Federal Reserve Audits and the GAO

Audits of the Federal Reserve System

- The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review.
  - The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General.
  - The Office of Inspector General also conducts audits, reviews, and investigations relating to the Board's programs and operations as well as to Board functions delegated to the Reserve Banks.

- The Reserve Banks' financial statements are audited annually by an independent outside auditor retained by the Board of Governors.
  - In addition, the Reserve Banks are subject to annual examination by the Board, which includes a wide range of ongoing oversight activities conducted onsite and offsite by staff of the Board's Division of Reserve Bank Operations and Payment Systems.
  - Federal Reserve operations are also subject to review by the Government Accountability Office.

Oversight by the Government Accountability Office

- The supervisory and regulatory functions of the Federal Reserve are subject to GAO audits to the same extent as the supervisory and regulatory functions of the other federal banking agencies.
  - GAO has full authority to audit the manner in which the Federal Reserve supervises and regulates bank holding companies on a consolidated basis.
  - In 2009, the GAO had nearly 30 engagements (both completed and underway) involving the Federal Reserve; as of March 2010, some 11 engagements were underway.
  - Since 2008, issues reviewed related to the Basel II capital framework, risk-management oversight, the Bank Secrecy Act, and the Board's Regulation B, which implements the Equal Credit Opportunity Act. In addition, the GAO has had engagements related to AIG, credit cards, payday lending, the capital purchase program (under TARP), and systemic risk determination, among others.

- In 2009, Congress clarified the GAO's ability to audit the Term Asset-Backed Securities Loan Facility (TALF), a joint Treasury-Federal Reserve initiative, in conjunction with GAO's reviews of the performance of Treasury's Troubled Asset Relief Program (TARP).

- Along with clarifying GAO authority to audit the TALF, the Congress also granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to "single and specific" companies under the authority provided by section 13(3) of the Federal Reserve Act, including the loan facilities provided to, or created for, American International Group and Bear Stearns.

<u>Protecting Monetary Policy Independence</u>

- The Congress, however, has purposefully--and for good reason--excluded from the scope of potential GAO audits monetary policy deliberations and operations, including open market and discount window operations, and transactions with or for foreign central banks, foreign governments, and public international financing organizations.

  By excluding these areas, the Congress has carefully balanced the need for public accountability with the strong public policy benefits that flow from maintaining the independence of the central bank's monetary policy functions and avoiding disruption to the nation's foreign and international relationships.

- The same public policy reasons that supported the creation of these exclusions in 1978 remain valid today. The Federal Reserve strongly believes that removing the statutory limits on GAO audits of monetary policy matters would be contrary to the public interest by tending to undermine the independence and efficacy of monetary policy in several ways.
  - First, the GAO serves as the investigative arm of the Congress and, by law, must conduct an investigation and prepare a report whenever requested by the House or Senate or a committee with jurisdiction of either body. Through its investigations and audits, GAO typically makes its own judgments about policy actions and the manner in which they are implemented, as well as recommendations to the audited agency and to Congress for changes or future actions. Accordingly, financial markets likely would see any grant of audit authority in this area to the GAO as undermining monetary independence—particularly because GAO audits, or the threat of a GAO audit, could be used to try to influence monetary policy decisions.

- Permitting GAO audits of monetary policy also could cast a chill on monetary policy deliberations through another channel. If policymakers believed that GAO audits would result in published analyses of their policy discussions, they might be less willing to engage in the unfettered and wide-ranging debates that are essential to identifying the best possible policy options. Moreover, the publication of the results of GAO audits related to monetary policy actions and deliberations could complicate and interfere with the communication of the FOMC's intentions regarding monetary policy to financial markets and the public more broadly. Households, firms, and financial market participants might be uncertain about the implications of the GAO's findings for future decisions of the FOMC, thereby increasing market volatility and weakening the ability of monetary policy actions to achieve their desired effects.
- Finally, permitting GAO audits of the broad liquidity facilities the Federal Reserve utilizes to affect credit conditions could reduce the effectiveness of these facilities in helping promote financial stability, maximum employment, and price stability. For example, even if strong confidentiality restrictions were established, individual banks be more reluctant to borrow from the discount window if they knew that their identity and other sensitive information about their borrowings could be disclosed to the GAO. Experience, including experience in the current financial crisis, shows that banks' unwillingness to use the discount window can result in high and volatile short-term interest rates and limit the effectiveness of the discount window as a tool to enhance financial stability.

❖ Overall, the Federal Reserve believes that removing the remaining statutory limits on GAO audits of monetary policy and discount window functions would undermine public and investor confidence in monetary policy by raising concerns that monetary policy judgments would be influenced by political considerations, thereby increasing inflation fears and market interest rates, ultimately hurting economic stability and job creation.