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<u>Global Payments in the 21st Century: A Central Banker's View</u>

Thank you, Bill, and good morning. I'm delighted to be here to share some of my views on global payments in the twenty-first century.

As we approach the new century, we've seen international payments go from a trickle to a torrent. The latest BIS report says that in April, 1995, the average daily turnover associated with foreign exchange contracts was 1.2 trillion dollars. That's more than double the size of the market just six years before, and more than one hundred times the size in 1973.

These numbers are impressive. They're a testament to the fact that high-speed global communications networks and other new technologies have cut the costs and the time involved in international financial transactions. They're also a testament to the efficiency of the world's payments systems in handling this surging volume.

And they've certainly caught the attention of central bankers. We're concerned that cross-border transactions may be growing so fast that they're outstripping the market's ability to recognize and manage the settlement risks involved. This concern is certainly evident in the tone of a number of the BIS reports—including the one just released in March.

Looking ahead to the next century, all of these issues are likely to intensify. There's every reason to expect the torrent of activity in cross-border transactions to build. And with that activity will come heightened concerns about settlement risk. So the shape of the payments system in the next century will be determined in large part by the efforts we *all* take to address risk.

These efforts are the focus of my comments this morning. I want to discuss two themes relating to settlement risk that were developed in the BIS reports. First, to a large extent, the initiatives for dealing with settlement risk need to come from the private sector. Second, central banks have a key role to play—in part because of the possibility of systemic problems that could threaten market stability, and in part because central bank services can diminish settlement risk.

Let me begin with some background on why we've seen the torrent of cross-border payments over the last twenty years. A number of developments have fostered international trade and led to increases in economic efficiency. For example, there's the growth in emerging economies, there's the opening of the newly independent states of central Europe, and there's the broad-based trend toward freer trade. The surge in cross-border payments also reflects trends toward financial liberalization, more open capital flows, and innovations in financial instruments. These have led to the globalization of financial markets, which means more efficient allocation of credit and financial risk. And world payments systems have been successful at accommodating the increase in cross-border payments. In other words, they've done a lot of what they should be doing—supporting global commerce and finance.

But, as I said, we central bankers are still concerned about whether everybody's paying proper attention to the accompanying risks. The risk I want to focus on is settlement risk—the risk that a transaction won't be completed because one of the counterparties fails to settle, which has the potential to trigger further defaults. While settlement risk is part and parcel of all types of payments, in cross-border payments it's exacerbated by several factors. I'll focus on three of them—time zones, payment conventions, and legal differences.

First, operating across different time zones means that countries have different hours for settlement. That leaves less opportunity to synchronize settlement and therefore more opportunity for something to go wrong between payment initiation and settlement. The most famous example of what can go wrong was the failure of Bankhaus Herstatt in 1974. The authorities closed the failed bank at the end of the German business day—*after* it had taken in marks, but *before* it had paid out dollars.

The second factor is payment conventions. The recent BIS report emphasizes that the way payment contracts are written, exposure in foreign exchange settlement can last for *days*, not just for hours. This is in part because parties can't unilaterally revoke payment instructions one to two days before the settlement date. The report also points to another possible exposure related to payment conventions: banks do not always get prompt information about whether they've actually received funds when they're due.

Finally, country-to-country differences in the laws governing payments can be a problem—especially when countries differ on the legal status of netting contracts.

As I said at the outset, it makes *sense* to look to the private sector for initiatives that address settlement risk in cross-border payments. For one thing, the private sector has extensive and well-developed networks of international correspondent banks and private industry groups. These networks provide the international links to the domestic payments systems. This puts the private sector in a better position than central banks to address the risk in these linkages. On top of that, the private sector has the *incentives* to raise the efficiency and reduce the risk in the payments system.

Let me just describe a few of the initiatives the private sector already has come up with. These initiatives to reduce settlement risk in cross-border transactions have focused on clearing and netting issues, as well as settlement issues. Basically, the approaches involve reducing the exposure—that is, exposure in terms of the length of time or exposure in terms of the amount of money involved—as well as other factors that affect the probability that a settlement problem will arise. Let me give you a few examples.

