U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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Comptroller General
of the United States

Accessible Version

April 20, 2020

The Honorable Jerome H. Powell

Chairman

Board of Governors of the Federal Reserve System

20th St. & Constitution Ave., NW

Washington, DC 20551

Priority Open Recommendations: Board of Governors of the Federal Reserve System

Dear Mr. Chairman:

The purpose of this letter is to provide an update on the overall status of the Board of Governors of the Federal Reserve System's (Federal Reserve) implementation of GAO's recommendations and to call your personal attention to areas where open recommendations should be given high priority. In November 2019, we reported that on a government-wide basis, 77 percent of our recommendations made 4 years ago were implemented.[1] The Federal Reserve's implementation rate for these recommendations was 80 percent. As of April 2020, the Federal Reserve had 23 open recommendations. Fully implementing these open recommendations could significantly improve the Federal Reserve's efforts to more effectively oversee risks to consumers and the safety and soundness of the U.S. banking system.

The Federal Reserve has seven priority recommendations remaining from those we identified in our April 2019 letter. We ask your continued attention on those remaining priority recommendations. We also are adding one new recommendation related to financial technology, bringing the total number of priority recommendations to eight, and three other important recommendations related to managing emergency assistance. (See enclosure for the list of recommendations.)

[1]GAO, *Performance and Accountability Report: Fiscal Year 2019*, GAO-20-1SP (Washington, D.C.: Nov. 19, 2019).

Financial Technology and Consumer Protection.

Consumers are using financial technology—or “fintech”—firms to aggregate information from their various financial accounts.

In March 2018, we reported that market participants disagreed over whether consumers using financial account aggregators would be reimbursed for losses arising from unauthorized activity. We recommended that the Federal Reserve engage in collaborative discussions with other relevant financial regulators and stakeholders to address these issues. Bank and credit union regulators and the Consumer Financial Protection Bureau (CFPB) have been holding such discussions, but these collaborations have yet to result in any coordinated public outcomes. To implement our recommendation, the Federal Reserve needs to continue to actively participate in these ongoing efforts to help ensure they result in tangible outcomes.

In addition, in December 2018, we found that some fintech lenders used data not traditionally used by national consumer reporting agencies in making credit decisions or attempting to detect fraud. Using alternative data, however, presents both potential benefits and risks. We recommended that the Federal Reserve coordinate with other federal banking regulators and CFPB and communicate in writing to banks that engage in third-party relationships with fintech lenders on the appropriate use of alternative data in the underwriting process. The Federal Reserve and the other banking regulators have issued third-party publications that can be used by banks that partner with fintech lenders, but these documents do not clearly communicate the regulators’ views on the appropriate use of alternative data. To fully implement our recommendation, the Federal Reserve needs to complete its plans to work collaboratively with the other banking regulators and CFPB to determine what type of communication would most effectively serve the purpose of addressing the recommendation.

Derisking.

One recommendation relates to derisking—the practice of banks limiting services or ending customer relationships to avoid perceived regulatory concerns about facilitating money laundering. In our February 2018 report, we determined that Bank Secrecy Act/anti-money laundering (BSA/AML) regulatory concerns have played a role in banks’ decisions to terminate and limit customer accounts and close bank branches. However, regulators have not fully assessed the BSA/AML factors influencing banks to derisk.

We recommended that the Federal Reserve jointly conduct a retrospective review of BSA/AML regulations and their implementation for banks with the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and the Financial Crimes Enforcement Network (FinCEN) and revise regulations or their implementation, as appropriate. This review should focus on how banks’ regulatory concerns may be influencing their willingness to provide services. The Federal Reserve agreed with the recommendation and convened a working group in 2018 with FDIC, OCC, FinCEN, the National Credit Union Administration, and the Office of Terrorism and Financial Intelligence that has taken important steps toward improving the efficiency and effectiveness of BSA/AML supervision. The working group has recently updated the examination manual for conducting BSA/AML examinations, which may influence banks to derisk. However, to fully implement our recommendation, the working group needs to consider and evaluate the full range of other supervisory concerns, such as conducting a retrospective review of BSA/AML regulations focusing on how banks’ regulatory concerns may be influencing their willingness to provide services.

