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SPEECH

Recent Global Developments and Central Bank Responsibilities in a Changing Risk Landscape

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It's an honor to be invited to speak to you.¹ Let me begin by offering my best wishes to you and your loved ones in these challenging times.

Since its inception in the early 1980s, SEACEN has been the learning hub for central banks in the Asia-Pacific Region, tasked with the important mission of building capacity in central banking and fostering networking and collaboration. As a strategic partner of SEACEN, the Federal Reserve is a proud supporter of SEACEN's mission and has been a longstanding collaborator on several SEACEN courses.

This event opens a new chapter in our partnership. Through the coordination of the New York Fed, the world's major reserve currency central banks, which I'll refer to collectively as the Official Sector Service Providers, have collaborated with SEACEN and Bank Negara Malaysia for the first time on a joint training event focused on official cross-border payment operations and risk topics.²

The upcoming sessions are timely and relevant for all central banks, but especially those in the Asia-Pacific region. The cross-border payment risk landscape is quickly evolving and all central banks must cooperate to stay ahead of highly adaptive cyber threat actors that, in recent years, have targeted the payment and reserve management operations of central banks. Unprecedented shifts in working arrangements due to COVID-19 only strengthen this imperative, especially in a region with some of the world's largest FX reserve holders.

In my remarks today, I'll offer some observations on the recent global backdrop and related risks and opportunities. I will then share my view on the responsibilities of, first, OSSPs as your service providers; second, central banks collectively in the current risk environment; and third, account holders in helping OSSPs better secure your reserve assets.

Before proceeding, let me provide the usual disclaimer that the views expressed here are mine alone and do not necessarily reflect those of the Federal Reserve Bank of New York, the Federal Reserve System, or other Official Sector Service Providers.

Recent global macro backdrop, emerging risks and opportunities

We meet today as all of our economies seek to recover from the deepest global economic contraction in our living memory, following widespread lockdowns to combat the COVID-19 pandemic.

The uncertain outlook triggered unprecedented market volatility and the worst economic downturn since the Great Depression. Advanced economies have seen an historic rise in fiscal deficits and debt issuance to offset sharp contractions in economic activity. Emerging markets faced record capital outflows – over \$80 billion in March alone – exceeding the pace and scale of any previous stress episode, including the Global Financial Crisis. In the race to safety, U.S. dollars became increasingly scarce, intensifying the stress across global markets as dollar

funding and hedging costs spiked, and prompting large-scale liquidations of foreign currency reserves across the globe.

These challenges reinforced the importance of close cooperation among central banks. To respond to global dollar funding strains, over a span of two weeks in late-March, we took coordinated action with other central banks, including several OSSPs, to enhance the provision of liquidity via our standing U.S. dollar liquidity swap line arrangements, and established temporary swap lines with nine additional central banks. We also established a new FIMA repo facility to support dollar liquidity to a broader range of countries.³ The extension of this umbrella of liquidity was unparalleled in its rapidity and global reach, consistent with a pandemic-induced sudden stop in the global economy and the changed contours of global dollar funding markets over the past decade.⁴ These actions have helped to restore calm to dollar funding markets and support a return to more normal conditions in global financial markets more generally, permitting a stabilization in global FX reserves.

The Asia-Pacific region has been on the leading edge of the crisis, offering important lessons for the rest of us. Asia made early progress in flattening the curve of infections and is now further along in its economic recovery. While Asian jurisdictions faced some of the most significant portfolio outflows in March, these have started to rebound and funding stresses have subsided. Nonetheless, collectively, we must remain prepared for the risks of further pressure on all fronts – including health outcomes, economic performance, and market functioning.

As we focus on the ongoing crises, I don't want to lose sight of some of the key risks and opportunities facing central banks going forward. I'll highlight two.

