United States Government Accountability Office

Report to Congressional Requesters

November 2017

LARGE BANK SUPERVISION

Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence

GAO-18-118

GAO Highlights

Highlights of GAO-18-118, a report to congressional requesters

November 2017

LARGE BANK SUPERVISION

Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence

Why GAO Did This Study

The Board of Governors created LISCC in 2010, in the wake of the financial crisis of 2007–2009, to strengthen supervision of the largest U.S. financial institutions that pose the greatest risk to the economy. However, questions have been raised about the independence of the supervisory process and the risk of regulatory capture.

GAO was asked to review regulatory capture and threats to independence in large bank supervision. This report discusses the Federal Reserve's policies for (1) managing risks of regulatory capture in the LISCC program using an ERM approach; (2) mitigating threats to supervisory independence for the LISCC program; and (3) mitigating conflicts of interest for LISCC supervisory personnel. GAO reviewed studies and Federal Reserve policies and procedures. GAO also interviewed officials and supervisory staff at the Board and the LISCC Reserve Banks.

What GAO Recommends

GAO is making six recommendations to help improve the Federal Reserve's implementation of ERM and to strengthen internal controls to more effectively mitigate risks of regulatory capture and threats to supervisory independence across the LISCC program. Although the Federal Reserve neither agreed nor disagreed with the recommendations, it identified ongoing and planned efforts to address them.

View GAO-18-118. For more information, contact Lawrance Evans, Jr. at (202) 512-8678 or EvansL@gao.gov.

What GAO Found

The Board of Governors of the Federal Reserve System (Board) has not finalized and implemented its enterprise risk management (ERM) framework, and as a result, it may have limited ability to manage risks across the Large Institution Supervisory Coordinating Committee (LISCC) program. One such risk is regulatory capture, a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest. GAO has previously found that regulators should be independent of inappropriate influence, including undue influence from the industry they are regulating. LISCC is a supervisory program developed by the Board to enhance the oversight of large, complex financial institutions. LISCC takes a cross-cutting approach to supervision, drawing staff from across the Federal Reserve System including the Board and four Federal Reserve Banks, and risks of regulatory capture span various aspects of the LISCC program. To help the Board manage its diverse risks, the Board has recognized the advantages of implementing an ERM, which the Office of Management and Budget (OMB) encourages all federal agencies to do. The Board began to develop an ERM framework in 2017, but it has not yet developed some of OMB's recommended key elements, such as risk identification and assessment. Completing and implementing the ERM framework should position the Board to better manage regulatory capture risks across the LISCC program.

The LISCC program has other policies to mitigate threats to independence for supervisory staff. For example, under the LISCC program, four Reserve Banks supervise the largest financial institutions with oversight from the Board, which increases the transparency and accountability of supervisory decisions and helps to ensure those decisions are free of inappropriate influence. In addition, the Federal Reserve has mechanisms for Reserve Bank staff to communicate their views directly to Board officials. However, GAO found weaknesses in some internal controls related to guidance and monitoring mechanisms. These limit the Board's assurance that policies are being implemented consistently across the LISCC program. Because of these weaknesses, the four Reserve Banks may not be mitigating regulatory capture risks and threats to supervisory independence as effectively or consistently as possible.

The Board and the four Reserve Banks have also implemented various conflict-of-interest and other ethics policies for LISCC examiners and other types of supervisory employees. While these policies are not explicitly designed to address regulatory capture, Federal Reserve officials said they use them in part for this purpose. However, GAO found weaknesses in the Federal Reserve's implementation of these policies. For example, the Federal Reserve officials said that they have policies to help mitigate threats to independence posed by the revolving door—that is, the movement of employees between the financial industry and the Federal Reserve—but they do not systematically collect employment data needed to implement these policies effectively. Without addressing this and other weaknesses, the Federal Reserve may be limited in its ability to use its ethics policies to mitigate regulatory capture.

Contents

Letter		1
	Background	4
	Enterprise Risk Management Frameworks Can Be Used to Manage Regulatory Capture Risks, but the Board Is Still Developing Such a Framework	17
	Board of Governors and Reserve Banks Have Policies to Mitigate Threats to Independence, but Some Related Internal Controls Have Weaknesses	21
	Implementation of Policies to Identify and Mitigate Conflicts of Interest Is Hampered By Lack of Data and Program Evaluations	36
	Conclusions	63
	Recommendations for Executive Action	64
	Agency Comments and Our Evaluation	65
Appendix I	Objectives, Scope and Methodology	69
Appendix II	Literature on Regulatory Capture in Financial Banking Supervision	73
Appendix III	Summary of Federal Reserve Investment and Borrowing Prohibitions for Examiners and Other Types of Employees	79
Appendix IV	Federal Reserve Bank Examination Staff with Active Conflicts of Interest, 2011–July 2016	82
Appendix V	Comments from the Board of Governors of the Federal Reserve System	85
Appendix VI	GAO Contact and Acknowledgments	91

Tables

Table 1: Summary of Available Pre- and Post-Employment Information of Federal Reserve Bank LISCC Program Examiners Employed 2011–July 2016 57
Table 2: Federal Reserve Guide to Investment and Borrowing Prohibitions and Situations Requiring Recusal 79
Table 3: Federal Reserve Examination Staff Working on Large Institution Supervision Coordinating Committee (LISCC) Examinations with Active Conflicts of Interest, 2011–July 2016 82

Figures

Figure 1: Federal Reserve Components That Participate in the LISCC Program 6
Figure 2: Components of the Federal Reserve's LISCC Program That Participate in Horizontal Examinations 9
Figure 3: Selected Factors That Can Increase Risk of Regulatory Capture and Mitigation Strategies 13
Figure 4: Summary of Internal Review Findings Relevant to LISCC Policies That May Mitigate Threats to Independence, 2012–2016 26
Figure 5: Federal Reserve Ethics Programs and Procedures That Apply to LISCC Employees 38
Figure 6: Conflict-of-Interest Disclosure and Review Process for Reserve Bank Examiners 47
Figure 7: Summary of Available Data on Federal Reserve Bank LISCC Examiners Hired from the Financial Industry Who Left Reserve Banks for the Financial Industry, 2011–July 2016 58

