



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551-0001

CONFIDENTIAL (FR)
CLASS III - FOMC

TO: Federal Open Market Committee DATE: December 14, 1995
FROM: Normand Bernard *N.B.*

Attached is a report of examination of the System Open Market Account. The examination was conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on September 29, 1995, and the report was submitted by Mr. Farnsworth, Director of the Division, on December 7, 1995. An audit of the Account is made in connection with the annual financial examination of the Federal Reserve Bank of New York in accordance with long-standing procedures.

The attached report will be on the agenda for consideration at the December 19, 1995 meeting of the Committee.

Also attached are a copy of the Management Letter relating to an outside audit by Coopers & Lybrand and the Federal Reserve examiners' comments on that letter.

Attachment



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

December 7, 1995

- RESTRICTED -

Mr. Donald L. Kohn, Secretary
Federal Open Market Committee
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Kohn:

This report is submitted for the information of the Federal Open Market Committee in compliance with the Committee's standing request. An examination of the System Open Market Account (SOMA), including domestic open market and foreign currency operations, was conducted as of the close of business September 29, 1995, in conjunction with the annual financial examination of the Federal Reserve Bank of New York. Accounts relating to repurchase agreement transactions were also tested.

SCOPE OF EXAMINATION

The financial examination of SOMA was conducted in accordance with generally accepted auditing standards as applicable to Federal Reserve Banks. The procedures used included verification of SOMA holdings and the related asset and liability accounts, tests of departmental accounting records to determine the appropriateness of the balances reported in earnings and profit and loss accounts, reviews of selected transactions to determine the level of compliance with established procedures and the adequacy of internal control systems, reviews of the scope and frequency of audits made by the resident auditing staff, and other examination procedures we considered necessary or appropriate.

Mr. Donald L. Kohn

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SUMMARY OF FINDINGS

Domestic Open Market Operations

In our opinion, the records of the Securities Department presented fairly the domestic security holdings as of September 29, 1995, and the results of operations for the interval since the last examination as of June 30, 1994. (Refer to Attachment I.) During the interval between examinations, it was determined that security holdings, earnings, discounts, premiums, and profits and losses resulting from open market operations were allocated among the Federal Reserve Banks in accordance with procedures approved by the Federal Open Market Committee and that transactions had been executed within the limits prescribed by the Committee.

Foreign Currency Operations

In our opinion, the records of the Foreign Exchange Department presented fairly the asset and liability accounts related to the foreign currency operations as of September 29, 1995, and the results of operations for the interval since the last examination as of June 30, 1994. (Refer to Attachment I.)

During the interval between examinations, it was determined that distributions of interest earnings on foreign currency balances and profits and losses on foreign exchange operations among the Federal Reserve Banks were made according to procedures approved by the Federal Open Market Committee, and foreign currencies were periodically revalued in accordance with generally accepted accounting principles.

The review of transactions on the date of our examination indicated that the pertinent authorizations issued by the Committee were being followed, and in our opinion, accounting records, internal controls, and audit attention were adequate.

OUTSIDE AUDIT

Further to Governor Kelley's September 14, 1995, memorandum, the examiners followed up on the management letter comments from Coopers & Lybrand's audit of the schedule of System participated accounts as of year-end 1994. The Report of the Schedule of Participated Accounts was provided to you under cover

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Mr. Donald L. Kohn

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of Governor Kelley's referenced memorandum. Please refer to Attachment II for a copy of Coopers & Lybrand's Management Letter and Attachment III for our comments.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Clyde H. Farnsworth, Jr.", written in a cursive style.

Clyde H. Farnsworth, Jr.
Director

Attachments

cc: Mr. Robinson, Mr. Dennis, Mr. Osterholm, Ms. Welch

ATTACHMENT I - TABLE A

SYSTEM OPEN MARKET DOMESTIC SECURITY AND FOREIGN CURRENCY HOLDINGS
(as of September 29, 1995)

