Jamie B Stewart, Jr: Developments in the US payment and settlement system and the Federal Reserve's interest in the securities settlement system

Remarks by Jamie B. Stewart, Jr, First Vice-President and Chief Operating Officer of the Federal Reserve Bank of New York, before the Securities Industry Association T+1 Foundation Conference held in New York on 24 October 2000.

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Good afternoon, ladies and gentlemen. I am pleased to join you at the SIA's T+1 Foundation Conference. This conference provides an excellent opportunity to review plans that have been announced for converting to a T+1 settlement cycle for securities transactions. Implementation of T+1 would represent a significant change in the payment and settlement environment.

Before commenting on this arrangement, however, I would like to stand back for a few moments and focus on some of the plans under way to improve the functioning of the payment and settlement system in the United States. In addition, I would also like to discuss briefly the Federal Reserve's interest in the securities settlement system.

There can be no doubt that a sound and effective payment and settlement system is critical to ongoing confidence in the US financial markets and to the continued health and competitiveness of the US financial sector. In an environment of rapid technological change and rising trading volumes such as we face today, it is essential to make certain that the integrity of the payment and settlement system remains intact. To this end, a number of initiatives are currently in progress to help ensure the continued efficiency of the payment and settlement system in the United States.

Let me be a bit more specific about some of the planned improvements to the infrastructure of the financial system that we expect to be implemented in a very short time. The first is the CLS Bank project, the Continuous Linked Settlement Bank, which has been under discussion since 1995. The owners of the CLS Bank are in the process of building the Bank's systems and getting supervisory approval to begin operations in the fall of next year.

The purpose of the CLS Bank is to create a privately owned and operated facility for payment-versus-payment settlement of foreign exchange transactions. Today, many foreign exchange transactions carry principal risk - that is, the risk that only one of the two legs of the transaction will be executed. This risk exists because of differences in the operating hours of large-value payment systems around the globe. However, when transactions are settled through the CLS Bank, the two legs of the transaction will be executed simultaneously with finality, thereby eliminating principal risk from the transaction.

A second initiative under way to improve the payment and settlement infrastructure has to do with CHIPS, the Clearing House Interbank Payments System. The New York Clearing House, which operates CHIPS, is planning to introduce fundamental changes to its processes for large-value interbank payments that will bring about intraday finality. What happens now is that participants in CHIPS submit payment instructions throughout the day. But actual settlement, performed on a net basis, is deferred and becomes final only at the end of the processing day.

In the new arrangement, which the New York Clearing House has announced it will put into operation in January, CHIPS participants will continue to submit payment instructions throughout the day. However, through the use of a bilateral and multilateral matching algorithm, the vast majority of payments will be settled and become final over the course of the day. By ensuring that final payment is made promptly, the new procedure will reduce settlement and operational risks and enable participants to manage their risks more effectively.

A third major improvement to the U.S financial infrastructure that the Federal Reserve has already implemented deals with a new net settlement service for Fedwire. The net settlement service was implemented in 1999 in response to requests from major US clearing associations. These groups asked the Federal Reserve to help their members reduce settlement risk while improving operational efficiency. They noted that Fedwire itself is not an effective way to settle obligations among the members of a clearing group. We agreed and rolled out a new settlement vehicle. This new service helps clearing houses and related arrangements achieve their goals by offering Fedwire-like, immediate and irrevocable finality for entries that have been submitted in a convenient file format by a group's agent.

An important, even ground-breaking characteristic of this service is that it allows clearinghouses and other groups to process and clear transactions on their own, although the clearinghouses will continue to achieve final settlement of the underlying obligations on accounts at the Federal Reserve in central bank funds. By permitting this separation of clearance and settlement, the new service opens opportunities for the private sector to develop clearance solutions while using the most sound and risk-free settlement mechanism available.

In addition to these major developments, the securities industry has put the T+1 project in motion for the settlement of equities and privately issued debt instruments. Like the CLS Bank project and the new CHIPS design, the T+1 project is an important effort not only to eliminate significant settlement and pre-settlement risks from the payment and settlement system, but also to raise the system's operational reliability and efficiency in the area of securities transactions.

