

441 G St. N.W.
Washington, DC 20548**Comptroller General
of the United States****Accessible Version**

May 27, 2021

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 recommendations and to call your personal attention to open recommendations that should be given high priority.¹ In November 2020, we reported that on a government-wide basis, 77 percent of our recommendations made 4 years ago were implemented.² The Federal Reserve's implementation rate was 88 percent. As of April 2021, the Federal Reserve had 12 open recommendations overall. Fully implementing the 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.

Since our April 2020 letter, the Federal Reserve has implemented five of eight priority recommendations. In doing so, the Federal Reserve has

- collaborated with other relevant financial regulators to clarify how consumer protection laws apply when customers use account aggregation services from financial technology firms and subsequently experience harm;
- jointly conducted a retrospective review with other federal banking regulators and the Financial Crimes Enforcement Network of Bank Secrecy Act/anti-money laundering regulations to help ensure that the regulatory objectives are being met in the most effective and least burdensome way;
- enhanced its assessment of important trade-offs associated with the level of severity in its stress testing of the banking system, which can help to balance any improvements in the resiliency of the banking system with any impact on the cost and availability of credit;

¹Priority recommendations are those that GAO believes warrant priority attention from heads of key departments or agencies. They are highlighted because, upon implementation, they may significantly improve government operation, for example, by realizing large dollar savings; eliminating mismanagement, fraud, and abuse; or making progress toward addressing a [high-risk](#) or duplication issue.

²GAO, *Performance and Accountability Report: Fiscal Year 2020*, [GAO-21-4SP](#) (Washington, D.C.: Nov. 16, 2020).

- used recently developed methods and metrics to assess the severity of multiple scenarios as part of stress testing the banking system, which can improve understanding of the range of potential crises against which the banking system would be resilient; and
- implemented a process to evaluate the sensitivity and uncertainty of the stress test results, which will enhance the Federal Reserve’s ability to effectively manage model risk from its entire system of stress test models.

We are not adding any additional priority recommendations this year. We ask your continued attention on the remaining three priority recommendations, which are related to financial technology (fintech) and stress testing. (See enclosure for the list of recommendations).

Financial Technology.

Fintech firms are partnering with banks to originate loans. In December 2018, we found that some fintech lenders used alternative data (that is, data not traditionally used by national consumer reporting agencies) in making credit decisions or attempting to detect fraud. However, using alternative data presents potential benefits and risks. We recommended that the Federal Reserve coordinate with other federal banking regulators and the Consumer Financial Protection Bureau (CFPB) to 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.

The Federal Reserve and other banking regulators have issued an interagency statement that 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, including issues to consider when selecting types of alternative data to use. To fully implement our recommendation, the Federal Reserve needs to provide—in coordination with other federal banking regulators and CFPB—written communication that gives banks in relationships with fintech lenders specific direction on the appropriate use of alternative data in the underwriting process.

Stress Testing of Banking Institutions.

In November 2016, we identified two recommendations that would help improve the Federal Reserve's ability to manage model risk and stress testing of banking institutions. First, we recommended that the Federal Reserve design and implement a process to communicate information about the range and sources of uncertainty surrounding post-stress capital ratio estimates, during capital analysis and review deliberations. In April 2021, Federal Reserve staff told us that they continued to develop such a process, and that the completion of related projects to test and document the sensitivity and uncertainty of post-stress capital ratios would facilitate its effort, and would provide documentation on the completion of these project later this year.

Second, we recommended that the Federal Reserve implement a process to articulate tolerance levels for key risks identified through sensitivity testing and for the degree of uncertainty in the projected capital ratios. The Federal Reserve has also continued to take steps to address the second recommendation related to managing model risk, such as taking actions to complete other related projects to test and document the sensitivity and uncertainty of post-stress capital ratios. Completing the implementation of these two remaining priority recommendations could

help the Federal Reserve manage the risks in its models and account appropriately for uncertainty and sensitivity of model results.

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In March 2021, we issued our biennial update to our [High-Risk List](#), 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.³ One of our high-risk areas—modernizing the U.S. financial regulatory system—centers directly on the Federal Reserve.

Several other government-wide high-risk areas also have direct implications for the Federal Reserve and its operations. These include (1) [improving the management of IT acquisitions and operations](#), (2) [improving strategic human capital management](#), (3) [managing federal real property](#), (4) [ensuring the cybersecurity of the nation](#), and (5) [government-wide personnel security clearance process](#). We urge your attention to the modernizing the U.S. financial regulatory system and other 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, OMB, and the leadership and staff in agencies, including within the Federal Reserve.

We are sending copies of this report to the Director of the Office of Management and Budget and appropriate congressional committees, including the Committees on Appropriations, Banking, Housing, and Urban Affairs, Budget, and Homeland Security and Governmental Affairs, United States Senate; and the Committees on Appropriations, Budget, Financial Services, and Oversight and Reform, House of Representatives. In addition, the report will be available on the GAO website at <https://www.gao.gov>.

³GAO, *High-Risk Series: Dedicated Leadership Needed to Address Limited Progress in Most High-Risk Areas*, [GAO-21-119SP](#) (Washington, D.C.: Mar. 2, 2021).

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 12 open recommendations, as well as those 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,

A handwritten signature in black ink that reads "Gene L. Dodaro". The signature is written in a cursive style with a large, prominent "D" and a long horizontal flourish extending to the right.

Gene L. Dodaro
Comptroller General
of the United States

Enclosure(s) – 1

cc: The Honorable Shalanda Young, Acting Director, Office of Management and Budget

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

Financial Technology

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 (Federal Reserve) should, in coordination with the other federal banking regulators and the Consumer Financial Protection Bureau (CFPB) 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 Federal Reserve agreed with the recommendation. In December 2019, the Federal Reserve and other banking regulators issued an interagency statement on the use of alternative data in credit underwriting. The statement broadly highlights some potential benefits and risks of using alternative data and encourages firms to responsibly use alternative data. However, the statement does not provide firms or banks with specific direction on the appropriate use of that data, including issues to consider when selecting types of alternative data to use. To fully implement our recommendation, the Federal Reserve needs to provide—in coordination with other federal banking regulators and CFPB—written communication that gives banks that engage in third-party relationships with fintech lenders specific direction on the appropriate use of alternative data in the underwriting process. We will continue to monitor the actions the Federal Reserve takes to provide specific direction on the appropriate use of alternative data.

Director: Michael E. Clements, Financial Markets and Community Investment

Contact Information: clementsm@gao.gov or 202-512-8678

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 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 Comprehensive Capital Analysis and Review deliberations.

Action Needed: The Federal Reserve agreed with the recommendation. In January 2019, it initiated a project to design and implement a process to communicate uncertainty surrounding the post-stress capital ratio estimates. In April 2021, Federal Reserve staff told us that the Federal Reserve has continued to develop such a process and that the completion of related projects to test and document the sensitivity and uncertainty of post-stress capital ratios would facilitate its efforts. We will continue to monitor the Federal Reserve's completion and implementation of this project, and 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: The Federal Reserve agreed with the recommendation. In January 2019, the Federal Reserve said that it had previously initiated a project to respond to our recommendation. In April 2021, Federal Reserve staff told us that the project work continued and that the completion of related projects to test and document the sensitivity and uncertainty of post-stress capital ratios would assist in its efforts to fully implement this 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.

Director: Michael E. Clements, Financial Markets and Community Investment

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High Risk Area: Modernizing the U.S. Financial Regulatory System

(Jobcode: 104748)