal to the other three great tenors.

Tom Melzer has given you an overview of our financial services structure. My function today is to describe the functions of the Wholesale Payments Product Office of the Federal Reserve Banks. As First Vice President of the Federal Reserve Bank of New York, I have a number of separate functions within the Federal Reserve System. One of these is to serve as Product Director of the Wholesale Payments Product Office. I am the second individual to serve in this position. The first was Jim Oltman who retired last June.

The Product Office is situated in the Federal Reserve Bank of New York. While I am responsible for the broad day-to-day management of the Wholesale Office, it is managed by the Product Manager, Dara Hunt, a Senior Vice President of the Bank. Dara joined our Bank from the Chicago Reserve Bank. She is the second Product Manager of the Office, the first, Carol Barrett, also retired last year. In addition to Dara Hunt and myself, the Wholesale Office has a staff of 7 professional and 3 clerical. We believe that we have a trim operation. The members of the Product Office staff are officers and employees of the Federal Reserve Bank of New York and benefit from their interrelations with others in other areas of the Bank, including those on our Banking Services, Markets, Supervision, Legal, and Research staffs. Of course, we need to be continually sensitive to the need to separate our banking functions from our supervisory functions. We have found that our bank examiners benefit from what they learn from the Product Office and Banking Services staffs. They are better able to carry out their examinations of the funds transfers operations of banking organizations because of this rapport. Except in the case of a failing bank, the information flow is in one direction -- from Product Office and Banking Service to Bank Supervision.

What products are within the ambit of the Wholesale Payments Product Office? Right now, those products include wire transfers of funds, the transfer of book-entry securities free and against payment, and net settlement. I will describe these more fully in a minute.

What functions are performed by the Wholesale Payments Product Office? The Office is responsible for the design, development, implementation, and operation of these services. This includes strategic as well as tactical planning for these services. While there are no completely new services being considered at the moment, we will be alert to providing new services to our customers, consistent with the standards that we need to satisfy to provide a new service. Enhancements to existing services are being developed and implemented. Last year the Office oversaw the implementation of new applications software for wire transfer of funds -- referred to as Funds 5.0. The Office is now overseeing the implementation of the new, expanded format for wire transfers of funds. This is a major effort that effects all depository institutions on line with Fedwire. That format is compatible with industry standards. The industry asked us to consider expansion of our Fedwire format and worked with us to design it. Thus, the project reflects something significant -- that is, the responsiveness of the Reserve Banks to the needs of their customers. That is something you will be seeing more of from all of our product offices. Also, you should not be reluctant to approach us with suggestions for service enhancements. We want to please -- indeed, surprise and delight -- our customers. We do not want to be regarded as the elephant who sits wherever it desires.

Getting back to our implementation efforts, the Office is now also overseeing the implementation of new applications software for the wire transfer of securities, referred to as the National Book-Entry System. Here we have at least two sets of customers -- depository institutions and the issuers of those securities, the Treasury Department, Federal agencies, Government sponsored Enterprises, and international organizations. We also serve a variety of entities that require the pledging of collateral, but that is a secondary function. Reserve Banks and their depository institution customers are scheduled to begin to switch over to this software this summer. We see the new Fedwire funds and book-entry applications as platforms for future enhancements.

Another major effort underway is preparing for the early opening of Fedwire for transfers of funds. Fedwire will open 12:30 am New York time which is 9:30 pm San Francisco time on the preceding calendar day. This new level of service could play a key role in the efforts of the G-10 central banks to reduce foreign exchange settlement risk. The governors have stated that: "where appropriate and feasible, central banks will make or seek to achieve certain key enhancements to national payments systems and will consider other steps to facilitate private sector risk reduction efforts." This expansion will present us with the challenge of managing the operation on an 18-hour basis. A number of complex policy issues will also need to be addressed.

We are also at work on the conceptual level. The Office is working jointly with the staff of the Board's Payments System Policy Advisory Committee on a policy for providing net- settlement services to bulk transfer payment services, such as automated clearing house payments. This effort should result in a uniform level of net-settlement services nationwide, governed by a standard service agreement or operating circular. Our goal is to meet the needs of the market place and our goals as central bank by providing a robust service that reinforces appropriate management of risk.

