Addresses
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Report to the Congress

on

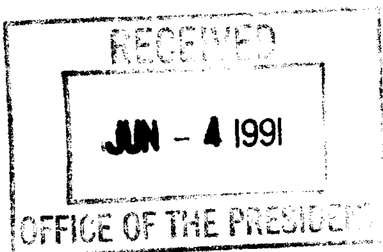
Intermarket Coordination

Submitted by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

May 31, 1991



In Fulfillment of Section 8a
The Market Reform Act of 1990

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MARKET REFORM ACT OF 1990 REPORT
May 31, 1991

I. Introduction

This report is in fulfillment of Section 8 of the Market Reform Act of 1990. Under that section, the Chairman of the Board of Governors of the Federal Reserve System is to report to the Congress by May 31 on efforts by the Federal Reserve in the areas of: the coordination of regulatory activities to ensure the integrity and competitiveness of U.S. financial markets; efforts to protect the payments and market systems during market emergencies; views on margin levels; and other matters related to the soundness, stability, and integrity of domestic and international capital markets.

The Federal Reserve has been active on a variety of fronts in the coordination of regulatory activities to enhance the soundness and competitiveness of U.S. financial markets. This coordination has involved domestic regulatory agencies--the Department of the Treasury, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC)--and foreign authorities, especially through international organizations. In addition, the Federal Reserve has worked closely with various private sector organizations, such as the Group of Thirty, on matters of common concern relating to risk reduction in the financial system, largely involving clearing and settlement mechanisms.

The Federal Reserve also has coordinated with the other domestic agencies on the matter of legislation relating to the regulation of stock index futures, including margins, and the so-called

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exclusivity provisions of the Commodity Exchange Act. Although the agencies continue to differ on some important issues, we have in the process developed a better appreciation of the various concerns of other agencies.

The remainder of this report is directed into four sections to reflect the specific concerns expressed by the Congress in Section 8.

II. Efforts to Ensure the Integrity and Competitiveness of U.S. Financial Markets

Much of the effort of the Federal Reserve to ensure the integrity and competitiveness of U.S. financial markets has been in working with other agencies and the private sector to identify ways to improve efficiency and reduce risks in financial markets that might threaten the financial system and spill over to the economy. Special attention has been given to measures that reduce risk in clearing, settlement, and payment systems. This work has proceeded along several paths, including: international work on payment netting systems, domestic efforts to implement shorter settlement periods, efforts to resolve legal impediments to the timely settlement of transactions, and efforts to ensure that privately operated payment mechanisms that use the Federal Reserve for interbank settlement have procedures in place to ensure settlement in times of financial stress. These efforts are described below.

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Cooperative Oversight of Payment and Netting Systems

In November 1990, the G-10 central bank governors authorized publication of the "Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries." The report was published at that time by the Bank for International Settlements (BIS), located in Basle, Switzerland. The Committee on Interbank Netting Schemes was composed of senior officials from the G-10 central banks and chaired by the general manager of the BIS. The Federal Reserve played a very active role in the preparation of this report.

The report analyzed various facets of cross-border and multi-currency netting schemes, including payment netting arrangements and proposals to create foreign exchange clearing houses in several countries. It took as a starting point the shared policy interests of central banks in maintaining, and encouraging improvements in, the efficiency and stability of interbank payment systems around the world. The report also noted that cross-border and multi-currency netting schemes of various types should be examined carefully because of their potential impact on these interbank payment systems.

As a result of its discussions, the Committee on Interbank Netting Schemes recommended and the G-10 central bank governors have endorsed minimum standards for the design and operation of cross-border and multi-currency netting schemes. In addition, the governors have adopted a set of principles for the cooperative central bank oversight of such arrangements.

The minimum standards contemplate that netting schemes will have a well-founded legal basis for their operation, along with sound

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risk management systems and reliable technical arrangements. At a minimum, multilateral netting systems should be capable of ensuring the daily completion of settlements, particularly in the event of default by one of the large participants in the system. Multilateral systems also should have in place admission standards that ensure that members have the financial and managerial capacity to meet their obligations while allowing fair and open access. Further, netting systems should embody reliable technical systems and have available adequate backup facilities.

The principles for cooperative central bank oversight are designed to help overcome ambiguities that might be created by the multinational and multi-currency characteristics of emerging arrangements. Thus, the report states that these principles "are intended to provide a mechanism for mutual assistance among central banks in carrying out their individual responsibilities in pursuit of their shared objectives for the efficiency and stability of interbank payment and settlement arrangements."