Stress Testing of Banking Institutions.

Five recommendations relate to the stress testing of banking institutions to assess how they might perform in adverse scenarios. In November 2016, we recommended that the Federal Reserve address limitations we identified in its scenario design and model risk management. As of March 2020, the Federal Reserve has initiated projects such as developing processes to communicate information regarding post-stress capital ratio estimates.

However, it has taken no additional actions to fully implement the recommendations, such as designing and implementing a process to communicate uncertainty surrounding the post-stress capital ratio estimates and articulating tolerance levels for key risks and the degree of uncertainty in projected estimates. Completing the implementation of our recommendations can help the Federal Reserve identify and manage the risks introduced into its models and account appropriately for uncertainty and sensitivity of model results.

Other Important Recommendations.

In response to the coronavirus pandemic, the Federal Reserve has implemented a variety of emergency lending facilities to support the provision of credit to consumers and businesses. As the Federal Reserve implements these facilities, I call your attention to three open recommendations we made in July 2011. The recommendations relate to managing emergency assistance—the authorization of new programs and financial assistance, under the Federal Reserve Act of 1913, to banking institutions to stabilize financial markets. In our July 2011 report, we recommended that the Federal Reserve (1) provide more specific guidance on how staff should exercise discretion and document decisions to restrict or deny access to emergency programs; (2) document a plan for estimating and tracking losses within and across its lending facilities that could occur under more adverse economic conditions, and use that information to inform policy actions; and (3) document the Federal Reserve's guidance to Reserve Banks on types of emergency program decisions and risk events.

The Federal Reserve agreed to give these recommendations serious attention and strongly consider how to respond to them. However, the agency has not provided us evidence that it has addressed these recommendations. We will continue to monitor actions the agency takes to provide more specific guidance to staff in exercising discretion and documenting decisions to restrict or deny access to emergency programs. Completing the implementation of our recommendations can strengthen procedures to guide efforts to manage emergency program access for higher-risk borrowers, ensure the transparency and consistency of decision making involving the implementation of any future emergency programs, manage risks related to emergency lending, and documentation of emergency program decisions.

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In March 2019 we issued our biennial update to our high-risk program, which identifies government operations with greater vulnerabilities to fraud, waste, abuse, and mismanagement or the need for transformation to address economy, efficiency, or effectiveness challenges.[2] Our high-risk program has served to identify and help resolve serious weaknesses in areas that involve substantial resources and provide critical service to the public.

One of our high-risk areas, modernizing the U.S. financial regulatory system, including encouraging regulators to strengthen systemic risk oversight and monitor progress on reforms,

[2]GAO, *High-Risk Series: Substantial Efforts Needed to Achieve Greater Progress on High-Risk Areas*, GAO-19-157SP (Washington, D.C.: Mar. 6, 2019).

centers directly on the Federal Reserve. Several other government-wide high-risk areas, including (1) Ensuring the Cybersecurity of the Nation, (2) Improving the Management of Information Technology Acquisitions and Operations, (3) Strategic Human Capital Management, (4) Managing Federal Real Property, and (5) Government-wide Personnel Security Clearance Process, also have direct implications for the Federal Reserve and its operations.[3]

We urge your attention to these government-wide issues as they relate to the Federal Reserve. Progress on high-risk issues has been possible through the concerted actions and efforts of Congress, the Office of Management and Budget, and the leadership and staff in agencies, including the Federal Reserve.

Copies of this report are being sent to the Director of the Office of Management and Budget and appropriate congressional committees, including the Committees on Appropriations, Budget, and Homeland Security and Governmental Affairs, United States Senate; and the Committees on Appropriations, Budget, and Oversight and Reform, House of Representatives. In addition, the report will be available at no charge on the GAO website at https://www.gao.gov.

I appreciate the Federal Reserve's commitment to these important issues. If you have any questions or would like to discuss any of the issues outlined in this letter, please do not hesitate to contact me or Daniel Garcia-Diaz, Managing Director, Financial Markets and Community Investment at garciadiazd@gao.gov or 202-512-8678. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Our teams will continue to coordinate with your staff on all of the 23 open recommendations, as well as those additional recommendations in the high-risk areas for which the Federal Reserve has a leading role. Thank you for your attention to these matters.

