For release on delivery
9:30 A.M., E.S.T.
December 12, 1985

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

December 12, 1985

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I appreciate the opportunity to discuss with you questions relating to the operational problems experienced by the Bank of New York on November 21 and the response of the Federal Reserve Bank of New York. My remarks will be relatively brief. Mr. Corrigan, President of the New York Federal Reserve Bank, who was on the scene and here with you today, is in a position to review the specific facts and the Federal Reserve response to the events as they unfolded in full detail.

The settlement problem which resulted in the $22.6 billion loan to the Bank of New York was caused by a computer system software failure. The effects in this instance were of unprecedented magnitude, measured by the amount of the overnight loan. But the effects in terms of market performance and risk were well contained.

It is also true that more limited computer interruptions, either at private participants or at one of the

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Reserve Banks, are not unusual. The impact is typically small, reflected only in temporary delays of minutes or hours in operations or in final settlement for a day's work. This time, the interruption was much more prolonged, extending overnight. Consequently, potentially serious implications for the payments system and the securities markets were highlighted although they were avoided in this instance.

Since Mr. Corrigan will be reviewing in some detail the particular circumstances surrounding the BONY borrowing, I will simply turn to some of the policy issues.

Like it or not, computers and their software systems -- with the possibility of mechanical or human failure -- are an integral part of the payments mechanism. The scale and speed of transactions permit no other approach. It is therefore appropriate to ask what type of backup systems -- both hardware and software -- and controls should be required of participants in the payments system, especially those with

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potentially large exposures measured relative to assets, capital, and any other measures.

That is a question that must in the first instance be faced by each participant. Those participants, however, also face intense competitive pressures to minimize costs and cash balances. As participants in and regulators of the payments system, the Federal Reserve has the responsibility to see to it that there is a countervailing pressure to provide protection against unacceptable risks for the system as a whole.

In approaching that question, the Federal Reserve has tried to identify and assess the risks facing participants in the payments and settlement mechanisms, how these risks interact, and what can be done to limit them in a cost-effective way.

For some years, the Federal Reserve has been actively encouraging participants to adopt measures and policies to limit risk in payments and settlement systems and we are

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reinforcing our own computer facilities, including back-up systems. After long discussions with other interested parties, the Federal Reserve Board earlier this year, in May, issued a policy statement addressing certain problems in this area. That statement called upon participants in private funds transfer systems -- including the so-called CHIP's system which handles some hundred thousand individual international payments transactions, valued at several hundred billion dollars, per day -- to better evaluate and control risks inherent in large scale automated transfers. We also announced at that time measures to control and reduce so-called "daylight overdrafts" on our own books -- overdrafts which occur when, in the course of a day, a bank exhausts its reserve balance with a Federal Reserve Bank.

In the last analysis, no mechanical system can be entirely "fail-safe" and also be commercially viable. The costs would simply be too high, and the money and Treasury

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securities markets could not operate at the present level of efficiency. Nor can key clearing operations be easily closed down in the middle of a day without potentially impacting severely on markets and third parties, sowing confusion at the least, and at worst a chain reaction of losses. In these circumstances, the importance of institutions having access to the discount window is evident; in this instance, we could extend credit with the knowledge that we were dealing with a known and reputable depository institution, supervised by federal authorities.

The discount window advance to the BONY was, by any measure, enormous, but the collateral in our hands -- U.S. Government securities that had been delivered to us for the account of BONY -- was sound and the Reserve Bank also had further security from BONY. The market could and did proceed with its business, with minimal disruption. In contrast, had the Federal Reserve Bank of New York refused to make payments

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on behalf of BONY as it received government securities for its account, other market participants would have found themselves short of cash, other banks and their customers presumably would have been forced into overdraft, and requests for discount window assistance, and financial pressures, would have appeared elsewhere.

A question about the interest rate charged BONY for the use of the discount window in this circumstance is entirely appropriate. I have been assured, and Mr. Corrigan will explain more fully, that the net result of all financial transactions between the Federal Reserve and BONY was to offset fully the "subsidy" arising from the fact that the discount rate was below the federal funds rate prevailing that day.

Those particular results were, however, fortuitous. At the same time, BONY did incur substantial expenses because it had to finance overnight some $25 billion of securities, upon which it received no interest. Notwithstanding that

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circumstance, a special penalty rate, designed to encourage better backup systems, when exceptionally large borrowing is caused by the institution's own computer problems may well be appropriate. Over time we will also be reviewing, as already contemplated, our policies toward tolerable levels of daylight overdrafts.

Your letter, Mr. Chairman, also asks whether the Federal Reserve itself should play a larger role directly in clearing securities -- as a priced service -- in order to reduce the overall risks to the System. That, frankly, is an area in which we would be extremely reluctant to enter, but we will be glad to provide further analysis of the advantages and disadvantages.

I believe it would be wrong to over-dramatize this incident. There was a serious operational problem which illustrated some potential vulnerabilities in the clearing mechanism. But it is also true that the problem could be dealt

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with effectively within our present arrangements -- in that sense the system did, in this instance, prove "fail-safe." The overnight loan, huge as it was, was fully secured, with an ample margin of protection.

But the incident is also indicative of the relevance of our continuing efforts -- and that of the banks -- to control risk in the payments system and of effective supervision of the participants. That work may seem mundane and tedious -- that is, until something goes wrong. Then, it is also seen as essential.

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