The COVID-19 pandemic already appears to be accelerating the shift to digital payments, particularly contactless payments, amid public concerns around virus transmission through cash. As this trend proceeds, so will attention on central banks to provide enabling infrastructure and technology to support fast, convenient, and safe digital payments for households and businesses, both domestically and across borders. Recent surveys show that most central banks now are engaged in some form of work on central bank digital currencies (CBDCs), including several in the Asia-Pacific region that have announced pilot projects, which could provide important test cases, including on cross-border payments.⁵ At the Federal Reserve, we are also collaborating with other central banks to advance our collective understanding of CBDCs. Important considerations for any potential CBDC include whether it would reduce operational vulnerabilities and complexity in payments, and also what would be required in terms of cross-border cooperation for CBDCs to address current frictions and reduce costs in cross-border payments.

Separately, a number of OSSP members have moved to establish faster payments systems domestically. In the U.S., the Federal Reserve last August announced plans to develop a new real-time payments and settlement service called the FedNowSM Service to support faster retail payments in the U.S. and which could also serve as the foundation for future innovation.⁶

Climate risks, with potential far-reaching implications for our economies, are also increasingly coming onto the agenda of central banks. A recent BIS survey found a large majority of central banks saw scope to include sustainability in their reserve management objectives over time. Of course this would need to be balanced with liquidity, safety and return considerations.⁷ With many central banks now engaged in corporate bond purchase programs, and markets for green bonds starting to mature – including with increasing sovereign issuance – OSSP events such as these could be forums to share experiences and best practices.

Responsibilities of the major reserve currency service providers

Let me now turn to the role of OSSPs in the current environment. In collaborating on events such as these, OSSPs are keenly aware of the special responsibilities that come along with being issuing authorities for the world's major reserve currencies. These responsibilities can be viewed from two perspectives—one global, one domestic.

The first responsibility relates to the role of OSSPs in supporting global financial stability. The network of account relationships between OSSPs and their official accountholders, both in Asia and elsewhere, provides vital channels through which global financial stability operations occur. OSSPs have a responsibility to ensure that this network maintains an operational capacity to distribute, when necessary, emergency liquidity to critical segments of the global economy. In exigent circumstances, not having this pre-established and direct transmission capacity could be debilitating for the timely and effective provision of emergency cross-border liquidity.⁸ This network has proven its value time and time again, both historically and during the current COVID crisis.⁹

A second responsibility relates to the trust and confidence that the world's central banks place in OSSPs for their self-insurance and investment needs. As you all know, the world's foreign reserve assets are denominated in just a small handful of currencies—those that are issued by the OSSPs, with the U.S. dollar alone accounting for approximately 60% of global FX reserves. A large share of the most liquid of these assets, representing

approximately 50% of total global foreign currency reserves, are held directly in accounts with OSSPs. OSSPs also recognize, that for most countries, the foreign reserves held with them comprise a significant portion of their account holders' national wealth and investment capital.¹⁰

For these reasons, OSSPs take their obligations seriously to provide safe, confidential, and reliable services to the global official community. We take seriously our obligation to ensure our services are operationally ready for central banks to execute critical cross-border financial operations. We take seriously our obligation to safeguard valuable national capital upon which can hinge the prosperity of nations. We do this by ensuring high levels of operational resilience and risk management. And we do this by recognizing that the stature of being a reserve currency must be earned through sound policies and institutions and should not be taken for granted.¹¹

Responsibilities of all central banks in the current landscape

In the current threat landscape, however, all central banks must continually rededicate themselves to the task of securing their assets and operations. While we have made progress in understanding the nature of the threats, the sophistication of criminal actors means we need to constantly reassess these risks, any potential impact to account operations, and the strength of our defenses. For central banks, as owners, operators, overseers, and users of critical financial market infrastructures, this is a paramount calling.

The COVID crisis and shifts to alternative working arrangements have only heightened this imperative. While there have been some pleasant surprises in terms of our ability to fall back on contingency postures to support critical operations, we must gird ourselves for the possibility of a new normal in our physical work settings and remote working expectations. We must manage this transition carefully without a lowering of standards and controls for the sake of convenience.