Abbreviations

Board of Governors or Board	Board of Governors of the Federal Reserve System
CCAR	Comprehensive Capital Analysis and Review
CLAR	Comprehensive Liquidity Analysis and Review
COFI	Conflict-of-Interest Application
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPC	Central Point of Contact
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
ERM	Enterprise Risk Management
Federal Reserve	Federal Reserve System
FRBNY	Federal Reserve Bank of New York
FRB Boston	Federal Reserve Bank of Boston
FRB Richmond	Federal Reserve Bank of Richmond
FRB San Francisco	Federal Reserve Bank of San Francisco
FSOC	Financial Stability Oversight Council
LISCC	Large Institution Supervision Coordinating Committee
OC	LISCC Operating Committee
OGE	Office of Government Ethics
OIG	Office of the Inspector General
OMB	Office of Management and Budget
Reserve Bank	Federal Reserve Bank
SSO	Senior Supervisory Officers

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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

November 6, 2017

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Al Green
Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
House of Representatives

Among many factors that contributed to the financial crisis of 2007–2009 was weakness in federal supervision of large banks, and some analyses have identified regulatory capture as one potential cause of this weakness. While definitions vary, regulatory capture can be defined as a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest due to actions taken by the interested parties.[1] The financial crisis that began in the summer of 2007 tested both the strength of financial institutions and the quality of the Federal Reserve System's (Federal Reserve), and other financial regulators', supervision. In our work since the crisis, we have found that regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure that they adequately manage their risks.[2] Among the characteristics that should be reflected in any well-functioning regulatory system, we have found that

[1]According to some scholars, regulatory capture requires both intent and action on behalf of the regulated industry which results in a higher evidentiary standard for the existence of capture. For a discussion of the implications of unclear definitions of regulatory capture including the potential for misdiagnosis and insufficient mitigation strategies, see D. Carpenter and D. Moss (eds.), *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York, NY: Cambridge University Press, 2014). Given our oversight role we are also interested in cases where regulation deviates from the public interest toward private interest for reasons unrelated to actions taken by the regulated industry. As a result, we refer more broadly to threats to supervisory independence where appropriate to cover both regulatory capture threats and other threats that might compromise effective bank supervision.

[2]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

regulators should be independent of inappropriate influence, including undue influence from the industry they are regulating.[3]

The Board of Governors of the Federal Reserve System (Board of Governors or Board) is responsible for, among other things, supervising bank holding companies, which are some of the largest financial institutions in the United States, and it has delegated certain aspects of day-to-day execution of this supervisory responsibility to the Federal Reserve Banks (Reserve Bank). In 2009, the Federal Reserve Bank of New York (FRBNY) commissioned an independent consultant to assess the lessons learned from the 2007–2009 financial crisis, with a particular focus on bank supervision. In a testimony to the U.S. Congress, the author of the report said that FRBNY suffered from weak regulatory capture, in that it did not strictly enforce regulatory requirements because of deference to supervised firms.[4] According to the President of the FRBNY, the supervision group at FRBNY has been reorganized as a result of the 2009 report to better promote unbiased analysis and professional objectivity. Additionally, in 2010 the Federal Reserve created a new system-wide supervisory program—the Large Institution Supervision Coordinating Committee (LISCC)—to enhance the oversight of large, complex financial institutions. This new approach has shown promise, but several studies have suggested possible weaknesses in the Federal Reserve's oversight of these banks, which in turn could impede the agency's goals of supervising this nation's largest, most systemically important financial institutions.

You asked us to examine issues related to regulatory capture and supervisory independence in the financial services industry. This report examines the Federal Reserve's policies and procedures for (1) managing risks, including regulatory capture, across the Federal Reserve LISCC program using an enterprise risk management (ERM) approach; (2) identifying and mitigating threats to supervisory independence for the LISCC program; and (3) identifying and mitigating conflicts of interest

[3]GAO-09-216.

[4]The 2009 report and its findings are summarized in a public testimony by the report's author. See *Improving Financial Institution Supervision: Examining and Addressing Regulatory Capture*: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the S. Comm. on Banking, Housing, and Urban Affairs, 113th Cong., 1st Sess. (Nov. 21, 2014) (statement of David O. Beim, Professor of Professional Practice, Columbia Business School).

among supervisory personnel in the LISCC program.[5] This report is the first in a series that we plan to conduct to review issues related to regulatory capture and supervisory independence among federal financial regulatory agencies.[6]

To assess the extent to which the Federal Reserve and Reserve Banks manage regulatory capture risks across the LISCC program, we reviewed ERM documentation from the Board of Governors and the four LISCC Reserve Banks and interviewed risk officers and other staff responsible for the supervision of risk management. In addition, to identify ways in which banking supervisors might experience regulatory capture and strategies for mitigation, we reviewed and summarized relevant academic studies and interviewed academic experts. To assess the Federal Reserve's policies and procedures for identifying and mitigating threats to supervisory independence for the LISCC program, we reviewed the Board's documentation of the program as well as internal evaluations, including reports by the Office of the Inspector General (OIG) of the Federal Reserve. We conducted individual interviews and focus groups with examiners and senior examination officials to assess the implementation of LISCC program policy changes that may mitigate regulatory capture. To assess the extent to which Federal Reserve policies and procedures mitigate conflicts of interest, we reviewed Board and Reserve Bank conflict-of-interest policies and procedures and relevant statutes and regulations and interviewed ethics officials at the Board and Reserve Banks. We collected data on conflict-of-interest disclosures of Reserve Bank LISCC examination staff and Federal Reserve members of the LISCC Operating Committee between 2011 and 2016. We also collected available data on prior and subsequent employment of LISCC program participants. To assess the reliability of data we received from the Federal Reserve, we interviewed Federal Reserve officials, reviewed related documentation, and tested the data for missing or erroneous values. We determined the data were sufficiently reliable for purposes of our review. Appendix I provides more detail on our scope and methodology.