Risk management is a unique aspect of the Office's responsibilities. As I am sure you are aware, the payments business is not simply a matter of processing paper or electronic messages. I regard payments as one of the essential features of banking. Payments involve debtor/creditor relationships. Payment services are used to discharge real transactions. In a payments transaction, an obligor will act to discharge its obligation on an underlying transaction to its obligee. The obligor will do this by having a credit owed it by its bank converted into a credit owed to the obligee by its bank. This is done with a payments instruction. A debit payment pulls funds from the obligor to the obligee; a credit payment pushes funds from the obligor to the obligee.

Wire transfers of funds over Fedwire are credit transfers of funds. A Fedwire payments instruction will give rise to a series of bilateral contractual relationships with a third-party beneficiary. Customer A requests Bank B to transfer funds to Bank C for credit to the account of Customer D. Bank B requests the Federal Reserve Bank to debit its account and credit the account of Bank C on the Reserve Bank's books. The Reserve Bank will notify Bank C of the credit; Bank C will credit Customer D's account. Such a transaction can be consummated in a second or two. The debits and credits to Bank B's and Bank C's accounts is final at the time the advice is dispatched by the Reserve Bank to Bank C.

Both Bank B and the Reserve Bank have credit risk. The Fedwire transfers of funds system is referred to as an RTGS system -- a real-time gross-settlement system. Both Bank B and the Reserve Bank make a credit decision when acting on the credit transfer request. If the customer does not have sufficient "actually and finally collected" funds in its account, should the bank nonetheless act on the payment request? If the bank acts and the payment gives rise to an intra-day overdraft, the bank is at risk. That credit decision can be regarded by the bank as a loan or as a credit exposure incidental to the payments service. In both cases, it involves the granting of credit. That credit exposure must be managed. The Reserve Banks do this through their Federal Reserve's risk control program. The Reserve Banks carry out virtually on-line, real-time accounting for their depository institutions. Debits and credits arising out of our various businesses are posted in a way that approximate the changes to the debtor/creditor relationship between the Reserve Bank and its customer. Because each Fedwire payment instruction is settled on a gross, real-time basis, the risk-reduction policy is intended to keep that risk within reasonable bounds. You should not forget, we certainly do not do so, that we are offering a commercial banking service. We should treat you just as you treat your customers. You do not undertake unreasonable credit risks; neither should we. You should not expect us to do so. Indeed, as central banks, we believe that we should be even more prudent than a commercial bank.

Under the risk-reduction policy, each depository institution that desires a daylight overdraft on Fedwire must conduct a self assessment which results in a cap -- that is, a ceiling on the aggregate net-debit position it can incur during a given interval. That process is reviewed by the bank's Federal bank supervisor; it is also reviewed by the Reserve Bank for reasonableness. Depository institutions must manage their payments flows to remain within their caps. I need to note at this point that the amounts included in the Fedwire daylight overdrafts calculation include those arising from wire transfers of book-entry securities against payment. Except in exceptional circumstances, an institution must stay within its cap.

The Reserve Bank, acting as a rational creditor, must actively manage that risk. One way this is done is through the imposition of a fee for daylight overdrafts. The purpose of the fee is to provide an incentive for depository institutions to manage their reserve account positions intra day. In addition, if the Reserve Bank perceives a deterioration in the institution's creditworthiness or, if the institution demonstrates that it is unable to manage its affairs and stay within its cap, the Reserve Bank can impose a cap on the account balance monitor -- the ABMS. The Reserve Bank can set a limit of zero or higher to limit daylight overdrafts. The Reserve Bank could require collateral against any overdraft.