This might be self-evident to a central banking crowd. We understand that on the issue of strengthening internal controls and cyber defenses, the question is often not one of intentions but one of resources or capabilities. Remediating deficiencies may require a substantial and often challenging re-orientation of priorities and resources. But so long as there is a weak link in the cyber security chain, cybercriminals will seek to exploit it. The cross-jurisdictional nature of the risks, spillovers, and solutions, also requires that central banks be open to stronger international cooperation and dialogue. This forum and the OSSPs' collective presence here are a clear signal of our willingness to engage in such dialogue.

How customers can work with OSSPs to help themselves better secure their assets

Over the coming weeks, you will hear many specific messages from the OSSPs on topics ranging from endpoint security, anti-money laundering and sanctions regulations, incident response, third party payments, and others. An overarching message is that we should strengthen collaboration and share experiences to help raise standards internally within our organizations and raise standards externally across the community.

What does raising standards within our organizations look like?

It means areas performing banking operations should first identify and monitor risks and ensure there are robust controls in place to mitigate those risks. This may require pushing for greater accountability through independent assessments. But it also means recognizing that effective risk management requires collaboration across our organizations and outside them. Certain risks may be outside our functional responsibility as banking operations specialists, such as security for information technology systems, but they may greatly impact our ability to conduct business. So collaborate as necessary with other internal departments, other agencies such as ministries of finance, and service providers. Highlight the business in being an active participant in these discussions and in flagging potential vulnerabilities. And be advocates for stronger controls and risk focus more broadly.

Raising internal standards also means preparing and exercising incident response and contingency plans. No matter how much we invest in our defenses, we must assume that not all incidents can be prevented. In such cases, speed is critical to contain the damage and potential financial losses. Make preparations with your service provider; plan outside coordination and communication ahead of time; understand what your service provider can and can't do in an incident; and finally, exercise your playbook. OSSPs would be happy to engage in dialogue with account holders on how we can support your incident response planning.

What does raising standards externally across the community look like?

First, it means expecting better and more responsive communication with each other. Reliable communication channels between OSSPs and our account holders are more essential than ever, not only to respond to time-sensitive matters, but also to address more routine issues.¹² The COVID crisis has forced many of us into becoming more familiar with video conferencing. Efforts should be made to make video conferencing even more reliable and routine even after we return to the office.

Raising standards externally also means open and transparent information sharing with each other on our expectations, guidance, and risk management practices and controls.¹³ It means seeking and sharing important transactional information to support OSSP compliance screening, including completing SWIFT message fields thoroughly and accurately. It means being willing to share insights on the payment origination flow, internal controls, technology systems, and other aspects to support "know your customer" (KYC) programs. It means sharing SWIFT Customer Security Program (CSP) data. While greater openness can lead to a sense of vulnerability, it can also inspire greater trust and thus more timely service provision.¹⁴

Conclusion

Distinguished participants, let me conclude by wishing you all fruitful meetings and discussions in the weeks ahead. This forum is a great example of the collective collaboration that will be required to keep our assets and operations secure. The OSSPs come here with a spirit of humbleness and a desire to understand the perspectives of our Asia-Pacific account holders. This is borne out of a keen sense of the trust you place in us as stewards of your foreign reserves and a recognition that we all face similar challenges in protecting ourselves against the threats to our cross-border operations.

Thanks for listening.

¹ I would like to thank Mark Choi and Brendan Kelly for their assistance in the preparation of these remarks.

² The twelve OSSPs participating in this training forum consist of the Federal Reserve Bank of New York, European Central Bank, Bank of England, Bank of Japan, Banque de France, Deutsche Bundesbank, De Nederlandsche Bank, Bank of Canada, Reserve Bank of Australia, People's Bank of China, Bank of Korea, and Bank for International Settlements.