A. DOMESTIC OPERATIONS

Banker's Acceptances: 1/	\$	-0-
U.S. Treasury and Government Agency Securities:		
Bought Outright	\$	370,564,115,000.00
Less Discount	\$	-3,671,832,744.15
Plus Premium	\$	4,003,017,804.25
Plus Interest Accrued	\$	<u>3,778,172,728.94</u>
Book Value	\$	374,673,472,789.04
Held under Repurchase Agreement 2/	\$	6,520,000,000.00
Less Discount	\$	116,459,222.02
Plus Premium	\$	147,777,500.00
Plus Interest Accrued	\$	<u>78,072,146.29</u>
Book Value	\$	6,629,390,424.27

B. FOREIGN CURRENCY OPERATIONS

	Units of Foreign Currency	U.S. Dollar Equivalent 3/
German Marks	19,197,956,719.84	\$ 13,429,840,307.69
Japanese Yen	708,848,998,254.00	\$ 7,152,865,774.51
	TOTAL	<u>\$ 21,538,884,625.66</u>

- 1/ The use of Banker's Acceptances to manage reserves was discontinued as of July 2, 1984. New York serves only as an agent in buying and selling acceptances for accounts of foreign central banks.
- 2/ Securities held under repurchase agreements are held for the account of the Federal Reserve Bank of New York at the direction of the Federal Open Market Committee and are included here to provide an accounting of all holdings purchased under the authority granted to the New York Reserve Bank by the Committee.
- 3/ Revalued at the 12:00 p.m. exchange rates of September 29, 1995.

ATTACHMENT I - TABLE B

INCOME RESULTING FROM SYSTEM OPEN MARKET
DOMESTIC SECURITY AND FOREIGN CURRENCY OPERATIONS
JANUARY 1 THROUGH SEPTEMBER 29, 1995

A. DOMESTIC OPERATIONS

Bankers' Acceptances:

Discount Earned-Outright Purchases	\$	-0-
Discount Earned-Repurchase Agreements	\$	-0-

U.S. Treasury and
Government Agency Securities:

Earnings-Outright Purchases	\$17,634,662,660.07
Earnings-Repurchase Agreements-New York	\$ 113,969,800.89

Earnings on SOMA New York Securities Loaned	\$ 2,814,245.12
Net Profit on Securities Sold	<u>\$ -6,516,701.52</u>

TOTAL	\$ 17,744,930,004.56
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B. FOREIGN CURRENCY OPERATIONS

Interest Earned on Foreign Currency Investments 1/	\$ 633,258,974.29
Profit or Loss on Foreign Exchange Transactions 2/	<u>\$ 1,342,294,956.68</u>
TOTAL	\$ 1,975,553,930.97

TOTAL INCOME	\$ 19,720,483,755.53
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1/ Interest earned is participated daily. All interest collected was distributed as of September 27, 1995, except \$8,131,241.00 in interest collected between September 27 and 29, which was distributed October 4, 1995.

2/ Participations on valuation gains and losses are distributed at month-end, and participations on realized profit or loss on sales of foreign currency are distributed on the value date.

FEDERAL RESERVE BANKS
MANAGEMENT LETTER COMMENTS
1994

**Coopers
& Lybrand**

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August 30, 1995

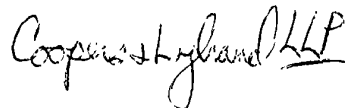
Federal Reserve Board
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
and
Board of Directors of the Federal Reserve Bank
of New York
33 Liberty Street
New York, New York 10045-0001

Dear Governors and Directors:

In planning and performing our audit of the schedule of participated accounts of the Federal Reserve Banks as of December 31, 1994, we considered the internal control structure relating to the participated accounts in order to determine our auditing procedures for the purpose of expressing our opinion on the schedule of participated accounts. Although our audit was not designed to provide assurance on the internal control structure, we noted certain matters involving the internal control structure and its operation, and we are submitting for your consideration related comments designed to help make improvements and achieve further operational efficiencies. Our comments reflect our desire to be of continuing assistance to the Federal Reserve Banks. The responses are those of the Federal Reserve Bank of New York which has been selected by the Federal Open Market Committee to execute open-market transactions.

The accompanying comments are intended solely for the information and use of the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Reserve Bank of New York, and management of the Federal Reserve Bank of New York.