Sincerely yours,

Gene L. Dodaro
Comptroller General
of the United States

Enclosure - 1

cc: The Honorable Mick Mulvaney, Director, Office of Management and Budget

Enclosure

[3]GAO-19-157SP. See pages 91-94 for Modernizing the U.S. Financial Regulatory System, pages 178-184 for Ensuring the Cybersecurity of the Nation, pages 123-127 for Improving the Management of IT Acquisitions and Operations, pages 75-77 for Strategic Human Capital Management, pages 78-85 for Managing Federal Real Property, and pages 170-177 for Government-wide Personnel Security Clearance Process.

Priority Open Recommendations to the Board of Governors of the Federal Reserve System (Federal Reserve)

Financial Technology and Consumer Protection

Financial Technology: Agencies Should Provide Clarification on Lenders' Use of Alternative Data. GAO-19-111. Washington, D.C.: December 19, 2018 (reissued with revisions on March 12, 2019).

Recommendation: The Chair of the Board of Governors of the Federal Reserve System should, in coordination with the other federal banking regulators and the Consumer Financial Protection Bureau and with input from relevant stakeholders, communicate in writing to banks that engage in third-party relationships with fintech lenders on the appropriate use of alternative data in the underwriting process, including issues to consider when selecting types of alternative data to use.

Action Needed: The Board of Governors of the Federal Reserve System (Federal Reserve) neither agreed nor disagreed with our recommendation. In response to our recommendation, in December 2019, the Federal Reserve, along with the other banking regulators, issued an interagency statement on the use of alternative data in credit underwriting. The statement highlights potential benefits and risks of using alternative data and encourages firms to responsibly use the data. However, the statement does not provide firms or banks specific direction on the appropriate use of that data. The Federal Reserve needs to offer further information as they gain a deeper understanding of the data's usages.

Director: Michael E. Clements, Financial Markets and Community Investment
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Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight. GAO-18-254. Washington, D.C.: March 22, 2018.

Recommendation: The Chair of the Board of Governors of the Federal Reserve System should engage in collaborative discussions with other relevant financial regulators in a group that includes all relevant stakeholders and has defined agency roles and outcomes to address issues related to consumers' use of account aggregation services.
Action Needed: The Federal Reserve agreed with the recommendation. Federal Reserve staff told us in March 2019 that the agency continues to collaborate with other agencies to address this issue. Specifically, the collaborating agencies need to define the short-term and long-term outcomes that the collaboration is seeking to achieve and clarify the roles and responsibilities of the participating agencies.
Managing Director: Daniel Garcia-Diaz, Financial Markets and Community Investment
Contact Information: garciadiazd@gao.gov or 202-512-8678

Derisking

Bank Secrecy Act: Derisking along the Southwest Border Highlights Need for Regulators to Enhance Retrospective Reviews. GAO-18-263. Washington, D.C.: February 26, 2018.

Recommendation: The Chair of the Board of Governors of the Federal Reserve System should jointly conduct a retrospective review of Bank Secrecy Act/anti-money laundering (BSA/AML) regulations and their implementation for banks with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Financial Crimes Enforcement Network (FinCEN). This review should focus on how banks' regulatory concerns may be influencing their willingness to provide services. In conducting the review, the Federal Reserve, FDIC, OCC, and FinCEN should take steps, as appropriate, to revise the BSA regulations or the way they are being implemented to help ensure that BSA/AML regulatory objectives are being met in the most effective and least burdensome way.
Action Needed: Federal Reserve agreed to address our recommendation and convened a working group in 2018 with FDIC, OCC, FinCEN, the National Credit Union Administration, and the Office of Terrorism and Financial Intelligence to identify ways to improve the efficiency and effectiveness of BSA/AML regulations, supervision, and examinations. Federal Reserve staff believe that the ongoing review conducted by this working group addresses our recommendation. However, we believe the recommendation will require the working group consider whether there are other supervisory concerns that factor into banks' decisions to derisk. In March 2020, Federal Reserve staff noted federal banking regulators and FinCEN were updating the examination manual for conducting BSA/AML examinations. We will continue to monitor the activities and related outcomes of the working group for actions that are fully responsive to our recommendation.
Managing Director: Daniel Garcia-Diaz, Financial Markets and Community Investment
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Stress Testing of Banking Institutions

Federal Reserve: Additional Actions Could Help Ensure the Achievement of Stress Test Goals. GAO-17-48. Washington, D.C.: November 15, 2016.