---

[5]The concept of regulatory capture was introduced by economist George Stigler in 1971 and was broadly applied to any regulated industry. This report focuses on regulatory capture by the financial industry of bank examiners and other supervisory staff.

[6]In forthcoming reports, we plan to assess similar issues for other federal financial and market regulators, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

We conducted this performance audit from April 2016 to November 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The Federal Reserve

The Federal Reserve Act established the Federal Reserve as the country's central bank. The act established the Federal Reserve as an independent, decentralized bank to better ensure that monetary policy would be based on a broad economic perspective from all regions of the country. The Federal Reserve consists of the Board of Governors, located in Washington, D.C.; 12 Reserve Banks, which have 24 branches located throughout the United States; and the Federal Open Market Committee, which is composed of the Board of Governors and five Reserve Bank presidents who serve on a rotating basis. The Board of Governors is an independent federal agency that is responsible for maintaining the stability of financial markets; supervising financial and bank and savings and loan holding companies, and the nondepository institution subsidiaries of those companies, state-chartered banks that are members of the Federal Reserve, and the U.S. operations of foreign banking organizations; and supervising the operations of the Reserve Banks.[7] Unlike the Board of Governors, the Reserve Banks are not federal agencies. Each Reserve Bank is a federally chartered corporation, and under the Federal Reserve Act, Reserve Banks are subject to the general supervision of the Board of Governors. The Board has delegated some of its responsibilities, such as certain aspects of supervision, to the Reserve

[7]The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) includes provisions that expand the roles and responsibilities of the Federal Reserve. In particular, the act authorizes the Board of Governors to regulate nonbank financial companies designated as systemically significant by the Financial Stability Oversight Council (FSOC). *See* Pub. L. No. 111-203, § 113(a), 124 Stat. 1376, 1398 (2010) (codified at 12 U.S.C. § 5323(a)). The Financial Stability Oversight Council, established by the Dodd-Frank Act, is chaired by the Secretary of the Treasury, and its membership includes the Chairman of the Board of Governors and the heads of the other federal financial regulators, among others. § 111, 124 Stat. at 1392 (codified at 12 U.S.C. § 5321).

Banks. Unlike federal agencies that are funded through congressional appropriations, the Board and the Reserve Banks are self-funded entities.

The Federal Reserve's LISCC Supervisory Program

Staff at the Federal Reserve supervise 13 financial institutions that are in the LISCC program.[8] At the Reserve Bank level, the LISCC program is made up of dedicated supervisory teams for each of these 13 firms, horizontal teams that cover issues across multiple firms and program, and System-level committees that provide direction and oversight. Based on the geographic location of currently designated LISCC firms, the Reserve Banks that participate in the LISCC program are those in Boston (FRB Boston), New York (FRBNY), Richmond (FRB Richmond), and San Francisco (FRB San Francisco).[9] In designating firms for supervision under the LISCC program, the Federal Reserve takes into account a number of factors, such as the size of the financial institutions, their interconnectedness, a lack of readily available substitutes for the services they provide, their complexity, and their global activities. In examining these institutions, the Federal Reserve aims to provide consistency across its firm-specific and horizontal supervisory decisions. Staff from across the Federal Reserve participate in supervising these large, systemically important firms.

The LISCC Operating Committee (OC) oversees the execution of the LISCC program. The OC is a multidisciplinary group composed of senior officials from various divisions at the Board and Reserve Banks and is chaired by a senior officer from the Division of Supervision and Regulation who reports to the Director of the Division of Supervision and Regulation at the Board. The OC, in consultation with the LISCC, sets priorities for and oversees the execution of the LISCC program, identifies common risks facing firms in the portfolio, and makes decisions about certain supervisory actions. The OC has several subcommittees that focus on different components of large financial institution supervision. The subcommittees consist of OC members and other Federal Reserve staff. For example, the OC's Vetting Committee is a forum to review the

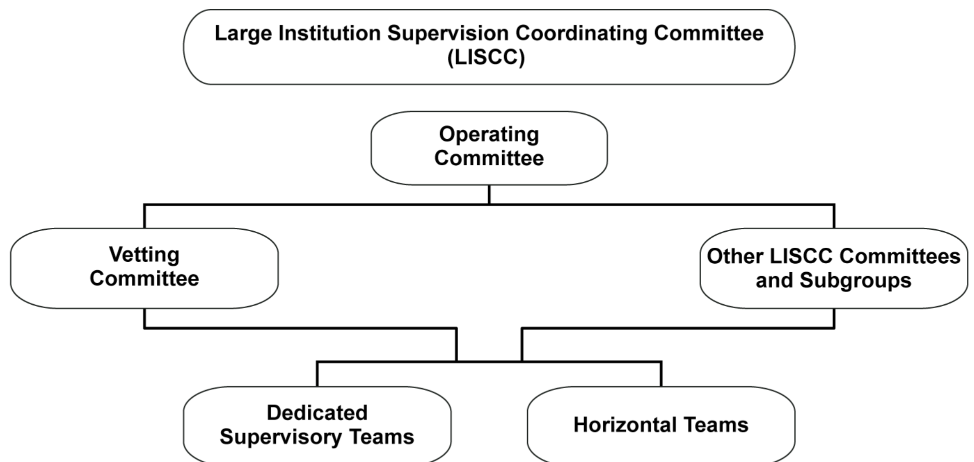
[8]FSOC designates non-bank financial firms for supervision by the Federal Reserve Board of Governors. The Board determines whether a firm is in the LISCC portfolio. On September 29, 2017, FSOC voted to de-designate AIG as a Non-Bank SIFI; as a result, AIG is no longer subject to supervision by the Board.

[9]FRB Boston supervises Prudential Financial Inc. and State Street Corporation; FRBNY supervises The Bank of New York Mellon Corporation, Barclays PLC, Citigroup Inc., Credit Suisse Group AG, Deutsche Bank AG, The Goldman Sachs Group, Inc., JPMorgan Chase & Co., Morgan Stanley, and UBS AG; FRB Richmond supervises Bank of America Corporation; and FRB San Francisco supervises Wells Fargo & Company.

results of key components of the supervisory program and provide feedback and guidance to various LISCC-dedicated supervisory teams. According to policy documents, the Vetting Committee tries to promote quality and consistency in supervisory approaches, key examination work and related communications, risk and risk management assessments, and supervisory actions and messages sent to individual firms.