Very truly yours,



DAD:amk

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1. No Authorized List of Participated Accounts Exists

There is no authorized list that details which accounts shall be participated or allocated to each of the Federal Reserve Banks (the "Reserve Banks"). The Financial Accounting Manual (the "Manual") describes which accounts are participated; however, such designation is not centrally located in the Manual.

• **Response:**

Board staff has indicated that they will consider including an authorized list of accounts that should be participated to the Reserve Banks in the next annual update of The Financial Accounting Manual.

2. Certain Accounting Practices Are Not Documented

Certain accounting practices are not documented in the Manual. Specifically, the following are not documented:

- Securities lending transactions.
- Matched sale-purchase transactions.
- The warehouse line that the Treasury Department has with the Federal Reserve to exchange foreign currencies for dollars under an agreement to reverse the exchange at some future date.
- Use of the settlement-date basis of accounting to record securities transactions.

• **Response:**

The Financial Accounting Manual focuses on the general transactions conducted by all Reserve Banks. The four specific items noted are New York specific transactions. The detailed accounting practice for these items were agreed to between both parties and were documented in letter format. Board staff has indicated that they will include more detailed information regarding these accounts in the next annual update of The Financial Accounting Manual.

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3. Document the STACS Input Check Between Open Market Accounting and Open Market Trading

The open market accounting department has procedures in place that call for verification of STACS input totals to trading room totals. This verification, which is often performed via telephone, is not documented by open market accounting personnel. Since the trading room prepares a recap of transactions for each operation on a pre-formatted log and forwards this log to open market accounting, we recommend that a STACS input clerk in open market accounting sign the completed recap as evidence of the comparison to STACS fanfold (i.e., trade detail) totals.

• **Response:**

The recommendation has been accepted and instituted effective August 1, 1995.

4. The Bank Does Not Monitor Credit Risk on a Global Basis

Although counterparty credit exposure may be monitored at a departmental level (e.g., open market, foreign exchange, funds transfer), FRBNY does not presently have a mechanism in place to determine aggregate counterparty credit exposure bank-wide on a daily basis.

• **Response:**

The creditworthiness of counterparties and account holders is reviewed on a regular basis by the Loans and Credit Department. Exposure resulting from payment services (Fedwire, Securities, Currency, Check, Automated Clearing House, etc.) are measured at predetermined intervals throughout the day and reviewed on an ex-post basis. This review can be done on a real-time basis if necessary. Toward the end of 1994, the Loans and Credit Department began developing a framework for incorporating all other lines of the Bank's businesses, including Foreign Exchange and Open Market operations, into global exposure monitoring. The effort will be implemented in phases, concluding in 1996.

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5. Monitoring of Employees' Personal Trading

All open market employees are prohibited from owning U.S. government securities and all Bank employees are prohibited from owning any debt or equity security of a depository institution or a primary dealer of government securities. In addition, employees are not permitted to engage in speculative dealings. Annually, open market employees and officers are required to complete a document detailing their holdings and submit this document to the Bank's ethics officer. The Bank, however, does not receive duplicate employee brokerage statements in order to monitor compliance with these policies.

• **Response:**

In 1993, the Federal Reserve System adopted a new Code of Conduct for all Reserve Bank personnel, prescribing permissible investments and other standards for behavior. Since the implementation of these guidelines, the SOMA Manager has been considering the feasibility and desirability of imposing a stricter enforcement mechanism of the System rules, on officers and employees of the Markets Group similar to that found in "street firms", which would involve receiving duplicate employee brokerage and other account statements. However, as this is not at present required of other System personnel -- such as funds transfer staff, bank examiners, or members of the FOMC -- the implications of having a different enforcement mechanism for the FRBNY Markets Group need to be considered in the broader context.

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6. Foreign Exchange Counterparty Limits are Exceeded Without Management Review and Approval

Counterparty limits for foreign exchange transactions are maintained within the Foreign Exchange Trading Application System ("FXTAS"). We noted that these limits can be exceeded without concurrent management review and approval. In addition, we noted that management only recently has begun receiving exception reports which indicate when limits have been exceeded. We recommend that management personnel approve all limit violations prior to execution. We also recommend that the foreign exchange department incorporate the review of the exception report into its daily procedures and that the report be authorized by an appropriate level of management.