Recommendation: To strengthen the scenario design process, the Federal Reserve should assess—and adjust as necessary—the overall level of severity of its severely adverse scenario by expanding consideration of the trade-offs associated with different degrees of severity.
Action Needed: In January 2019, the Federal Reserve said it had initiated two projects that would allow a more efficient evaluation of multiple scenarios, including assessing trade-offs associated with different levels of scenario severity. In December 2019, Federal Reserve staff provided updates on these projects, which remain in progress. We will continue to monitor the Federal Reserve's completion and implementation of these projects and any additional actions it takes that may be responsive to our recommendation.
Recommendation: To improve understanding of the range of potential crises against which the banking system would be resilient and the outcomes that might result from different scenarios, the Federal Reserve should assess whether a single severe supervisory scenario is sufficient to inform Comprehensive Capital Analysis and Review (CCAR) decisions and promote the resilience of the banking system. Such an assessment could include conducting sensitivity analysis involving multiple severe supervisory scenarios—potentially using CCAR data for a cycle that is already complete, to avoid concerns about tailoring the scenario to achieve a particular outcome.

Action Needed: In January 2019, the Federal Reserve said it had initiated two projects that would allow a more efficient evaluation of multiple scenarios. In December 2019, Federal Reserve staff provided updates on these projects, which remain in progress. We will continue to monitor the Federal Reserve's completion and implementation of these projects and any additional actions it takes that may be responsive to our recommendation.
Recommendation: To improve the Federal Reserve's ability to manage model risk and ensure that decisions based on supervisory stress test results are informed by an understanding of model risk, the Federal Reserve should design and implement a process to test and document the sensitivity and uncertainty of the model system's output—the post-stress capital ratios used to make CCAR quantitative assessment determinations—including, at a minimum, the cumulative uncertainty surrounding the capital ratios and their sensitivity to key model parameters, specifications, and assumptions from across the system of models.
Action Needed: In January 2019, the Federal Reserve said that it had previously initiated multiple projects to respond to our recommendation and that several of these were complete. In December 2019, Federal Reserve staff provided updates on the remaining projects, which remain in various stages of completion. We will continue to monitor the Federal Reserve's completion and implementation of these projects, and we will update the status of this recommendation once we receive documentation demonstrating the completion of responsive actions.
Recommendation: To improve the Federal Reserve's ability to manage model risk and ensure that decisions based on supervisory stress test results are informed by an understanding of model risk, the Federal Reserve should design and implement a process to communicate information about the range and sources of uncertainty surrounding the post-stress capital ratio estimates to the Board during CCAR deliberations.
Action Needed: In January 2019, the Federal Reserve said it had previously initiated a project to respond to our recommendation. In December 2019, Federal Reserve staff provided updates on the project, but as of February 2020, had not provided documentation fully supporting implementation of a process consistent with our recommendation. We will continue to monitor the Federal Reserve's completion and implementation of this project, and we will update the status of this recommendation once we receive documentation demonstrating the completion of responsive actions.
Recommendation: To improve the Federal Reserve's ability to manage model risk and ensure that decisions based on supervisory stress test results are informed by an understanding of model risk, the Federal Reserve should design and implement a process for the Board and senior staff to articulate tolerance levels for key risks identified through sensitivity testing and for the degree of uncertainty in the projected capital ratios.
Action Needed: In January 2019, the Federal Reserve said that it had previously initiated a project to respond to our recommendation. In December 2019, Federal Reserve staff provided updates on the project, but as of February 2020, had not provided documentation fully supporting implementation of a process consistent with our recommendation. We will continue to monitor the Federal Reserve's completion and implementation of this project, and we will update the status of this recommendation once we receive documentation demonstrating the completion of responsive actions.
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