The OC also provides direction to the LISCC firms' dedicated supervisory teams and horizontal teams. LISCC-dedicated supervisory teams and horizontal teams are required to develop detailed supervisory plans to establish an official record of supervisory activities planned for the annual supervisory cycle and vet that plan with the OC. At the end of the annual supervisory cycle, the dedicated supervisory teams compile the findings from firm-specific and horizontal exams and other supervisory work related to the firm into an annual assessment, which conveys supervisory ratings, messages, and key issues and risks for each LISCC firm. The designated supervisory teams recommend ratings to the OC, and the OC is responsible for approving the final rating. Figure 1 illustrates the Federal Reserve components that participate in the LISCC program.[10]

Figure 1: Federal Reserve Components That Participate in the LISCC Program



Source: GAO summary of Board of Governors of the Federal Reserve System information. | GAO-18-118

[10]According to Federal Reserve officials, other staff from across the Federal Reserve may also at times participate in examinations of LISCC firms.

Reserve Banks have organized their dedicated supervisory teams differently by establishing additional layers of management or assigning examiners to different subgroups. All of the designated supervisory teams include a key top management figure, but some use different titles for their staff. For example, designated supervisory teams at FRB Boston, Richmond, and San Francisco are led by a Central Point of Contact (CPC), while FRBNY calls the leaders of its designated supervisory teams Senior Supervisory Officers (SSO).[11] Reserve Banks and the Board also contribute staff to system-wide horizontal teams. All participating Reserve Banks have risk specialists—staff responsible for understanding a supervised entity's risk exposures and risk management that may be assigned to dedicated supervisory teams or horizontal teams, depending on the Reserve Bank's chosen structure. According to FRBNY, risk specialists in their Reserve Bank are aligned with both dedicated teams as well as horizontal teams to (1) ensure that sufficient resources are dedicated to understanding the complexities of any given LISCC firm and (2) enable specialists with expertise on a specific firm to be informed by colleagues with similar expertise on similar firms. FRBNY has also formalized distinct roles within each designated supervisory team to focus supervision more on how specific areas of a firm's business strategies may affect risk.

According to the Federal Reserve, work generally consisted of several types of examination activities, including continuous monitoring; enhanced continuous monitoring; and full-scope or target examinations:

- **Continuous monitoring**. Continuous monitoring activities provide information to assess inherent risks; stay abreast of risk management and internal control processes; and assist in the assessment of management, corporate governance practices, and the specific firm's financial condition. Continuous monitoring also assists in the identification of emerging risks. Examples of continuous monitoring activities include ongoing meetings with management, review of firm management information system reports, and meetings with other supervisors.
- **Enhanced continuous monitoring**. Enhanced continuous monitoring is a planned event that requires a "deeper dive" than routine continuous monitoring in order to learn more about a particular issue at a specific firm. These events have fewer documentation

[11]For the purposes of this report, CPCs and SSOs are referred to as managers.

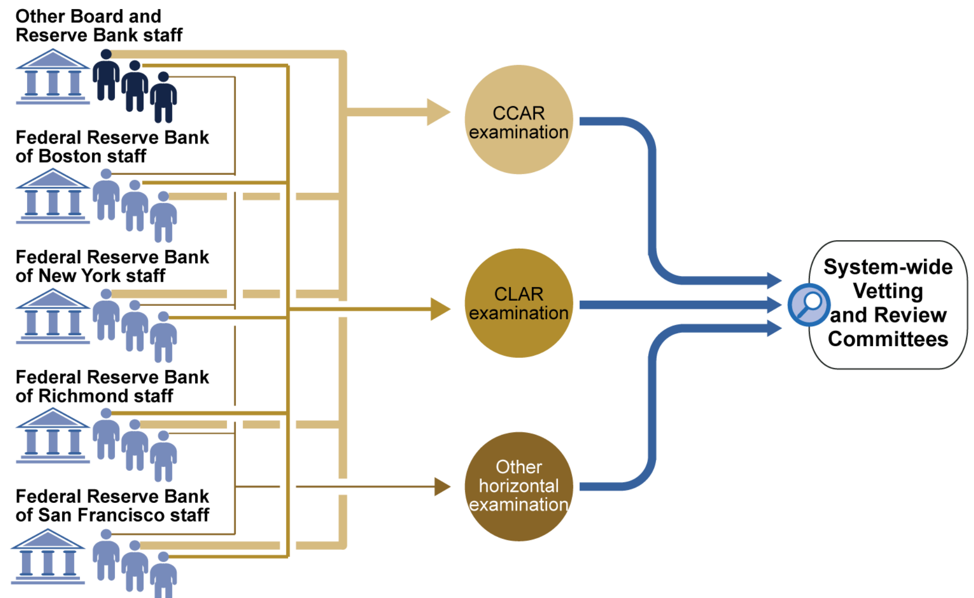
requirements, are typically less formal than a target review, and are meant to fill a knowledge gap or determine if more formal supervisory work is needed.

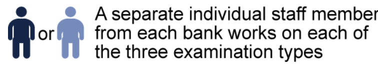
- **Firm-specific full scope and target examinations**. Full scope examinations are planned events that assess safety and soundness and assign supervisory ratings to state member bank subsidiaries. Target reviews are limited in scope and assess the quality and effectiveness of a firm's control function (e.g., audit), line of business, or business process (e.g., credit origination process).