The principles help to ensure that the establishment and operation of netting systems are brought to the attention of central banks concerned. The principles are based on the presumption that host-country central banks for such systems will have primary oversight responsibility. The principles also recognize the interests of central banks whose currencies are cleared in these arrangements. They establish joint responsibilities, involving the central bank with primary oversight responsibility and the central bank whose currency is

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cleared, for determining the adequacy of the settlement--and fail-to-settle--procedures of a system. A final principle suggests that a central bank that lacks confidence in the design or management of a cross-border or multi-currency arrangement should discourage use of the system by institutions subject to its authority.

Group of Thirty Recommendations

The Federal Reserve, largely through the Federal Reserve Bank of New York (FRBNY), has been working with the SEC to implement the Group of Thirty recommendations on clearance and settlement practices in securities markets. Specifically, FRBNY and SEC staff participate in industry subgroups working to shorten the interim between trade and settlement from five business days to three business days and to make payments in same-day funds rather than next-day funds.

Discussions focus on the legal, regulatory, operational, and behavioral aspects of changing market practices in several areas. Some of the issues being addressed include: adjustment of retail customer payment practices; acceleration of the transaction confirmation process; implementation of the recommendations for municipal securities in the same time frame as corporate securities; reduction of credit and liquidity risks in the clearing corporations and depositories for corporate securities; and imposition of a book-entry settlement requirement for institutional market participants and other methods for reducing the use of physical securities. FRBNY and SEC staff are working with the industry subgroups to develop specific proposals that are expected to be issued for public comment later this year.

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Depository Trust Company (DTC)

In October 1990, the Federal Reserve, in consultation with the SEC, completed a rigorous review of the Depository Trust Company's proposed system for settling commercial paper transactions in book-entry form. The review process involved interviews with market participants regarding the risks in the traditional physical clearance and settlement process and the benefits of a book-entry environment for commercial paper. The FRBNY now monitors processing patterns within the DTC system closely in order to assess the adequacy of DTC's risk management system. Currently, the FRBNY is reviewing a proposed acceleration of DTC's implementation schedule for commercial paper and a proposed rule change filed with the SEC to modify the way in which DTC sets limits on credit exposure to its participants.

The FRBNY and the SEC are providing feedback to the DTC and the National Securities Clearing Corporation as they develop systems changes to accommodate a same-day funds settlement convention for corporate securities, one of the Group of Thirty goals. In the next few months, the Federal Reserve and DTC expect to discuss DTC's study of other financial instruments that may be appropriate for book-entry settlement in a depository.

Government Securities Clearing Corporation (GSCC)

In 1989, Government Securities Clearing Corporation began netting trades in Treasury securities, substantially reducing the gross trading volumes in settlement. Prior to the implementation of this system, the Federal Reserve reviewed proposals submitted by GSCC, provided guidance, and communicated its evaluation of the plans to the

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SEC. Recently, GSCC has been consulting with the FRBNY as it develops proposals for improving the netting, margining, and settlement of when-issued trades.

Efforts to Strengthen the CHIPS Settlement Mechanism

As a part of its program to reduce risk in large-dollar payment systems, the Federal Reserve has worked with the New York Clearing House Association over the years to strengthen the Clearing House Interbank Payments System (CHIPS). This funds transfer system handles about $1 trillion in payments each day. Settlement of net interbank positions over CHIPS is done through a settlement account maintained by the FRBNY. A large portion of these payments are for settlement of foreign exchange transactions involving the United States dollar.

Some time ago, the Federal Reserve assisted the Clearing House in its efforts to change CHIPS settlement from a next-day to same-day settlement system. Meanwhile, the Federal Reserve has been encouraging the Clearing House to implement arrangements that allow banks participating in CHIPS to limit their exposure to other participating banks. Moreover, with the encouragement of the Federal Reserve, the Clearing House implemented settlement finality for CHIPS in October 1990. Under the settlement finality arrangement, CHIPS participants agree to a loss-sharing arrangement and to hold liquid collateral that will ensure settlement in the event that a participant is unable to meet its net debit obligation. The FRBNY supports the CHIPS settlement finality arrangement by serving as custodian for the collateral pledged by CHIPS participants.