• **Response:**

Foreign exchange counterparty limits can be exceeded without management's concurrent approval since trades are entered into FXTAS shortly following execution of the deal. However, there are established procedures designed to preclude such occurrences. For instance, the Deal Manager must check the available counterparty credit limits information available on FXTAS to assure that limits will not be exceeded before executing a trade with that counterparty. If execution of the trade would cause the limit to be exceeded, the deal must then be taken to the next counterparty with available credit lines.

In spite of established control procedures, an error by a trader can cause the counterparty credit limit to be exceeded. In such cases, excessions can only be reviewed and approved ex-post. As noted by the auditors, management does receive and review exception reports when limits have been exceeded. Management will review and take steps to improve its review of exception reports.

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7. Consider Participating System Balances Less Frequently

Participated accounts, including securities holdings and related premiums, discounts, and accrued interest, are generally allocated among the Reserve Banks on a daily basis. The System should consider participating these balances on a less frequent basis to enhance efficiency.

• **Response:**

FRBNY Markets Group management is currently reviewing the basis of participating the various accounts, with particular consideration focused on participating both the domestic and foreign accounts on the same basis. In that context, consideration will be given to participating the domestic balance on a weekly, rather than a daily, basis.

8. Improvements to Repurchase Agreements Should Be Considered

A separate contract is executed for each repurchase transaction. These contracts are often received subsequent to settlement of the transactions. In addition, these contracts do not describe all the terms and conditions of the transactions and lack certain provisions contained in the standard industry agreement (e.g., collateral coverage, margin maintenance procedures, events of default). Consideration should be given to establishing a master repurchase agreement with each counterparty or expanding the existing general pledge and collateral agreements.

• **Response:**

Although we believe that the general pledge and collateral agreement and Board Resolution we receive from our counterparties address issues of collateral coverage and default, we also recognize the advantages of a master repurchase agreement similar to the standard industry agreement. We are in the process of developing a master agreement that meets the particular needs of the FRBNY.

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9. Improvements to Securities Loan Agreements Should Be Considered

A separate contract is executed for each securities lending transaction. These contracts are often received subsequent to settlement of the transactions. In addition, these contracts do not describe all the terms and conditions of the transactions (e.g., collateral coverage, margin maintenance procedures). Consideration should be given to augmenting the existing securities loan agreements. As part of this process, the standard industry securities lending agreement should be reviewed to identify any additional provisions which might be relevant.

• **Response:**

We are in the process of reviewing the securities lending program to determine whether it should be continued. If it is continued, we will consider improvements to the securities loan agreement along the lines suggested.

10. Trade Confirmation Procedures Should Be Re-evaluated

In 1994, FRBNY began using the Trading Room Automated Processing System ("TRAPS") to execute securities transactions with the primary dealers. TRAPS effectively confirms trades on-line at the time of execution. FRBNY personnel also compare all counterparty confirmations received to STACS' trade detail reports. Since most open market trades are same-day settlement transactions, trade confirmations are usually received subsequent to settlement. In light of the above, we suggest that FRBNY eliminate the existing confirmation comparison procedures.

• **Response:**

FRBNY's response via TRAPS advises the dealers on-line of our acceptance of their propositions (in whole or in part). This action effectively confirms the trade. However, TRAPS currently generates "tickets" providing the terms of the accepted trades. The detailed trade data is currently keyed into STACS. We are working on the next phase of TRAPS which provides for an automated interface of the trade data into STACS.

The existing step of comparing counterparty confirmations to the verified STACS trade detail report has been viewed as a necessary step due to the re-keying effort. However, given the automated matching process and the timing that the manual confirmation comparison is generally performed, we have reconsidered our position and will discontinue the practice, as recommended.

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11. Benchmark Returns on Foreign Currency Investments

The reserve management department is responsible for maximizing returns on the System's foreign currency holdings while maintaining its primary goals of preserving liquidity and capital in accordance with FOMC policy directives. This is accomplished, in part, by exploring new investment opportunities and formulating new investment policies. We noted that FRBNY does not measure the portfolio's performance against other key performance indicators. FRBNY should consider tracking the performance on its foreign currency portfolio against an interbank offering rate or other appropriate benchmark in order to maximize portfolio returns.