In addition, horizontal examinations look at specific issues, such as the adequacy of capital and the sufficiency and resiliency of liquidity, across multiple firms. The OC oversees the committees that are charged with the execution of horizontal examinations for LISCC firms: among others, the Comprehensive Capital Analysis and Review (CCAR), the Comprehensive Liquidity Analysis and Review (CLAR), and the Supervisory Assessment of Recovery and Resolution Preparedness (SRP). CCAR is the Federal Reserve's annual process for evaluating capital adequacy of LISCC firms (and other firms subject to the Federal Reserve's capital plan rule) under normal and stressed conditions, as well as assessing their capital planning processes. CLAR is the Federal Reserve's annual, forward-looking program to evaluate the liquidity position and liquidity risk management practices of LISCC firms. SRP is the Federal Reserve's annual review of the LISCC firms' options to support recovery and progress in removing impediments to orderly resolution.[12] The OC also oversees ad hoc horizontal examinations that are developed in support of LISCC priorities—for example, horizontal examinations have reviewed such issues as cyber-security and model risk management across multiple LISCC firms. Ad hoc horizontal examinations are performed by staff drawn from horizontal teams comprised of staff from multiple Reserve Banks and staff at the Board of Governors who have particular technical expertise. Figure 2 illustrates how horizontal examinations work within the LISCC program.

[12]The nonbank systemically important financial institutions (SIFIs) are not subject to CCAR or CLAR. Nonbank SIFIs and foreign firms are not subject to SRP until 2018.

Figure 2: Components of the Federal Reserve's LISCC Program That Participate in Horizontal Examinations





CCAR - Comprehensive Capital Analysis and Review
CLAR - Comprehensive Liquidity Analysis and Review

Source: GAO summary of Board of Governors of the Federal Reserve System information. | GAO-18-118

Note: Other horizontal examinations include the Supervisory Assessment of Recovery and Resolution Preparedness (SRP).

Regulatory Capture

Regulatory capture exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest. However, there is no commonly accepted definition of regulatory capture, and some scholars have offered more precise definitions to facilitate detecting, measuring, and mitigating it.[13] Nevertheless, articles and studies we reviewed generally agree that capture is a complex and significant threat to effective regulation and can

[13]For example Carpenter and Moss, *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (2014), offer a stricter and more nuanced definition: "Regulatory capture is the result of a process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and toward the interest of the regulated industry by the intent and action of the industry itself." While many definitions of regulatory capture do not require action on behalf of the regulated industry, these scholars maintain that not doing so contributes to a fairly low evidentiary standard for assessing whether or not capture has occurred. The concern is that these definitional issues can lead to agencies misdiagnosing and insufficiently treating regulatory capture.

take many forms. For example, while regulatory capture was traditionally posited as phenomenon in which incumbent firms actively pursue regulations to the disadvantage of new potential entrants ("traditional" or "anticompetitive" capture), more recent academic literature largely addresses "corrosive" or "deregulatory" capture, in which regulated entities look to avoid, minimize, or eliminate regulations to the detriment of the public good.[14] Regulatory capture is typically distinguished as a condition that compromises an entity's ability to serve the public interest to some extent (weak capture) or that completely undermines the public interest (strong capture) to the extent that Congress would need to eliminate or replace an agency to reestablish the public-interest qualities of regulation.[15] Moreover, capture could compromise an entire agency or could be limited to a smaller segment of an agency that executes a portion of the agency's mission. In all cases, capture is generally considered to operate less explicitly than outright bribery. However, similar to more extreme versions of corruption, private interests (in this case the regulated entities) exploit available points of leverage—financial, social, or informational—to influence the target regulator's decisions, particularly those decisions that require substantial judgment which can then be biased in ways that are difficult to identify definitively.

The potential negative effects of capture on bank regulation and supervision requires well-designed preventative measures by prudential banking regulators.[16] Some experts argue that banking regulation is particularly susceptible to regulatory capture given a number of factors ranging from size and profitability of the regulated entities and the existence of influential trade associations to the banks' ability to offer regulators (implicitly or explicitly) attractive employment opportunities, among other things.[17] Capture may influence regulatory and supervisory

[14]As this report is concerned with the supervisory process for large financial institutions, it is concerned with an assessment of corrosive capture.

[15]Strong capture (which is often associated with traditional capture) can imply regulation is counterproductive in that it is harmful to the public interest. See G. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2 (Spring 1971). Weak capture, on the other hand (typically associated with corrosive capture), implies only that regulation is less effective.

[16]For the importance of preventative actions in response to the risk of regulatory capture, see J. Yellen, "Improving the Oversight of Large Financial Institutions," https://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm.

[17]See for example, D. Hardy, "Regulatory Capture in Banking," IMF Working Paper, WP/06/34, Washington, D.C. (2006).

decisions affecting banks and other financial institutions. For example, according to some experts, supervisors may exercise less scrutiny than they should, overlooking potentially risky practices, or become reluctant to impose harsh penalties for transgressions as a consequence of pressure or inducements from regulated entities. Several factors may threaten the independence of banking supervisors, according to some experts, thereby increasing the risk of regulatory capture. Such factors include, among others, information asymmetry, a "revolving door" (that is, movement of personnel between a regulating agency and a regulated entity), cultural capture, an agency's funding structure, and external pressure.

- **Asymmetry in information and participation.** Information asymmetry occurs when regulators depend on regulated firms for information, such as specialized knowledge and financial data, and may be unable to view that information skeptically. Some studies indicate that regulated firms may have more expertise than regulatory agencies because firms generally have more resources. An agency's lack of expertise can limit a regulator's ability to evaluate industry practices, thus providing leverage for the regulated entity to exploit. Some studies indicate that asymmetric participation may pose a risk of regulatory capture where large regulated firms have more resources and incentives to hire experts, and lobby effectively.
- **Revolving door.** A revolving door situation may threaten the independence of supervision in different ways. For example, according to some experts, banking supervisors may consider taking higher-paying job opportunities at supervised banks, potentially making them less willing to challenge supervised firms. In addition, when supervised banks hire examiners or other experienced staff from a banking regulator, these employees may help the bank navigate the regulatory requirements, according to these experts.
- **Cultural capture.** Shared cultural values between employees of the regulating agency and the regulated institution may cause supervision to be less objective—a situation sometimes referred to as "cultural capture." For example, the employees of a regulatory agency can come to share the beliefs, views, and perspectives of the regulated industry. Some studies indicate that regulators come to value relationships developed through repeated interactions and may avoid making decisions that could harm those relationships. Past employment or a shared professional background can also lead to cultural capture and affect the regulator's confidence and trust in the regulated industry. In addition, when a regulatory agency lacks a clear mission to pursue and prioritize public interests, there is a risk of

regulatory capture in which agencies become passively persuaded by regulated parties.