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Post-Drexel Initiatives

In the wake of Drexel's failure in February 1990, the president of the FRBNY assembled senior officials from some major financial institutions, self-regulatory organizations, the SEC, and the CFTC to discuss what lessons could be learned. The outcome was the establishment of three committees of private-sector executives, each with a FRBNY liaison, to explore, among other things, possible long-run improvements in payment and settlement systems and ways to reduce the legal uncertainties surrounding securities transactions during periods of market stress.

The Payments and Settlements Improvement Committee has organized subgroups to study five broad issues. One group is examining the temporal risk associated with the settlement of single-currency and multi-currency transactions across time zones. A second group is considering how foreign exchange netting can reduce risk associated with vast numbers of transactions for large gross amounts transacted daily among the same counterparties. The third group is exploring ways to reduce credit and operational risks in the federal funds market. A fourth group is investigating possible depository links and ways to reduce collateral needs so that in times of market stress surplus collateral posted in one settlement system may be made available to cover a collateral deficit in another system. A fifth group is studying whether expanding access to the payments system has the potential to reduce risk.

The second group, the Contingency Market Improvement Team, has focused on the establishment of a Payments and Settlements Advisory

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Committee consisting of a representative group of private market participants that can facilitate communication and consultation with regulators and other market participants in times of market stress. Whether the source of stress is due to credit, liquidity, or operational factors, the Advisory Committee would help to ensure marketwide settlements. In the near term, the Advisory Committee also will act as an "umbrella" coordinating group for initiatives of the other post-Drexel groups.

The third group, the Market Improvement Legal Group, has recommended legislation that would bolster counterparty confidence by reducing legal uncertainties surrounding market transactions that might arise during times of stress. The initiative would permit other market participants to exercise all of their rights and remedies to close out promptly all open financial market contracts with a failed participant. Discussions continue between the Federal Reserve, the SEC, and the CFTC on the specifics of the proposal and its future direction.

Clearing Bank and Clearing Organization Roundtable

Staff members of the Board of Governors, the FRBNY, and the Federal Reserve Bank of Chicago participate in the Clearing Organization and Clearing Bank Roundtable. This organization includes representatives of the SEC and CFTC, as well as clearing organizations in the securities and derivatives markets and the banks that provide settlement services to the markets. The Roundtable provides a forum for discussion of financial market issues that cut across regulatory and exchange boundaries and for coordinating action on these issues. Discussions this past year have focused on: an assessment of problems

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that arose in the Drexel Burnham Lambert liquidation; implementation of the Group of Thirty recommendations; precautions that participants took around the time of the Persian Gulf war, especially on the Martin Luther King holiday when the banking system was closed and the markets were open; and contingency planning related to disaster recovery. The Roundtable also provides a sounding board for discussion of Federal Reserve payments system policies.

Consultation on Securities Margin Regulations

Federal Reserve staff consult frequently with staff at the SEC on issues involving the implementation of margin regulations, including compliance questions and issues that arise in connection with new financial products. On occasion, Board staff have provided interpretive letters for use in actions brought by the SEC that involve margin issues. Margin questions frequently arise in connection with SEC capital requirements and other rules applied to broker-dealers; frequent communication allows the staffs of the two agencies to deal with these matters efficiently and with minimum administrative burden on market participants. Board staff is currently participating in an SEC initiative that would provide uniformity among the exchanges and the NASD with regard to extensions of time for payment under the Board's Regulation T.

The Federal Reserve also works with the CFTC when the Board's margin regulations affect the futures clearing agencies. This coordination helps to ensure that clearing agencies regulated by the CFTC and those regulated by the SEC are accorded similar treatment under margin regulations.

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Government Securities Act

The Board of Governors, in cooperation with the Treasury and SEC, submitted a report titled "Study of the Effectiveness of the Implementation of the Government Securities Act of 1986" to the Congress on October 1, 1990. In addition to addressing the effectiveness of the regulations promulgated under the Government Securities Act, the report discusses three issues pertaining to competition in and soundness of the market for government securities: the expansion of access to broker information, the need for additional sales practice rules, and the extension of coverage of Securities Investor Protection Corporation insurance. Board staff met with representatives from the other two agencies on several occasions in 1990 to discuss these issues. While there was general agreement among the three agencies regarding the effectiveness of the implementation of the Act, there were some differences regarding the appropriateness of additional action. The agencies agreed to present the issues without making specific recommendations.