One that Jill is very close to is laid out in the recent New York Clearing House Association report, which explores multicurrency cross-border issues. Another is an effort by the New York Foreign Exchange Committee. In 1994, it issued several recommendations about how to choose a correspondent bank in order to reduce risk—I'll just touch on three of them. First, to reduce the time exposure, they recommended increasing the emphasis on correspondent banks' quality of settlement services. In other words, choose a correspondent bank that will be responsive to customer demands for synchronizing settlement times for different currencies. The second recommendation was to scrutinize correspondent banks' creditworthiness more carefully. This would lower settlement risk by reducing the chances that problems would arise. The third recommendation was to choose a correspondent bank that has a well-defined process for identifying who's responsible for losses when a counterparty defaults.

Another private sector initiative involves establishing multilateral foreign exchange clearing houses. Two groups of banks are at work in this area. One is the Exchange Clearing House Ltd.—known as ECHO—which began operating in London in August last year. The other is the Multinet International Bank, which is still in the proposal stage and would operate in North America. In both cases, the effort to synchronize multicurrency settlements across time zones should help reduce the time exposure and therefore the risk.

Finally, there's the "Group of 20" banks. The group consists of participants from different countries in the foreign exchange markets. Their efforts to reduce the time exposure involve exploring new institutional schemes for multicurrency settlement. For example, they're considering the possibility of organizing a special purpose multicurrency bank for net settlement.

These are laudable efforts. And I'm certainly in favor of the private sector coming up with ways to address as many problems as possible. At the same time, however, central banks *do* have responsibilities for reducing settlement risk. In this respect, they have at least two roles. One role is as an overseer, and that role stems from the fact that settlement risk is a source of *systemic* risk. Systemic risk is the risk that one bank's default may cause a chain reaction of payments system failures—and even threaten the solvency of institutions. It falls to central banks to worry about systemic risk, because the private sector simply doesn't have the incentives to address this risk adequately. In fact, that's the very genesis of central banks' traditional oversight role in payments system issues.

In its role as overseer, a central bank can help reduce settlement risk by working cooperatively—both with the private sector and with other central banks. For example, the recent BIS report calls for central banks to work with industry groups to clarify and help resolve legal issues arising in cross-border settlements. In terms of cooperating among themselves, the Lamfalussy report pointed to several areas where central banks could help by sharing information and even responsibility. One concrete example is the way interested central banks cooperated with the Bank of England in overseeing the development of ECHO.

There's a second role for central banks in reducing settlement risk. It stems from the unique advantage central banks have in being able to provide irrevocable, final settlement through the use of central bank money. The Fed, in fact, is involved in this with international payments already—for example, the vast majority of international U.S. dollar wire transfers moves through CHIPS, which relies on the Federal Reserve's Fedwire for final, end-of-day settlement.

In fulfilling this role in a changing environment, we *are* taking proactive measures. One such measure is to expand Fedwire's operations from 10 hours a day to 18 hours a day in the fourth quarter of 1997. This will give banks more opportunities to achieve final settlement of U.S. dollar payments during the business hours of other large-value transfer systems for other major currencies. Fedwire's expanded hours are complemented by a strong movement among other central banks to provide real-time gross settlement services in their national currencies.

Looking forward to the twenty-first century, I'm optimistic about the prospects for significantly reducing cross-border, multicurrency settlement risk. We have a better understanding of that risk. We've identified practical approaches for improving settlement arrangements. And we've actually implemented some of those approaches, while others are in the pipeline.

But there's certainly more to be done. Going the distance on this issue will require more coordination of efforts. By that I mean both cooperation and coordination between central banks and the private sector *as well as* cooperation and coordination among central banks themselves. Our reward will be a more reliable worldwide payments system and, therefore, a more efficient and stable global economy.