• **Response:**

The System's foreign currency reserves are currently invested in a portfolio structure approved by the Manager and subject to the constraints established by the FOMC in its authorization and directive. No deviation from the instruments and maturity approved by the Manager are permitted. In particular, the FOMC's current requirement is that these funds be invested in instruments with remaining maturity of no greater than 12 months. Benchmarks for investment portfolio typically serve two purposes: first, as a means of limiting risk by limiting permissible deviation from the benchmark; and second, to measure performance on a relative basis. In the context of the 12 month maturity ceiling, which acts as a risk limit, and the gradual evolution of a more diversified portfolio, the relevant benchmark continues to be the limited investments traditionally available through other central banks and the Bank for International Settlements. The Markets Group Foreign Currency Investment Staff routinely undertake such comparisons. However, there is little point in measuring the portfolio performance against interbank offering rates, or other similar benchmarks, when these are instruments in which investments are not permitted. However, should the 12 month maturity ceiling be removed and replaced with an average duration ceiling or target, prior to making any investments benchmarks would be developed and permissible deviations from benchmarks would be established.

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12. The Foreign Exchange Processing Systems Are Not Integrated

Currently, there are several levels of record keeping in the foreign exchange department due to the numerous systems involved and the nature of those systems. Presently, FXTAS serves only as a deal-entry system and, therefore, does not maintain foreign currency portfolio details or perform record keeping and accounting functions. Specifically, FXTAS cannot calculate accruals, revalue the portfolio, calculate Reserve Bank allocations, or maintain any historic information. This information is manually entered in other software packages (i.e., d-Base, which maintains portfolio details, Lotus 1-2-3, which calculates accruals, revalues the portfolio and also maintains portfolio details, and FPS (Foreign Processing System), which is the account processing system maintained by the Central Bank Services department). All of the present systems currently in use (FXTAS, d-Base, Lotus 1-2-3, and FPS) do not interface with each other or with IAS (Integrated Accounting System, FRBNY's general ledger), or maintain any sort of communication linkage. Consequently, many record keeping tasks are duplicated among the various systems leading to significant inefficiencies and a greater potential for errors.

We understand that Phase II of the FXTAS, which is scheduled for implementation in August, 1995, will address many of these issues. Any issues that will not be addressed should be evaluated for consideration.

• **Response:**

Under the current environment, the processing of foreign currency deals and investment transactions entails a number of computer application systems that do not interface with each other. This less-than-ideal process has been recognized by management as a source of risk and is being addressed in the design and implementation of FXTAS. As noted by the audit team, with the implementation of FXTAS Phase II later this year, several of the tasks currently processed on stand-alone systems will be incorporated into the FXTAS application. The enhanced system will have the capability for entry and verification, confirmation, settlement, accounting and reconciliation and reporting of all foreign exchange contracts and investment transactions. Accounting entries, including the daily accruals and monthly revaluation figures, will be generated from the system application. Further, foreign currency account positions and balances will be monitored, thereby eliminating the need for accounting ledgers to be maintained on separate Lotus files.

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In addition, an input file of the day's debits and credits affecting accounts of foreign central banks will be downloaded directly onto the Foreign Processing System (FPS), thus eliminating data keying redundancies. With respect to investment transactions, cost considerations lead to area management's decision to retain the portfolio records on dBase. Thus, after the investment transactions are keyed, settled and accounted for on FXTAS, each investment record will be automatically stored onto dBase. Finally, while FXTAS Phase II will generate the daily accounting entries, an interface with the Integrated Accounting System (IAS) is not currently planned. FXTAS/IAS interface will be evaluated at a later date.

13. Securities Trading and Clearing System (STACS) Access Controls Needs Improvement

We reviewed access to the sensitive transactions used for the Forced Matching (OM310A) and Wire Reversal (OM440A) processes that occurs during the matching of BESS security transaction information to STACS anticipated receipts. We found that all Securities Transfer Division personnel have access to these sensitive transactions as well as potentially others, which are not required for their job functions. This occurred because access to these transactions were not restricted to specific job functions.

This access could result in the unauthorized processing of STACS transactions. We recommend that the matrix used for defining all STACS transaction access be reviewed and modified to reflect the actual access required for each user within this Division.

