U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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Washington, DC 20548

Comptroller General
of the United States

May 24, 2024

The Honorable Jerome H. Powell
Chair
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave., NW
Washington, D.C. 20551

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

Dear Chair Powell:

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 continued personal attention to open recommendations that should be given high priority.[1] In November 2023, we reported that, on a government-wide basis, 75 percent of our recommendations made 4 years ago were implemented.[2] The Federal Reserve's recommendation implementation rate was 75 percent. As of May 2024, the Federal Reserve had 13 open recommendations. Fully implementing these open recommendations could significantly improve the Federal Reserve's efforts to oversee risks to consumers and the safety and soundness of the U.S. banking system.

In our August 2023 letter, we noted that four of the open recommendations were priority recommendations. Since that time, the Federal Reserve has implemented two of our four open priority recommendations. Specifically, in March 2024, the Federal Reserve finalized a process to communicate information about the uncertainty surrounding stress test capital ratio estimates to the Board. Also in March 2024, the Federal Reserve implemented a process for the Board and senior staff to articulate tolerance levels for key risks and for the degree of uncertainty in projected capital ratios.[3] By taking these two actions, the Federal Reserve will enhance its ability to effectively evaluate and manage its model risk and ensure that the Board is informed of significant model risks when making decisions based on stress test results.

We are not adding any new priority recommendations this year. We ask for your continued attention to the remaining two priority recommendations, which are related to blockchain

[1]Priority 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 operations—for example, by realizing large dollar savings; eliminating mismanagement, fraud, and abuse; or making progress toward addressing a high-risk or duplication issue.

[2]GAO, *Performance and Accountability Report: Fiscal Year 2023*, GAO-24-900483 (Washington, D.C.: Nov. 15, 2023).

[3]GAO, *Federal Reserve: Additional Actions Could Help Ensure the Achievement of Stress Test Goals*, GAO-17-48 (Washington, D.C.: Nov. 15, 2016).

technology and financial technology (fintech). (See the Enclosure for the list of recommendations.)

The two priority recommendations fall into the following two areas:

Blockchain technology. Volatility, bankruptcies, and instances of fraud in the crypto-asset markets illustrate the harm consumers and investors may face without adequate protections. In June 2023, we recommended that the Federal Reserve and other financial regulators jointly establish or adapt an existing formal coordination mechanism to identify and address risks posed by blockchain-related products and services. The Federal Reserve neither agreed nor disagreed with the recommendation.

In April 2024, the Federal Reserve stated it has taken a step to address the recommendation through its participation in the Digital Asset Working Group, a formal working group of regulators, to promote information sharing and enhance interagency coordination in identifying blockchain risks. To fully implement the recommendation, the working group should include planning processes for identifying and addressing such risks. Fully implementing this priority recommendation would help the Federal Reserve and other financial regulators collectively identify risks posed by blockchain-related products and services and develop and implement a regulatory response in a timely manner.

Financial technology. Fintech lenders may analyze large amounts of alternative data on borrower characteristics (e.g., information from bank accounts) when determining borrowers' creditworthiness. We recommended that the Federal Reserve, other federal banking regulators, and the Consumer Financial Protection Bureau communicate the appropriate use of alternative data in the underwriting process with banks that engage in third-party relationships with fintech lenders. Implementing our priority recommendation in this area could better position federally regulated banks to manage the risks associated with partnering with fintech lenders that use these data.

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In April 2023, we issued our biennial update to our High-Risk List. This list identifies government operations with greater vulnerabilities to fraud, waste, abuse, and mismanagement. It also identifies the need for transformation to address economy, efficiency, or effectiveness challenges.[4] One of our high-risk areas—modernizing the U.S. financial regulatory system—relates directly to the Federal Reserve. Specifically, we urge your attention to the effective and efficient oversight of financial institutions and activities.

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) managing the government-wide personnel security clearance process.

In addition to the Federal Reserve's high-risk area, we urge your continued attention to the other government-wide high-risk issues as they relate to the Federal Reserve. Progress on high-risk issues has been possible through the concerted actions and efforts of Congress, Office of Management and Budget, and the leadership and staff in agencies, including within the Federal

[4]GAO, *High-Risk Series: Efforts Made to Achieve Progress Need to be Maintained and Expanded to Fully Address All Areas*, GAO-23-106203 (Washington, D.C.: Apr. 20, 2023).