³ Under the temporary FIMA (Foreign and International Monetary Authorities) Repo Facility, FIMA account holders at the Federal Reserve Bank of New York (which include central banks and other monetary authorities) can enter into overnight repos (repurchase agreements) with the Federal Reserve, temporarily exchanging U.S. Treasury securities in their accounts for U.S. dollars, which can then be provided to institutions in their respective jurisdictions. See Federal Reserve announces establishment of a temporary FIMA Repo Facility to help support the smooth functioning of financial markets, Federal Reserve Board Press Release, March 31, 2020. Other OSSPs have similarly rolled out facilities to enhance liquidity in their currencies. For example, the ECB recently announced a precautionary repo facility for its foreign central bank account holders. See New Eurosystem repo facility to provide euro liquidity to non-euro area central banks, ECB Press Release, June 25, 2020.

⁴ Of note, at the peak of usage in May nearly 60% of swap line funding, or \$256 billion, was extended to Asian jurisdictions – highlighting the increased importance of Asia and Asian institutions in dollar funding globally, not to mention global financial markets more broadly. While volumes in the FIMA Repo Facility have been comparatively light to date, it has been a significant backstop for central banks that invest in U.S. Treasury securities. Since the facility's announcement, FIMA account holders have resumed strong purchases of U.S. Treasury securities. Reflecting this, U.S. Treasuries held in custody by FIMA account holders at the Federal Reserve have recovered approximately two-thirds of their decline in March.

⁵The latest survey by the Bank for International Settlements, released this January, found that 80% of central banks surveyed were engaged in work on CBDCs, with 40% having progressed to proof-of-concept experiments and 10% engaged in pilot projects. Improved payments efficiency and safety domestically were cited as top motivations, and secondarily more efficient cross-border payments – though questions remain on whether CBDCs are the best way to achieve these aims. See *Impending Arrival – A Sequel to the Survey on Central Bank Digital Currency*, Bank for International Settlements, January 2020.

⁶ "FedNow" is a service mark of the Federal Reserve Banks.

⁷ See *Reserve Management and Sustainability: The Case for Green Bonds?*, Bank for International Settlements, March 2020.

⁸ In this context, the Fed's prior experience during the Global Financial Crisis in establishing temporary swap lines (2008-10) contributed to the Fed's ability to rapidly re-implement them during the 2020 COVID-19 crisis. Likewise, the ability to rapidly implement the FIMA Repo Facility partly reflected years of advance operational planning.

⁹ For more information on the history and role of inter-central bank account services in support of global financial stability, see Potter, Keynote Remarks for the Commemoration of the Centennial of the Federal Reserve's U.S. Dollar Account Services to the Global Official Sector", December 20, 2017.

¹⁰ The total FX reserve holdings of emerging market economies, in particular, are equivalent to approximately one-fifth of their collective GDP.

¹¹ For a useful exposition of the general requirements for a currency to earn and maintain its stature as a reserve currency, see Dudley, Panel Remarks at the 7th High-Level Conference on the International Monetary System, May 10, 2016.

¹² Account contacts should be reachable to answer questions from OSSPs and vice versa. OSSPs and customers should also explore establishing secure communication channels such as encrypted email, and account contacts should get to know their OSSP relationship manager and exploit any opportunities for in person meetings.

¹³ Relatedly, it also means adhering to international best practices and supporting strategies for their global adoption and tracking by participation in official sector stock-taking exercises such as through the BIS, FSB, etc.

¹⁴ In addition to sharing information with each other, inspiring greater confidence in the shared information will also be critical. In this digital era of information overload, the challenge often is in separating the signal from the noise. The signal-to-noise ratio can be improved by increasing the demonstrated costs of the signal. For some this may entail heightened efforts to engage in dialogue to help interpret shared information. It could also entail hiring third parties to engage in independent assessments of, for example, SWIFT CSP compliance.