III. Coordination to Protect Market Systems During Market Emergencies

The Federal Reserve has routinely worked closely with other relevant agencies in times of market emergency or at times when the prospects for a market emergency appeared significant. There have been two notable examples over the past year or so, the failure of Drexel Burnham Lambert and the outbreak of war in the Persian Gulf.

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Failure of Drexel Burnham Lambert

The failure of Drexel Burnham Lambert in February 1990 posed a threat to its regulated government securities and broker/dealer subsidiaries and to the financial system more broadly. The Federal Reserve's interests in this matter stemmed from our oversight of Drexel's primary dealer government securities subsidiary and from our broad responsibility for the smooth functioning of the financial system.

To minimize disruptions, the Federal Reserve worked with the SEC, the Treasury, the CFTC, and various parties in the private sector on an orderly winding down of Drexel's business, especially that done in the regulated government securities and broker/dealer subsidiaries. This involved the exchange of information and discussion of issues, including strategies for an orderly wind-down. To facilitate the completion of transactions and closing out of positions, Fedwire was kept open unusually long hours. In addition, to avoid gridlock in the payments for securities and foreign exchange, the Federal Reserve worked closely with private parties involved in these transactions and proposed to make facilities available at the FRBNY where parties could meet and complete transactions. (In the event, the provision of such services proved unnecessary.) Throughout this process, there was frequent consultation among the federal authorities, including the Treasury Department, the SEC, and the CFTC, to exchange information and discuss issues.

In retrospect, it would seem that the process of closing out Drexel positions, especially in the government securities and broker/dealer subsidiaries, went quite smoothly. In particular,

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customers of the regulated entities did not incur any losses and a contagion effect was avoided. This owes in no small part to the cooperative efforts of the various agencies and the private sector.

Persian Gulf Hostilities

Iraq's invasion of Kuwait dramatically increased uncertainty about oil prices and raised concerns that large price movements could lead to defaults on futures and options contracts, potentially affecting brokers and clearing and settlement systems. Soon after the invasion, Board economists assessed the potential implications of a sharp increase in oil prices for the financial condition of the New York Mercantile Exchange (NYMEX), which lists futures (and options on futures) for crude oil and other related products. CFTC economists, accountants, and lawyers provided information to the Federal Reserve regarding oil price volatility and NYMEX's risk management system; additional information was obtained from NYMEX. Prior to the outbreak of war, the Federal Reserve was in contact with the CFTC, SEC, and Treasury to assess the potential for major disruptions in various markets arising from a war and to discuss areas to be monitored closely.

The Federal Reserve Banks extended Fedwire hours on Friday, January 18, and opened Fedwire early on Tuesday, January 22. This was done to facilitate margin payments on the futures and options exchanges.

IV. Margin Levels

On the matter of margins on securities and their derivatives, the Federal Reserve Board continues to believe that the primary objective of federal margin regulation should be to protect the

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financial integrity of market participants and thereby ensure contract performance. Margins should be adequate to protect clearing organizations, brokers, and other lenders from credit losses arising from changes in securities prices. As such, they are one important element of a package of prudential safeguards, including capital requirements, liquidity requirements, and operational controls, aimed at limiting the vulnerability of the financial markets to losses or disruptions arising from the failure of one or more key participants. The failure of, or even the loss of public confidence in, a major intermediary in any of the stock, futures, or options markets could immediately place significant strains on other markets, their clearing systems, and on our nation's payment system.

The Board has been skeptical, however, of whether setting margins on stock index futures at levels higher than necessary for prudential purposes will reduce excessive stock price volatility. The Board has been concerned about what seems to be a higher frequency of large price movements in the equity markets, but it is not convinced that such movements can be attributed to the introduction of stock index futures and the opportunities they offer for greater leverage. Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that margins in the cash markets and in the futures markets have not affected volatility in any measurable manner. Moreover, the Board has been concerned that raising maintenance margins on stock index futures to levels well above those necessary for prudential purposes

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could drive business offshore or substantially reduce futures market liquidity.

