For release on delivery
9:00 a.m. EST
March 10, 1994

Remarks by

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Chairman, Board of Governors of the Federal Reserve System

at the

International Symposium
on
Banking and Payment Services

Washington, D.C.
March 10, 1994

Good morning ladies and gentlemen. I would like to welcome you to the Federal Reserve's International Symposium on Banking and Payment Services. Over 250 financial institutions from more than 60 countries are represented at the conference, including more than 180 private banking organizations and more than 50 central banks. Individuals representing academia, the press, and various government bodies are also with us this morning. I am delighted to see this wide range of participation in our Symposium. I trust that a mixture of views, both in presentations and discussions over the next two days, will help to deepen our understanding of some of the current issues facing the international banking community.

An overall theme of the conference is the development of new arrangements for making payments and settlements that will help to reduce risks in the international financial system. In this context, as well as more broadly, we will hear about developments in the derivatives, foreign exchange, and international securities markets.

On our program, we have speakers with a number of different viewpoints on developments in the over-the-counter derivatives markets, including the possible introduction of new clearing arrangements. I look forward to these presentations and discussions. It seems to me that, notwithstanding the studies that have been conducted and the steps that have been taken, we are still at a preliminary stage in the development of appropriate public policies toward over-the-counter derivatives markets.

Much is being done in the regulatory community to adjust supervisory practices to take into account the growth of trading in derivative instruments. In addition, steps are being taken to ensure the legal enforceability of derivatives contracts, and to strengthen accounting and disclosure standards for derivatives activities. We will hear this morning, not only about the work of the Group of Thirty last year to provide important insights into the uses and prudent management of derivatives, but also about some of the follow-up steps that have been taken since the publication of the G-30 report.

We must remember that derivatives tighten the arbitrage among primary markets and therefore enhance the efficiency of the financial system. But that very efficiency also means that crises are transmitted throughout the system at an advanced pace. Thus, it will require special vigilance to anticipate and suppress latent crises before they become systemic.

As we think more broadly about derivatives, it is important to bear in mind the principles of modern financial analysis. One of the most fundamental is that the risks and returns from engaging in particular lines of business, or investing in particular financial instruments, must be judged in the context of the entire portfolios of individual investors, financial institutions, and markets as a whole. Yet surprisingly little is said in discussions of derivatives about the full portfolios of dealers in these instruments or of end-users. Instead the focus is on particular instruments--derivatives--and their individual financial characteristics. I believe that important risk issues, including the measurement and management of risk, can only be meaningfully addressed in a broader context.

I am not suggesting that we ignore the development of derivatives or other financial innovations, which have occurred in the past few years or are yet to come. Senior bank management and regulatory authorities have a duty to examine important changes in financial practices, in order to ensure that our institutions, market arrangements, and supervisory systems are sound. I would suggest, however, that a broad perspective, rigorous analysis, and detailed attention to risk issues--within the context of the full portfolios of financial institutions--are critical to sound financial arrangements and public policy.

Both today and tomorrow we will also hear speakers address the issue of settlement risk in the foreign exchange markets, also known as Herstatt risk. The volume of trading in foreign exchange markets has grown exponentially in the two decades since the closure of Bankhaus Herstatt brought this issue to worldwide attention. Since that event, significant improvements have been made in the internal risk management systems of banks. However, more needs to be done to explore how daily settlement practices may be improved, in order to reduce substantially the settlement exposures and risks in the international banking system. The lack of progress has been due, in part, to the costs of making technological changes to help control and better coordinate foreign exchange settlements. In addition, the management of foreign exchange settlements is heavily dependent on the operational characteristics of a number of national payment systems, which are beyond the control of any one commercial banking organization or central bank. In sum, the management of settlement risk can quickly become a costly and complex process.

I believe that with recent worldwide changes in payment system designs and policy there are important opportunities to reduce settlement risk. I would caution, however, that there may not be a single, simple solution to reducing Herstatt risk. Instead, there may be a process of reducing risk that involves a number of changes to current settlement practices and institutional arrangements.

This afternoon, Governor Kelley will discuss the Federal Reserve's recent decision to open the Fedwire payment system at 12:30 a.m. Eastern Time beginning in 1997, an eight hour expansion of current operating hours. This decision reflects a public policy objective to begin removing operational barriers that may discourage the international banking community from developing safer methods of settling foreign exchange contracts. These methods may involve new clearing house arrangements, delivery-versus-payment settlements of one currency against another, or altogether new settlement practices that financial organizations may devise to reduce risk. The important point is to begin trying to tackle a problem that has long eluded effective solutions.

Over the next two days, we will also hear speakers address current issues in the international securities markets, including issues relating to cross-border settlement. I would note the very rapid growth of cross-border trading in securities, and in particular, the growing use of repurchase agreements in a number of currencies. These agreements can be very effective instruments for increasing the liquidity of money markets, and are well known in the United States. In the international context, however, large volumes of daily settlements from repurchase transactions are a novelty.

I believe that it would be prudent to ensure that proper legal foundations are in place even when old instruments such as repos become more widely used in international trading. It is also prudent to ask whether more can be done to make cross-border settlement arrangements for repos and other securities transactions safe and efficient.

In conclusion, I would like to return to the general theme for this Symposium with which I began, namely the development of new institutions and arrangements for making payments and settlements in the international banking system. It is important to remind ourselves, as we listen to the speakers over the next two days, that all of us have an important stake in the international payment system, and in the international financial system more broadly. Without a prompt and certain means of payment and settlement, markets that we rely upon every day to borrow and invest will not function effectively, if they function at all. Moreover, because large amounts of interbank and customer credit are extended through the operation of the payment system, the good order of the payment system and the international banking system are closely intertwined. Thus, we need to look for ways to make practical improvements in our payment and settlement systems that will help to ensure the liquidity and efficiency of our financial markets, especially during times of financial stress.