• **Response:**

Recommendation accepted. We are in the process of modifying the matrix used to define STACS access to restrict access to job functions and expect to complete the process by September 1, 1995.

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14. Security Administration

We observed that ACF2 system access for a sample of transferred employees was not rescinded in a timely manner. Our understanding of the process is that it is the responsibility of the employee's supervisor to notify the Data Security department ("Data Security") of the impending transfers. As a fail safe, Data Security receives a report from the Human Resources department that lists transferred employees. Based on our discussions with Data Security, supervisory notification does not occur in many instances. In addition, we sampled two Human Resources reports that identified transferred employees. For the first report, we found that two of the employees sampled did not have their access suspended for two and three weeks, respectively. For the February report, we found that as of April it was not reviewed to determine if any employees listed should have their access rescinded.

This situation could result in unauthorized access by transferred employees. We recommend that supervisors be reminded of the importance of notifying Data Security when employees transfer. In addition, Data Security should review the Human Resources report in a more timely manner. As part of this review process, Data Security should notify the senior manager in the area when notification of transferred employees is not received. Finally, operating procedures should be updated to reflect this process.

• **Response:**

ACF2 access authority of transferred employees is now current. It should be noted that a management decision was made earlier in the year to redirect its limited resources to a critical project of establishing an ACF2 environment on mainframe computers managed by the Federal Reserve Automation Services. Consequently, certain "non-critical" Monthly Transfer production work was delayed. The Monthly termination report continued to be processed as soon as they were received.

In regard to the specific recommendations: the Electronic Access Control Staff (EACS) will send out correspondence to remind local management that EACS must be notified of all transfers involving employees who had mainframe access for their previous job; EACS will pursue a vehicle for notifying management when supervisory notification of a transfer is not received; with the aforementioned two additional steps we do not believe it necessary to run the Human resources report more frequently at this time; operating procedures will be updated to reflect all changes made by EACS.

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15. Foreign Exchange Trading and Accounting System (FX/TAS) Data Processing Controls Need Improvement

Based on our review of the data center where the FXTAS application resides, we found the following weaknesses:

- smoke detectors are not employed; and
- back-up tapes are not stored off-site.

These conditions are indicators that FXTAS processing may not be able to be resumed in the event of a prolonged interruption in the primary system. We recommend that:

- smoke detectors be installed; and
- back up tapes be stored at the East Rutherford Operations Center (EROC).

We also understand that change control procedures are in a draft format and security and violation monitoring procedures are being developed. We recommend that these procedures be finalized as soon as possible.

- **Response:**

The Markets Group is scheduled to relocate to new quarters in late 1996. Accommodations for smoke detectors in the new technology room have been made.

The final arrangements to our FXTAS contingency plan was approved by EROC systems personnel. Effective June 1, 1995 back-up tapes for the FXTAS system are stored at EROC. Tapes are sent monthly.

As noted, Change Control Procedures are in draft format and Security Violation Monitoring Procedures are being developed. Completion is targeted for 4th quarter 1995 following the final phased-in installation of FXTAS.

FINANCIAL EXAMINATION FOLLOW-UP

During the 1995 examination of the Federal Reserve Bank of New York, the examiners followed up on those issues identified during the December 1994 Coopers & Lybrand Audit (transmitted to Board management on August 30, 1995) relating to Domestic Open Market and Foreign Currency Operations. The follow-up consisted of an analysis to determine the severity of the items identified and a meeting with area management to discuss the Bank's response to each issue. The examiners concluded that none of the items indicated serious weaknesses in the internal control structure. The results of our follow-up of each issue are described below:

1. No Authorized List of Participated Accounts Exists.

Accounting policy issues are being addressed by the Division of Reserve Bank Operations and Payment Systems' Accounting Section. The response from section management indicated that the next issue of the Financial Accounting Manual (FAM) would include the listing.

2. Certain Accounting Practices Are Not Documented.

As indicated in item 1. above, this issue is being addressed in the next release of FAM. This issue, as it relates to the Foreign Exchange area, focused on the fact that the warehousing arrangements between the Treasury and the Federal Reserve were not documented in FAM. There were no warehousing arrangements in effect during the examination. Board staff has agreed to include more detail in the next annual update to FAM.