- **Agency funding structure.** How an agency is funded can affect the agency's risk of regulatory capture. For example, according to some experts, some regulators are funded through fees paid by the regulated firms, in which case regulators may feel pressure to make decisions that favor those firms.
- **External pressure.** External pressure, such as from the political sphere, can also subject the supervisory process to regulatory capture. For example, according to some experts, regulated firms may be influential campaign donors with the ability to pressure politicians when the regulated firms disagree with the regulators.[18]

Banking supervisors can mitigate these threats to supervisory independence, according to some experts, by adopting and implementing policies and strategies such as promoting transparency and accountability, countering cultural capture, slowing the revolving door, and reducing asymmetries and undue industry influence. For example, hiring staff from diverse backgrounds can provide different perspectives to supervisory decision making, while training may help to cultivate a supervisory mindset and counter cultural capture. Encouraging employees to voice and document divergent views can enhance transparency and hold supervisory staff and management accountable for their supervisory decisions. Further, increasing data collection and facilitating increased engagement by multiple groups can reduce information asymmetry. In the case of the revolving door, restricting former employees' employment—or specific employment activities—with financial institutions they supervised for a set period can help to mitigate threats to supervisory independence, according to some experts. In addition, financial regulators may further mitigate threats to their independence by addressing individual employees' ethical and conflict-of-interest issues and by implementing risk management practices. Figure 3 illustrates selected factors that can increase financial institutions' risk of regulatory capture and strategies for mitigating these factors. See appendix II for more information on factors that can increase the risk of regulatory capture and strategies for mitigation.

[18]See appendix II for summary of our literature review of factors that may contribute to regulatory capture and strategies for mitigating it in banking supervision and regulation.

Figure 3: Selected Factors That Can Increase Risk of Regulatory Capture and Mitigation Strategies

Threat factor		Mitigation strategy
Asymmetry in information and participation Regulator dependent on regulated firms for information. Regulated industry having more resources and incentives.		E F
Revolving door Potential jobs and social ties result in conflicts of interest.		A B C
Cultural capture	**Ideology** Regulator and regulated industry share same beliefs and perspectives.	A B C D E
	Lack of clear mission Separation between public and private interests not clearly stated.	A E F
Agency structure Funding mechanism facilitates direct or indirect undue influence.		F
External pressure Political or electoral factors influence regulator decisions/actions.		A B E F

A **Transparency and accountability** (staff movement, independence, operating procedures, publicize decisions)

B **Management of supervisory teams** (rotating vulnerable roles, adequate staffing, limited external contractor use, diverse hiring, team site visits)

C **Slow or eliminate revolving door** (higher salaries, cooling-off period)

D **Counter cultural capture** (diverse hiring, contrarian roles, incentives, training, whistle-blower protection)

E **Reduce asymmetries** (proxy advocacy, increase data collection)

F **Reduce undue influence** (term limits, information sharing, regulatory fees)

Source: GAO analysis based on review of relevant literature. | GAO-18-118

Enterprise Risk Management (ERM) and Internal Controls Related to Regulatory Capture

ERM is a forward-looking management approach that allows an organization, such as a federal agency, to assess threats and opportunities that could affect the achievement of its goals. ERM is part of overall organizational governance and accountability functions and encompasses all areas where an organization is exposed to risk. The Office of Management and Budget (OMB) has defined “risk” as the effect of uncertainty on objectives. Risk management is a series of coordinated activities to direct and control challenges or threats to achieving an organization’s goals and objectives. ERM can address the full spectrum of the organization’s external and internal risks by understanding the combined impact of risks as an interrelated portfolio, rather than

addressing risks only within silos. Agency leaders are responsible for managing complex and risky missions. ERM is a way for these leaders to manage risk across their organizations—including risks related to regulatory capture.

In 2016, OMB updated its Circular A-123, which requires all executive branch agencies to implement ERM frameworks and adjust their internal controls to align with GAO's updated Standards for Internal Control in the Federal Government.[19] In the 2016 guidance, OMB also encouraged all non-executive branch federal agencies to implement ERM. OMB Circular A-123 and the Federal Managers' Financial Integrity Act of 1982 have been central to federal efforts to help ensure accountability within government agencies.[20] The Federal Reserve is an independent entity and is not subject to OMB's risk management guidelines, but the Board of Governors voluntarily complies with the Federal Managers' Financial Integrity Act of 1982 as a best practice. We recently reported on good practices some federal agencies use to implement their ERM frameworks.[21] These include aligning ERM with agency goals and objectives; identifying risks; assessing risks; selecting risk responses; monitoring risks; and communicating and reporting about risks.

An agency can use an ERM framework to manage its regulatory capture risks, which can span functional areas of organizations and can be categorized by type of risk. The Committee of Sponsoring Organizations of the Treadway Commission (COSO), which developed an ERM framework to help organizations manage risks, noted that ERM helps ensure effective reporting and compliance with laws and regulations and helps avoid damage to the entity's reputation and associated

[19]OMB, *Circular A-123: Management's Responsibility for Enterprise Risk Management and Internal Control* (Washington, D.C.: July 15, 2016); GAO, *Standards of Internal Control for the Federal Government,* GAO-14-704G (Washington, D.C.: Sept. 10, 2014).

[20]Pub. L. No. 97-255, 96 Stat. 814 (codified as amended at 31 U.S.C. § 3512).

