

**MANAGING RISK IN BANKING
AND PAYMENTS SYSTEMS**

by

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Good morning. It's a great pleasure for me to speak to you today at your General Session. I understand that this is the first annual conference VISA has ever held in this country, so, on behalf of the Federal Reserve System, let me welcome you to the United States.

As President of the San Francisco Fed, I'd also like to welcome you to our beautiful city, which is the headquarters of the Twelfth Federal Reserve District. By now, I hope you've had a chance to see a bit of the Bay Area. If you have, I'm sure you'll agree with Kipling, who said, "San Francisco has just one drawback. . . it's very hard to leave it."

I want to talk to you today about the serious issue of risk management in the banking system. But I'd like to begin by acquainting you--very briefly--with the Federal Reserve. As you no doubt know, the Federal Reserve is our nation's central bank. The Federal Reserve System is made up of the Federal Reserve Board in Washington and twelve District Banks. The Twelfth is the largest of the Districts, both geographically, and in terms of economic activity. Our District covers the nine westernmost states, and is administered through five offices: the headquarters here in San Francisco, and branches in Los Angeles, Seattle, Portland, and Salt Lake City.

The Federal Reserve's broad national objectives are to maintain price stability and economic growth. We meet these objectives in a number of ways. First, we use monetary policy to influence money and credit in the economy. Second, we regulate

and supervise bank holding companies, and many banks themselves, with the aim of achieving a safe and sound banking system. Third, in addition to serving as fiscal agent for the Treasury, we offer a number of services to depository institutions, including important payments system services. In fact, only a few weeks ago, the Federal Reserve extended certain settlement services to banks using VISA for ACH processing. Our objective regarding the payments system is to ensure its integrity, reliability, and efficiency.

The Challenge: Better Risk Management

It's the last two functions I want to focus on today, because right now the safety, soundness, and efficiency of the banking system are critical challenges. In fact, I would like to pick up the theme of your conference--"a bridge to the future"--as a metaphor for these challenges.

One of the most critical structural elements of a safe and efficient banking system--indeed, of our bridge to the future--is wise risk management. In particular, the Fed is concerned with developing incentives that encourage banks not to take excessive risk. And I know that this is important to you, both as members of an interdependent banking system and as participants in our economy.

Let me begin to address risk management by describing the present situation. As you are well aware, it's not a pleasant picture. The banking industry in this country has been going

through some very rough times. Since 1980, over a thousand banks have failed. And, most recently, the recession has hit banks hard, especially in commercial real estate lending. Worse yet, our Bank Insurance Fund is in dire need of recapitalization in order to avoid possible insolvency.

With this kind of grim picture, it may seem hard to imagine where we would begin to build a "bridge to the future," a bridge that will lead us to a safe, sound, efficient environment for banking.

But I want to assure you that we are working on the blueprint for that bridge. First of all, in the near term, economic recovery will clearly give U.S. banks a better footing. Our best estimates suggest that we are now near the bottom of the downturn, and that activity will pick up later this year. As the economy begins to recover, banks' exposure to credit risk will improve, and we can expect to see fewer delinquencies, loan losses, and charge-offs.

But what about the long term? How do we improve the chances that the next shift in the economy won't devastate banks, as has the recent downturn in New England, or, before that, the collapse of the oil industry in the Southwest? How do we make the necessary structural changes? As I said, we are working on the blueprint. That blueprint is banking reform, which has a high priority on the national agenda.

One of the most important elements in reform is reducing banks' incentives to take on excessive risk. Indeed, excessive

risk-taking is arguably the major source of the problems plaguing the industry today.

Does Deposit Insurance Reform Go Far Enough?

Why have banks and thrifts been taking on excessive risk? On this question, I agree with many others who have linked excessive risk-taking to the incentives inherent in our deposit insurance system.

Deposit insurance was instituted in the 1930s as a response to the legitimate concern over bank runs. However, deposit insurance, as currently implemented, creates a hazard. Economists call it a "moral hazard." This simply means that because its deposits are insured, a bank can have little to lose and, potentially, much to gain, by taking excessive risks.

If there were no deposit insurance, a bank would have something to lose because it would face discipline from the market. For example, the discipline could come from its depositors, who might either pull their money out of the bank or demand a higher interest rate. But, unfortunately, our current system, by protecting deposits, has weakened market discipline. This is especially so in the case of large banks. We have tended to insure all deposits at large banks, and not just those protected by law.

Fortunately, there is some recognition that the bridge to a safe and efficient future for banking requires reforms that are aimed at controlling the moral hazard problem in deposit

insurance. The most prominent example of reform efforts to date is the U.S. Treasury's Bank Reform proposal. This proposal has much to recommend it. It recognizes that capital requirements play an important role in controlling the moral hazard problem. It recognizes the need for more timely action by regulators, proposing stages of prompt corrective action when banks' capital becomes deficient. In addition, it recognizes that market discipline needs to be enhanced.

I'm very sympathetic with the aims of the proposal--but, in some ways, I don't think the measures go far enough. The recommendations for prompt corrective action, for example, leave too much latitude for regulatory forbearance. As for enhancing market discipline, the proposal calls for scaling back effective deposit insurance coverage. But, I'm not sure that this is politically feasible, nor am I sure how much additional discipline you'd get from the depositors who'd be affected. Instead, we should require that banks rely more on their own capital, and less on deposit insurance, to attract depositors--and leave discipline to subordinated debt and equity holders.