3. Document Securities Trading and Clearing System (STACS) Input Check Between Open Market Accounting and Open Market Trading.

Tests of the noted change in the process to comply with the recommendation indicated that the Bank has satisfactorily addressed the issue. Staff in Open Market Accounting advised that the pending updates to STACS would provide improved controls since the transactions will be processed in an automated format. Tests of controls should be performed again after the next system upgrade to ensure that logical controls provide the same level of assurance.

4. The Bank Does Not Monitor Credit Risk On A Global Basis.

The examiners' discussions with department management and staff found that the Bank remains committed to the timeframe indicated.

5. Monitoring of Employees' Personal Trading.

Discussions with Bank management indicated that, as specified in the response, there are no plans to adopt a more stringent Code of Conduct for Market Groups staff. While acknowledging that there were no plans

to change the policy, management advised that it had previously considered this issue.

6. Foreign Exchange Counterparty Limits Are Exceeded Without Management Review and Approval.

Bank management concluded that counterparty limits for foreign exchange transactions could be exceeded without management review and approval; however, this did not occur during Coopers & Lybrand's on-site attention nor has this occurred in the past. There are preventive controls in place that require the deal manager to review counterparty limits prior to the execution of a transaction and detective controls in the form of exception reports. Management agreed to review existing controls with the intent of strengthening them if warranted.

7. Consider Participating System Balances Less Frequently.

Bank management has reviewed this issue and is currently researching the feasibility of participating these balances less frequently. A change in the frequency of participation will require the review and approval of Board staff.

8. Improvements to Repurchase Agreements Should Be Considered.

While the value of a master repurchase agreement that is consistent with industry practices was acknowledged, the recent need to focus on debt ceiling demands resulted in the surfacing of further considerations. In accordance with these considerations, management is working with the Legal staff to develop an agreement that will include the noted enhancements by adapting the industry standard contract and providing the necessary language to reflect the specific, unique aspects of the roles of the Markets Group as agent of the Treasury and as Central Banker. Discussions on this issue continue.

9. Improvements to Securities Loan Agreements Should Be Considered.

When the program was instituted, it provided a service for the paper-based definitive securities industry. Given the changing market conditions, management continues to weigh the need to maintain this service. The Legal staff, however, is considering matters related to a new contract in conjunction with the work referenced in item 8. above.

10. Trade Confirmation Procedures Should Be Re-evaluated.

Given the existence of logical controls in the software, the department discontinued the manual matching process as recommended.

11. Benchmark Returns on Foreign Currency Investments.

The various investments in foreign currencies are the result of the purchase and sale of foreign currencies to preserve liquidity and capital in accordance with FOMC policy directives. Although these investments are approved at the manager level, the instruments in

which the currencies are invested have various maturity and type constraints that have been determined by the FOMC. It is meaningless for the Bank to track the performance of the foreign currency portfolio against a benchmark rate when investments in these types of securities are not permitted. The New York Bank does not have the authority to alter the direction or types of investments in this portfolio. Effecting any change in the investments in this portfolio would require a change in the policies and directives of the FOMC.

12. The Foreign Exchange Processing Systems Are Not Integrated.

The examiners reviewed the progress for implementation of the Accounting module (Foreign Exchange Trading and Accounting System [FXTAS] II). Due to the recent reorganization of SOMA and the Foreign Exchange area into one group and the resulting requirements to cross-train staff and merge some of the existing procedures, the implementation of FXTAS II has been delayed until first quarter 1996.

13. STACS Access Controls Need Improvement.

Management indicated that corrections were made on September 23 and October 25, 1995. Testing of the changes were performed as part of the review of Collateral and Custodies.

14. Security Administration.

Tests of Trading Room and System Accounting personnel confirmed compliance as indicated in the response.

15. FXTAS Data Processing Controls Need Improvement.

Selected tests and discussions with management indicated that appropriate, corrective action was being taken or was planned as reflected in the response.

The results of the examiners' follow-up indicated that management had focused considerable attention on the resolution of these issues and, when possible, had taken immediate, corrective action. However, due to the nature of the activities in this function, some issues will require approval by and changes in the policies and directives of the FOMC.