Thus, in the Board's view, the critical question has been whether margins on stock index futures have been maintained at levels that are adequate to protect against failures that could give rise to systemic risks. Although no futures clearinghouse has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearinghouses in recent years raise questions about the adequacy of futures margins from a broader public policy perspective. Specifically, we have had concerns about the tendency for these organizations to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. While such a practice has heretofore protected the financial interests of the clearinghouses and their members, it tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. In the Board's view, margin levels on stock index futures somewhat higher, on average, than those that have been maintained historically would reduce the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The Board continues to believe that federal oversight is appropriate to ensure that margins on stocks and stock index futures are established at levels that are adequate under a wide range of market conditions. Futures self-regulatory organizations (SROs) should

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continue to have primary responsibility for developing and refining margin policies. But the appropriate federal agency should have both the authority to initiate changes in margins on stock index futures and the authority to veto changes proposed by the relevant SRO. That authority should not be limited to emergency authority such as the CFTC currently has over futures margins. Title III of the Futures Trading Practices Act, which was passed by the Senate on April 18, 1991 (S. 207), would provide for such federal oversight authority over stock index futures, assigning it to the Federal Reserve Board. As the Board has noted in congressional testimony, while we prefer that this authority be given to the SEC or CFTC, should Congress assign such authority to the Board, we would, of course, endeavor to discharge this responsibility in a careful and serious manner.

V. Other Issues

Uniform Legislation on Settling Market Transactions

The American Bar Association established the Advisory Committee on Settlement of Market Transactions (the "Haydock Committee") to address questions raised after the October 1987 market break concerning state and federal laws governing the transfer and pledge of publicly traded securities and the impact of these laws on the settlement of securities transactions. Staff of the FRBNY, the SEC, CFTC, and Treasury serve on the committee. The committee has issued for comment an interim report with recommendations on changes to federal laws concerning setoff rights in bankruptcy proceedings, and to state laws

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concerning financial intermediary insolvency proceedings, choice of law rules, and clearance in the U.S. of non-U.S. securities.

OECD Study of Systemic Risk

In February 1991, the OECD published a report entitled Systemic Risk in Securities Markets, with a focus on international securities markets. Board staff, along with staff of the Treasury and SEC, were members of the committee that prepared the report. This report identifies various factors that contribute to systemic risk in global securities markets and areas potentially in need of international coordination of regulation. Among the areas analyzed are market mechanisms (such as market structure, capacity, circuit breakers, and margins), clearing and settlement systems, supervisory coverage, and capital requirements.

Federal Reserve's Risk Reduction Program

The Federal Reserve's Risk Reduction Program for large dollar payments continues to seek to improve the integrity of U.S. financial markets and dollar payments while sensitizing the private sector to the risks in clearing and settlement. To date, the program has resulted in a significant reduction in the amount of public sector intraday credit extended by the Federal Reserve relative to the value of payments being processed and has prompted the private sector to design new and improved clearing and settlement practices to reduce risk.

During 1990, four developments are particularly noteworthy. First, as noted above, in response to the Federal Reserve's program, CHIPS (the Clearing House Interbank Payment System) introduced an improved risk management program in October 1990 that incorporated

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explicit loss-sharing rules backed by collateral requirements on the participants. Based upon these changes, CHIPS daily settlement is assured even if the largest single participant within the system is unable to settle at the end of the day. Second, a new delivery-versus-payment (DVP) system capability was introduced in October 1990 under the Federal Reserve's Policy Statement regarding DVP when Depository Trust Company (DTC) added commercial paper to its electronic same-day-funds-settlement system. When fully phased in by the middle of 1992, this system will effectively replace physical delivery of more than $40 billion of commercial paper daily with netted, book-entry transactions. Moreover, the DTC system will centrally manage the intraday credit and liquidity risks associated with commercial paper trading to accord with prudential rules. Previously, these risks were less well understood and managed by the individual participants in the market.

Third, in January 1990, the Federal Reserve incorporated overdrafts arising from the transfer of book-entry government securities into its payment system risk reduction program and modified its treatment of daylight overdrafts incurred by branches and agencies of foreign banks. The inclusion of book-entry government securities in the calculation of intraday overdrafts and the explicit provision for collateralizing these overdrafts when they are "material and frequent" further reduces the Federal Reserve's risks in this area. The modified treatment of overdrafts for those foreign banks that both comply with international capital standards and demonstrate substantial U.S. dollar

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liquidity provides greater equity of treatment of such banks relative to their U.S. counterparts.

Finally, the Federal Reserve continues to work closely with banks to devise an approach for calculating daylight overdrafts that is fair to payors and payees and that does not result in public subsidization through the creation of intraday float. Pricing such intraday Federal Reserve credit is expected to provide further incentives to the private sector to reduce its use of such central bank credit.

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