[21]GAO, *Enterprise Risk Management: Selected Agencies' Experiences Illustrate Good Practices in Managing Risk*, GAO-17-63 (Washington, D.C.: Dec. 1, 2016). Internal control is also part of ERM and is used to manage or reduce risks in an organization. Beyond traditional internal controls, ERM promotes risk management by considering its effect across the entire organization and how it may interact with other identified risks. Additionally, ERM also addresses other topics such as setting strategy, governance, communicating with stakeholders, and measuring performance, and its principles apply at all levels of the organization and across all functions.

consequences.[22] In addition, OMB's guidance on ERM highlights the process of identifying and categorizing risks.[23] Among the risk categories OMB identifies are legal, compliance, and reputational risks. Risks of regulatory capture span these three risk categories. Legal and compliance risks refer to the risk that an agency will fail to comply with statutory or regulatory requirements, respectively. Reputational risk is a failure to fulfill the agency's role (whether such failure is actual or perceived) in such a way that the agency faces diminished stature, credibility, or effectiveness. According to OMB, reputational risk—which could damage the reputation of an agency or component of an agency to the point of having a detrimental effect capable of affecting the agency's ability to carry out mission objectives—is one of the most common risk types. Reputational risks are inherent in agency processes and encompass factors such as regulatory capture, employee conduct, supervision, and legal issues.

We have previously reported that effective ERM implementation starts with an agency establishing a customized ERM program that fits its specific organizational mission, culture, operating environment, and business processes.[24] OMB Circular A-123 specifies elements that federal agencies' ERM frameworks should include and steps agencies should take to develop these frameworks. These include a planned risk management governance structure, a process for considering risk appetite and risk tolerance levels, a methodology for developing a risk profile, a general implementation timeline, and a plan for maturing the comprehensiveness and quality of the risk profiles over time.[25] OMB and

---

[22]Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management-Integrated Framework*, 2004. COSO has since updated the ERM framework, *Enterprise Risk Management-Aligning Strategy with Performance*, exposure draft issued in June 2016, but we did not include this in our analysis.

[23]Further, the Chief Financial Officers Council and Performance Improvement Council published a guide to implementing OMB's revised circular that noted that one of the most salient lessons from past crises and negative reputational incidents is that both public and private sector organizations would benefit from establishing or reviewing and strengthening their risk management practices. U.S. CFO Council and Performance Improvement Council, Playbook: *Enterprise Risk Management for the U.S. Federal Government* (Washington, D.C.: July 29, 2016).

[24]GAO-17-63.

[25]OMB Circular A-123 also stated that agencies have discretion in terms of the appropriate content and format for their risk profiles; however, in general risk profiles should include the following seven components: 1. Identification of Objectives; 2. Identification of Risk; 3. Inherent Risk Assessment; 4. Current Risk Response; 5. Residual Risk Assessment; 6. Proposed Risk Response; and 7. Proposed Action Category.

COSO define risk appetite as the amount of risk an organization is willing to accept in pursuit of its mission. It is established by the organization's most senior leadership and serves as the guidepost to set strategy and select objectives. OMB and COSO define risk tolerance as the acceptable level of variance in performance relative to the achievement of objectives. Reserve Banks, which are separately incorporated entities, have voluntarily followed guidance from COSO on ERM.

Preventing Conflicts of Interest

While regulatory capture threatens the independence of supervision at the agency-wide level, employees' individual conflicts of interest can also undermine their independence in performing supervisory duties. To help ensure that federal employees act in the interest of the public rather than their own personal interests, Congress has enacted legislation intended to prevent conflicts of interest or the appearance of conflicts of interest.[26] Congress also established the Office of Government Ethics (OGE) in 1978 to provide direction to executive branch agencies in developing policies related to preventing conflicts of interest on the part of officers and employees.[27] OGE, with a staff of approximately 75, oversees federal ethics programs administered by more than 4,500 agency ethics officials across the executive branch; these agency ethics officials, in turn, have the primary responsibility for directing the agency's ethics program and coordinating with OGE. OGE also has issued standards of conduct for

[26]For example, a criminal conflict of interest statute prohibits former employees from representing another person or entity by making a communication to or appearance before a federal department, agency, or court concerning the same "particular matter involving specific parties" with which the former employee was involved while in public service. 18 U.S.C. § 207. In addition, certain senior officials are subject to a "cooling off" period, so that for a period of one year after leaving a senior position, the former employee may not represent another person or entity by making a communication to or appearing before the former employee's former agency to seek official action on any matter. 18 U.S.C. § 207 (c).

[27]Ethics in Government Act of 1978, Pub. L. No. 95-521, tit. IV, 92 Stat. 1862 (codified as amended at 5 U.S.C. app. §§ 401-408). By Federal Reserve regulation, employees of the Board are subject to OGE's executive branch-wide standards of ethical conduct, codified at 5 C.F.R. part 2635, and the executive branch-wide financial disclosure regulation, codified at 5 C.F.R. part 2634.

federal employees, as well as regulations that help implement federal statutes intended to prevent conflicts of interest.[28]

In addition, federal agencies—including independent entities such as the Federal Reserve—have issued supplemental ethics regulations that impose additional ethics restrictions on their employees.[29] Board regulations include prohibitions on employees receiving preferential terms from regulated institutions and on supervisory employees from seeking credit from institutions that are involved in the employee's work assignments.[30] The Board of Governors and Reserve Banks maintain internal policies that reflect applicable statutes and regulations and impose additional restrictions. The statutory, regulatory, and Federal Reserve policy restrictions generally apply to the employees themselves, although some regulations and policies also apply to an employee's spouse, domestic partner, or dependent children.[31]

Enterprise Risk Management Frameworks Can Be Used to Manage Regulatory Capture Risks, but the Board Is Still Developing Such a Framework

ERM frameworks could be used to manage regulatory capture risks across the LISCC program, and the Federal Reserve Board just recently started the development of an ERM framework in 2017. The four Reserve Banks that participate in the LISCC program already maintain their own ERM frameworks. However, they have limited ability to manage regulatory capture risks because the individual Reserve Banks do not have visibility across the LISCC program, and their risk management officers' access to and reporting of supervisory information is restricted. An ERM framework would enhance the ability of the Board of Governors to look comprehensively across the Federal Reserve to identify, assess, and monitor sources of reputational risk, including the risk of regulatory capture across the system.

[28]Executive Order 12674 (as modified by Executive Order 12731) set out fourteen basic principles of ethical conduct for executive branch personnel and directed OGE to establish a single, comprehensive, and clear set of executive branch standards of ethical conduct. OGE's Standards of Ethical Conduct for Employees of the Executive Branch regulation, 5 C.F.R. part 2635, became effective on February 3, 1993. 57 Fed. Reg. 35006 (Aug. 7, 1992).

