U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

Comptroller General
of the United States

August 1, 2023

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 implementation of GAO's recommendations and to call your continued personal attention to open recommendations that should be given high priority.[1] In November 2022, 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 for these recommendations was 84 percent. As of July 2023, the Federal Reserve had 13 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.

In our June 2022 letter, we noted that three of the open recommendations were priority recommendations. Since that time, the Federal Reserve has not implemented any of them. We ask for your attention to these three priority recommendations, which are related to financial technology (fintech) and stress testing. We are also adding one new priority recommendation related to oversight of blockchain technology. This brings the total number of priority recommendations to four. (See enclosure for the list of recommendations.)

The four priority recommendations fall into the following three areas:

Blockchain technology. Recent volatility, bankruptcies, and instances of fraud in the crypto asset markets illustrate the harm consumers and investors may face without adequate protections. We recommended that the Federal Reserve and other financial regulators jointly establish or adapt an existing formal coordination mechanism to identify and address blockchain-related risks. If implemented, the Federal Reserve and the financial regulators would

[1]Priority recommendations are those that we believe 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 2022*, GAO-23-900398 (Washington, D.C.: Nov. 15, 2022).

be able to 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, such as 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.

Stress testing of banking institutions. The 2007–2009 financial crisis resulted in the Federal Reserve and other banking regulators conducting stress tests to determine whether banking institutions had enough capital to survive further economic shocks and still continue lending activities. In November 2016, we made two recommendations to improve the Federal Reserve's ability to manage model risk and stress testing of banking institutions. These recommendations include designing and implementing a process to communicate information about the uncertainty surrounding post-stress capital ratio estimates during capital analysis and review deliberations. They also include implementing a process to articulate tolerance levels for key risks identified through sensitivity testing and for the degree of uncertainty in the projected capital ratios. If implemented, these two priority recommendations could help the Federal Reserve manage the risks in its models and account appropriately for uncertainty and sensitivity of model results.

In light of recent bank failures and federal banking regulators' emergency response, we also urge you to revisit the Federal Reserve's prompt corrective action framework. In 2011, we recommended that the Federal Reserve and other regulators consider adopting noncapital triggers that would require early and forceful regulatory actions tied to unsafe banking practices.[3] The regulators considered noncapital triggers, but have not added them to the framework. We maintain that incorporating noncapital triggers would encourage earlier action and give the regulators and banks more time to address deteriorating conditions.

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In April 2023, 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.[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.

In addition, 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

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[3]GAO, Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness, GAO-11-612 (Washington, D.C.: June 23, 2011).

[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).

acquisitions and operations, (2) improving strategic human capital management, (3) managing federal real property, (4) ensuring the cybersecurity of the nation,[5] and (5) managing the government-wide personnel security process.

We urge your attention to the government-wide high-risk issues, as well as the high-risk area for which the Federal Reserve has a leading role. 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 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.[6]

In addition to your continued attention on these issues, Congress plays a key role 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.[7]

There are various strategies Congress can use in addressing 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. 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 an agency explicit authority to implement a recommendation or requiring an agency 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 http://www.gao.gov.

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

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[5]With regard to cybersecurity, we also urge you to use foundational information and risk-management practices for the communications technology supply chain set forth in our December 2020 report: GAO, *Information Technology: Federal Agencies Need to Take Urgent Action to Manage Supply Chain Risks*, GAO-21-171 (Washington, D.C.: Dec. 15, 2020).

[6]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).

[7]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 yours,

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.

Action 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, the regulators' coordination efforts have not always addressed risks posed by crypto assets in a timely manner. We maintain that a formal coordination mechanism focused on collectively identifying risks posed by blockchain-related products and services and formulating timely regulatory responses could improve protections for consumers and investors, mitigate illicit finance and threats to financial stability, and promote responsible innovation and U.S. competitiveness.

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 Mar. 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.

Action Needed: The Federal Reserve agreed with the recommendation. In July 2021, the Federal Reserve, along with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, proposed interagency guidance on third-party risk management. As of June 2023, the regulators issued final interagency guidance but it did not include specific direction to banks engaging with fintech lenders on the use of alternative data in the underwriting process. Rather the guidance indicates that it is broadly applicable to all topics and third-party relationships and, accordingly, did not address specific topics, such as the use of alternative data, or specific types of third-party relationships, such as relationships with fintech companies. However, the guidance states regulators may issue additional guidance on specific topics in the future.

In March 2021, these agencies and the Consumer Financial Protection Bureau and National Credit Union Administration issued a request for information on artificial intelligence, including machine learning. The comment period for the request for information ended on July 1, 2021, and the regulators were working on next steps for the request for information.

To fully implement our recommendation, the Federal Reserve needs to provide—in coordination with other federal banking regulators and Consumer Financial Protection Bureau—finalized 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. Clear communication on appropriate use of alternative data 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
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.

Year Recommendations Made: 2017

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. As of January 2023, Federal Reserve staff had communicated uncertainty surrounding the post-stress capital ratio estimates (how much capital is available to cover unexpected losses in stress scenarios) to senior officials. As of June 2023, the Federal Reserve did not provide any additional updates. We will continue to monitor its progress on addressing our recommendation. To fully implement our recommendation, the Federal Reserve needs to implement a process to communicate this information to the governors of the Federal Reserve. Until this process is completed, the

Federal Reserve may miss important connections between elements of component models, which in turn may limit understanding of risks inherent in their modeling choices.

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. As of January 2023, Federal Reserve staff and senior officials had discussed and approved tolerance levels for key risks based on uncertainty analysis results. As of June 2023, the Federal Reserve did not provide any additional updates. We will continue to monitor its progress on addressing our recommendation. To fully implement our recommendation, the Federal Reserve needs to implement a process for the Board itself to articulate tolerance levels for these key risks. Without systematically identifying and communicating acceptable levels of risk in its supervisory stress test models, the Federal Reserve may be limited in its ability to effectively evaluate and manage its model risk.

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

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