Consideration of risk issues is just one aspect of Product Office work. Other aspects are similar to private-sector product managers planning for enhancement. The Product Office serves two broad classes of customers -- one directly; the other indirectly. The Product Office is a creature of the 12 Reserve Banks and serves the 12 Reserve Banks, in the provision of our wholesale payments services. We also serve depository institutions and other customers indirectly, primarily through the Reserve Banks. Last month, the General Accounting Office expressed some concern about the management of resources by the Reserve Banks. I think that the conclusion drawn by the GAO is way off base as a general matter and especially so as respects our wholesale payments services. The Product Office budgets not only its staff but all of the developmental and implementation work being done, in addition to doing the best it can on its part to ensure that, as required by the Monetary Control Act, the Reserve Banks payments services revenues meet or exceed costs. While there is always room for improvement, especially in a structure barely two years old, I think we do quite well in managing these businesses.

The most important aspect of our wholesale payments services is the fact they serve as the foundation of this nation's, if not the world's, financial markets. The United States Government securities market is the largest and most efficient securities market in the world. Almost $630 billion par value of securities transfers against payment are handled over Fedwire each day; that amounted to $159 trillion in 1995. Fedwire transfers of funds provides services to 11,000 customers within the United States (of which 7,500 are on line), as well as to departments and agencies of the Federal Government, Government sponsored enterprises, international organizations, and foreign central banks and governments. Almost $900 billion is handled in Fedwire funds transfers each day, amounting to about $223 trillion in 1995.

I cite these large dollar amounts not to impress you but instead to show why we are so concerned about the reliability of this service. For this reason, another important aspect of the Wholesale Payments Product Office's work is planning to reduce or manage better various types of operations risk; this is our contingency planning.

It would not be appropriate for me to complete my remarks without saying a bit more about our net-settlement service. That is a matter that should be of keen interest to you. Reserve Banks have been in the net-settlement business for nearly as long as their existence. In our earliest days, this involved settling the balances for check clearing house and clearing arrangements. Until relatively recent times, net settlement involved only institutions within a single Federal Reserve District. Just as banking has changed in this regard, so has the settlement service. Conceptually, it is a rather simple service. A group of depository institutions engage in clearance of financial transactions of some sort. This results in each institution having a net-debit balance, a net-credit balance, or a zero balance. The total sum of all balances equals zero. This is a closed loop, with aggregate amount of debits equaling credits. "Not a very risky business" you say. I do not agree. As I indicated earlier in talking about our Fedwire transfer of funds operations, a Reserve Bank incurs credit risk when it debits an account that does not contain a sufficient balance. In a Fedwire transfer, if we reject a Fedwire payment instruction because of insufficient funds, only the originating bank knows. That bank can attempt to purchase funds in the market or borrow at the discount window. But when an agent, such as the operator of a clearing arrangement, sends in a settlement sheet and we reject that sheet because we cannot post all of the net debits, we may communicate the constraints placed on the institution through our response. Banking is an industry where confidence in the institution is crucial. A lack of confidence can result in a run on the bank. Runs today do not consist of lines of depositors. By number, most depositors have FDIC-insured deposits. Instead, the run will be a "silent run" where business customers and customers with uninsured deposits will instruct the bank to transfer funds from their accounts to accounts at other banks. We need to structure our net-settlement services to minimize the risk of contributing to any announcement of problems.

Another factor to consider is that we need to manage our credit risk arising out of a net-settlement arrangement. The credit risks in such arrangements should be borne by the participants in that arrangement. We realize that, to the extent that depository institutions believe that that risk will be borne by the Reserve Banks, the depository institution participants in that arrangement will be inclined to not take appropriate steps to manage the credit risks in that system. In the international area, the G-10 central bank governors have agreed to the Lamfalussy standards. These standards are to be applied to cross-border clearing and settlement systems. To the extent that systemic risk is involved, they are equally applicable to domestic systems. Even if there is no systemic risk, they still are a useful set of guidelines to consider in designing a clearance or settlement system.

I know that you have been hard at work addressing credit-risk issues surrounding ACH arrangements. I have not had the opportunity to review the private sector report on settlement risk management, but I commend the task force's efforts. You will be hearing more from the Federal Reserve on net settlement later this year.

Thank you for your attention.