Finally, even though the Treasury proposal moves away from too-big-to-fail, I believe we could go further in removing protection from uninsured deposits at large banks. For one thing, I'd make it even more difficult to decide a bank is too big to fail, possibly by making the Treasury itself, rather than the insurance fund, bear the cost of saving the bank.

Risk in the Payments System

The problem of moral hazard is no less important, no less a challenge, in the payments system. As I'll explain, there are important parallels between the way that deposit insurance affects bank risk-taking and the way that certain of our payments system practices affect risk-taking. Even though we take precautions that help alleviate the moral hazard problem in the payments system, risks still remain, and we are attempting to address these.

First, I'll focus on Fedwire, the large-dollar component of the payments system. The risk that arises on Fedwire results largely from efforts taken to keep the payments system running smoothly. For example, banks that use Fedwire get immediate credits to their reserve accounts for funds received. These credits are irrevocable--essentially guaranteed by the Fed. Also, subject to certain constraints, participating banks can overdraw their accounts during the day, creating daylight overdrafts, without paying any interest. These practices help to "lubricate" the payments system by facilitating an elastic system of payment settlement.

However, in the absence of controls, these practices also can contribute to a moral hazard problem on Fedwire. As a matter of public policy, the Fed guarantees credits on Fedwire. But, as a result, banks have little incentive to avoid acting on a payment from a bank that is not creditworthy. In addition, banks have little incentive to avoid overdrawing their accounts.

Conceptually, without Fed guarantees, receiving banks would want to verify that banks that were sending payment messages would be able to settle later on. Similarly, banks would have a bigger incentive to avoid daylight overdrafts if they were priced, as surely they would be if private markets were providing intraday credit. These policies obviously affect the volume and pattern of payments and the types of contracts used in financial markets. More importantly, both the guarantee of irrevocability and our historically liberal policy toward daylight overdrafts result in concentration of payment system risk on the shoulders of the Fed.

Beginning in the 1980s, we adopted special precautions to help ensure that participants do not abuse the system. For example, Fedwire participants voluntarily set self-determined "caps," which we review. These caps limit the amount of daylight overdrafts they are permitted. Depending on the circumstances, we may counsel banks that breach their caps. We also prohibit overdrafts for problem institutions.

While I believe that these precautions are effective, pricing of overdrafts would be even more effective because it would introduce a more sensitive incentive structure. As I am sure many of you know, this is just what the Federal Reserve has proposed for the near future, with phased implementation possibly as soon as 1992. Under our proposal, Fedwire participants would pay fees that increase with the amount of overdrafts. Pricing thus would directly link increased overdrafts to increased costs

for banks and give added impetus for banks to avoid them.

Regulation and Self-Regulation in the Payments System

What about controlling the risk that arises because banks that receive payments may not carefully scrutinize banks that send payments? From the beginning, our solution has relied on regulating banks and monitoring their financial condition. This allows us to be comfortable in our role as guarantor of Fedwire transactions. But this is not the only answer; self-regulation can work too. Many of you probably are familiar with how self-regulation works in one of the private sector components of the payments system, the Clearinghouse Interbank Payments System (CHIPS). CHIPS is a privately operated large-dollar system that is used mainly for international transactions. CHIPS net positions are settled via Fedwire.

In response to our requirement for greater settlement assurance within CHIPS, CHIPS recently has put in place a loss-sharing arrangement. By increasing the probability of settlement in the event a participant fails, loss-sharing lubricates the system and lessens settlement disruptions. However, just as on Fedwire, such a system can also introduce a moral hazard problem.

Fortunately, CHIPS' system of self-regulation helps to address this problem. Here's how it works. Each member sets its own limit on the net payments that it will accept from every other member--in other words, each sets individualized credit limits. Then, if a member defaults, the loss is covered

according to a formula based on the credit limits. Effectively, each member's obligation to cover the loss is correlated with its self-imposed credit limit with the defaulting member.

Thus, the loss-sharing formula gives banks an incentive to limit their risk exposure, and it gives receiving banks an incentive to set lower credit limits on their transactions with less creditworthy banks. This approach should prove highly effective in controlling moral hazard on CHIPS, provided participants have timely access to accurate information regarding other participants' condition.

I'd like to conclude with a few comments on risk in international transactions, specifically, foreign exchange, and I'd like to voice a word of caution. Foreign exchange markets have seen annual growth of about 40 percent in recent years, and growth should increase with the advent of European Community reforms in 1992.

Efforts to manage risk in foreign exchange also are growing. Risk arises in foreign exchange markets in part because there is no mechanism available to ensure simultaneous settlement of both legs of a foreign exchange transaction--for example, sending of dollars in one direction and yen in the other. During the interval between the settlement of each leg, the party that has made the first payment risks losing the full value of the second payment if its counterparty defaults on its obligation. Participants in the foreign exchange markets are seeking ways to control and reduce risk, including well-founded netting

arrangements.

These ongoing efforts are examples of how private parties, when exposed to risk, can work to develop sound methods to manage it. In this light, we, as policy makers, must be careful to concentrate on the same goal. In the process of trying to make the payments system flexible and accessible, we must be careful not to redistribute part of the risk to central banks or other public settlement entities, and thereby introduce a moral hazard problem. As our experience with deposit insurance has taught us, an uncontained moral hazard problem can have very real and damaging consequences. If we recognize that moral hazard also can exist in payments systems, we will be better able to manage risk wisely in our increasingly integrated world financial markets.