Reserve. In March 2022, we issued a report on key practices to successfully address high-risk areas, which can be a helpful resource as your agency continues to make progress to address high-risk issues.[5]

We also recognize the key role Congress plays in providing oversight and maintaining focus on our recommendations to ensure they are implemented and produce their desired results. Legislation enacted in December 2022 includes a provision for GAO to identify any additional congressional oversight actions that can help agencies implement priority recommendations and address any underlying issues relating to such implementation.[6]

Congress can use various strategies to address our recommendations, such as incorporating them into legislation. Congress can also use its oversight processes to incentivize the Federal Reserve to act on our recommendations and monitor its progress. For example, Congress can hold hearings focused on the Federal Reserve's progress in implementing GAO's priority recommendations or take other actions to provide incentives for the Federal Reserve to act. As relevant here, Congress held hearings in 2023 at which federal banking regulators testified about crypto asset and fintech issues, which are topic areas related to GAO's priority recommendations. Congress also plays a key role in addressing any underlying issues related to the implementation of these recommendations. For example, Congress can pass legislation providing the Federal Reserve explicit authority to implement a recommendation or require the Federal Reserve to take certain actions to implement a recommendation.

Copies of this report are being sent to the Director of the Office of Management and Budget and the appropriate congressional committees. In addition, the report will be available on the GAO website at Priority Open Recommendation Letters | U.S. GAO.

I appreciate the Federal Reserve's continued 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 13 open recommendations, as

[5]GAO, *High-Risk Series: Key Practices to Successfully Address High-Risk Areas and Remove Them from the List*, GAO-22-105184 (Washington, D.C.: Mar. 3, 2022).

[6]James M. Inhofe National Defense Authorization Act for Fiscal Year 2023, Pub. L. No. 117-263, § 7211(a)(2), 136 Stat. 2395, 3668 (2022); H.R. Rep. No. 117-389 (2022) (accompanying Legislative Branch Appropriations Act, H.R. 8237, 117th Cong. (2022)).

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,

Gene L. Dodaro
Comptroller General
of the United States

Enclosure

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

Enclosure

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

Blockchain Technology

Blockchain in Finance: Legislative and Regulatory Actions Are Needed to Ensure Comprehensive Oversight of Crypto Assets. GAO-23-105346. Washington, D.C.: June 22, 2023.

Year Recommendation Made: 2023

Recommendation: The Chair of the Board of Governors of the Federal Reserve System should jointly establish or adapt an existing formal coordination mechanism with the Consumer Financial Protection Bureau, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Securities and Exchange Commission for collectively identifying risks posed by blockchain-related products and services and formulating a timely regulatory response. To facilitate these objectives, this mechanism could include formal planning documents that establish the frequency of meetings and processes for identifying risks and responding to them within agreed-upon time frames.

Actions Needed: The Federal Reserve neither agreed nor disagreed with the recommendation. In its agency comment letter, the Federal Reserve said it routinely engages with the other federal financial regulators on emerging risks posed by blockchain-related products and services. However, these mechanisms do not regularly convene specifically to identify the full range of risks and regulatory challenges of existing and emerging blockchain products and services and provide a timely response to any unaddressed risks.

In April 2024, Federal Reserve officials told us that the Financial Stability Oversight Council established a coordination mechanism through the creation of the Digital Asset Working Group to promote information sharing and enhance interagency coordination in identifying potential risks in the digital asset space. They stated that the working group meets regularly and has discussed a variety of topics, including regulatory developments, rulemaking, risks, data collection, and market developments. They said that given the still-nascent nature of digital asset activities, the working group's risk discussions have been broad and not confined narrowly to vulnerabilities that directly implicate financial stability.

The establishment of the Digital Asset Working Group is a positive step towards implementing a formal coordination mechanism that can identify and address risks posed by blockchain-related products and services. To fully implement the recommendation, a formal coordination mechanism such as the Digital Asset Working Group should include planning documents. Such planning documents could include (1) objectives and meeting frequency; (2) processes for identifying the full range of risks and regulatory challenges concerning blockchain-related products and services (not only those related to financial stability); and (3) processes for responding to these risks and challenges within agreed-upon timeframes.

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

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

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

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).

Year Recommendation Made: 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 financial technology (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.

Actions Needed: The Federal Reserve agreed with the recommendation. In June 2023, the Federal Reserve, along with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, issued interagency guidance on third-party risk management. In March 2024, the regulators said they believe this action fulfills the recommendation. But the guidance does not include specific direction to banks that engage with fintech lenders on the appropriate use of alternative data in the underwriting process. Rather, the guidance broadly applies to all topics and third-party relationships. Accordingly, it does not address specific topics, such as the use of alternative data, or specific types of third-party relationships, such as relationships with fintech companies.

Although the regulators helped to clarify third-party risk management through the June 2023 guidance, to fully implement our recommendation, the Federal Reserve needs to provide—in coordination with the other federal banking regulators and the Consumer Financial Protection Bureau—finalized written communication that gives banks specific direction on the appropriate use of alternative data in the underwriting process when partnering with fintech lenders. Such communication would give fintech lenders greater certainty about their compliance with consumer protection laws and help banks manage the risks associated with partnering with fintech lenders.

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

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