All of these planned improvements to the functioning of the payment and settlement system demand a high level of cooperation between the private and public sectors. In my view, it is especially important for the financial services sector to support common interests and shared goals. I say this because I am convinced that only through these joint initiatives can the financial services sector adequately address efficiency issues and the potential for systemic risk in the current environment. At the same time, I recognize that industry-wide efforts pose new challenges as they are applied to ever more difficult and complex issues. The push for T+1 will require the committed support of both the public and private sectors because the stakes are very high.

I would like to turn now to the securities settlement system and the Federal Reserve. Since its inception, the Federal Reserve System has been deeply interested in the design and operation of the securities settlement system in the United States. The Federal Reserve's interest stems from its overall concern for the efficiency, reliability and stability of the financial system as a whole.

First and foremost, the Federal Reserve System was created by Congress in 1914 to oversee the stability of the nation's financial system. As part of its oversight responsibilities, the Federal Reserve Banks stand ready to lend funds from the discount window to US depository institutions and, under extraordinary circumstances, to other US entities. In addition, the Federal Reserve is a member of the international community of central banks, bank supervisors and securities regulators and, as such, works cooperatively with its counterparts in other countries to promote financial stability globally.

Second, the Federal Reserve is responsible for supervising US depository institutions and US bank and financial holding companies, some of which are very involved in the securities settlement system. Commercial banks provide wholesale custodial services to both institutional investors and intermediaries in the securities business. Commercial banks also lend to firms in the financial services sector, providing short-term credit and thereby adding critical liquidity to securities markets. Furthermore, some of the very largest commercial banks earn a substantial portion of their net revenues from the various payment and credit services they offer to the securities industry. In addition, the Federal Reserve and the Securities and Exchange Commission jointly regulate and oversee the Depository Trust and Clearing Corporation through which privately issued bonds and equities are settled in the United States.

Third, as fiscal agent, the Federal Reserve provides a variety of payment-related services on behalf of the United States Treasury and other government agencies. These services include the processing of government payments as well as the creation, safekeeping, and transfer of book-entry records detailing ownership of the public debt. As an extension of these fiscal agent duties, the Federal Reserve also seeks to promote the efficient operation of the government securities market.

Fourth, the Federal Reserve oversees private clearing and settlement systems and provides payment services, principally Fedwire. These services are central to overall financial stability because disruptions in payment systems have the clear potential to impair the functioning of the financial sector and the real economy. Moreover, a major financial or operational problem at a key institution in a securities settlement system can also spill over to the payment systems that it uses and thereby have systemic repercussions.

Finally, to enhance the general welfare of the US economy, the Federal Reserve promotes the efficient functioning of the payment system and helps to supply payment services. A secure, fast, and reliable payment and settlement system is a key element in a modern economy. Through its Payment System Development Committee, the Federal Reserve seeks to address emerging payments-related issues. The basic aim of this committee is to work with the private sector to advance the use of electronic payments throughout the US economy.

In taking the step to T+1, the US securities industry will be assuming an important leadership role in the evolution of securities settlement systems around the world. I should also note that implementation of a shorter settlement cycle is consistent with the position taken by the International Securities Services Association (ISSA), the securities industry's own review body. In a set of recommendations this association released earlier this year and discussed at a session of the Sibos conference last month, ISSA explicitly calls for adoption of a T+1 settlement cycle in its member countries.

I would like to make clear that the Federal Reserve supports the SIA's effort to adopt the T+1 settlement cycle. Faster, more reliable, and more cost-efficient processing of securities transactions is desirable for several reasons.

First, high or excessive transaction fees may serve to distort or hinder financial activity. Inefficient trading and settlement arrangements used by the secondary market for securities could discourage the use of securities relative to other financial instruments. The choice of instrument should be based on the needs of borrowers and investors.

Second, inefficient settlement arrangements may interfere with active risk management. High settlement fees could discourage institutions and portfolio managers from taking full advantage of advances in risk management techniques.

Finally, a high cost structure for securities settlements could influence competition among financial centres. The efficient processing of commercial and financial transactions, including those generated by securities trading, is a necessity in a marketplace as competitive as ours is in the United States today. In my view, we are likely to see much more competition among financial centres in the future because financial centres provide a source of high-paying jobs. Cities around the world will increasingly compete to be prime financial locations.

In sum, your efforts in moving to T+1 are part of an industry-wide effort to reduce risk and thereby ensure that our payment and settlement system continues to work well under all conditions. We are supportive of your efforts and applaud your initiative because we all want our payment and settlement system to remain sound, secure and efficient as it adapts to the changing needs of our global economy.