[29]*See* 5 C.F.R. pt. 6801.

[30]5 C.F.R. §§ 6801.105 - 6801.106.

[31]The restrictions may also apply to other associates of the employee, such as general partners. *See, e.g.,* 5 C.F.R. § 6801.106(b)(3).

The Board of Governors Only Recently Began Developing an ERM Framework that Could Help Manage Regulatory Capture Risks

The Board of Governors did not have an ERM framework for the period of our review, 2011 through 2016, but began to develop a framework in January 2017. As noted previously, OMB has encouraged all nonexecutive branch federal agencies to implement ERM, and ERM can be used to manage reputational risks, including the risk of regulatory capture. The Federal Reserve OIG also recommended that the Board adopt a comprehensive risk management structure in its 2016 management challenges report, restating a recommendation the OIG first made in 2013 (the Board agreed to implement the 2013 recommendation but had not done so by 2016). A senior Board official we spoke with said the reason the Board is moving ahead with developing an ERM framework now, even though the Reserve Banks have had such frameworks for some time (and the OIG made such a recommendation in 2013), is that the Board has come to recognize the diverse set of risks the Federal Reserve faces and the Board believes that a more structured framework would be useful in understanding and managing these risks. However, this Board official was not clear about the relevance of regulatory capture risk to ERM. To manage regulatory capture risks within supervisory programs such as the LISCC program, an ERM framework would integrate existing supervision and ethics internal controls and procedures into a system-wide risk management approach.

Board officials indicated that development of an ERM framework is a multiyear effort and that the Board plans to set up a preliminary program within the next 10 months and enhance the program going forward. Board officials told us that the new ERM framework will focus on strategic risk management for the Board as a whole. Officials explained that the rationale for the Board's decision to develop an ERM framework was twofold: first, the ERM framework would enable the Board to look across business lines and obtain a comprehensive understanding of and better define risks, and identify any gaps. Second, the Board wants to use information from this comprehensive understanding to assist with operational or budgetary decision making. According to officials with whom we spoke, the Board of Governors senior leadership supports the effort. As part of the ERM development process, according to the presentation materials we reviewed, Board of Governors officials interviewed senior officers and stakeholders, including senior officers at 12 of the Board's 15 divisions, to assess support and concerns about developing an ERM framework at the Board level. Officials also reviewed the ERM frameworks of other agencies, such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance

Corporation, and those of the Reserve Banks to learn about ERM practices.

Although the Board has taken some steps to develop an ERM framework, as of August 2017 it had not yet developed key ERM elements OMB has identified. For example, OMB guidance highlights the need for a planned risk management governance structure, a process for considering risk appetite and risk tolerance levels, a methodology for developing a risk profile, a general implementation timeline, and a plan for maturing the comprehensiveness and quality of the risk profiles over time. Risk appetite and risk tolerance statements would include identification of risks including reputational risks such as regulatory capture. For example, the Office of the Comptroller of the Currency's risk appetite statement includes regulatory capture as one of the types of reputational risks it attempts to mitigate through its ERM framework. The Board had not taken these steps as of August 2017, although officials told us that plans to further assess how ERM would fit with the Federal Reserve culture are proceeding. Until the Board includes these key elements to identify and assess risks of regulatory capture in its ERM framework, the Board will be unable to comprehensively mitigate regulatory capture risks across the system.

The Four LISCC Reserve Banks' ERM Frameworks Cannot Provide Visibility into Risks across the System

The four Reserve Banks that participate in the LISCC program maintain their own ERM frameworks but the frameworks were not intended and have limited ability to fully manage all relevant regulatory capture risks across the system. These Reserve Banks' ERM structures feature three lines of defense. The first line of defense is the individual business line, or functional area. For example, the supervision function at each Reserve Bank is considered part of the first line of defense. Additionally, each Reserve Bank has an independent quality management framework within the supervisory program to review and assess supervisory work.[32] The second line typically includes the risk management and legal and compliance functions—including ethics functions—because these functions look across the business lines at risk issues. The third line is the internal audit function, which serves an independent review, oversight, and evaluation function. The four Reserve Banks also each designate a senior official who acts as the Chief Risk Officer. Within this structure, the

[32]This was required by Advisory Letter 07-23, *Revised Guidelines for Reserve Bank Quality Management Frameworks*.

four Reserve Banks have processes to identify, prioritize, and assess risk, and they have risk-response functions in place, such as processes for reporting on risk events to senior management.

These four Reserve Banks' risk officials told us that they mitigate regulatory capture risks through policies in the supervision and ethics functional areas of their organizations, which we discuss in greater detail later in this report. These risk officials noted that ethics oversight is integrated into the Reserve Banks' risk management frameworks. For example, the chief risk officer regularly communicates with the bank's chief ethics officer, who is a member of the banks' risk management group.

However, these Reserve Banks' risk officials also said they face limitations, particularly in reporting on risks related to supervision. The Reserve Banks' risk management functions do not have access to confidential supervisory information, nor do they have the expertise and background to make judgments on supervisory activities, according to Reserve Banks' risk management officials. Moreover, the Reserve Banks' boards of directors do not oversee the Reserve Banks' supervisory activities because of Federal Reserve Act restrictions.[33] For this reason, these four Reserve Banks' ERMs are limited in their reporting on supervision-related risks to Reserve Bank boards.[34] FRBNY risk officials noted that they monitor operational risks related to supervision but do not report on supervision-related risks to their board of directors or externally. As a result, when these four Reserve Banks produce their annual consolidated risk reports, they do not address risks related to supervisory activities.[35]

[33]*See* 12 U.S.C. §§ 248, 301.

[34]The directors do not oversee the Reserve Banks' supervisory activities of their member banks, bank holding companies, or nonbank SIFIs. Reporting lines vary by Reserve Bank, but the Chief Risk Officer usually reports to a committee of the Bank's Board of Directors or to the Bank President. The risk officers produce reports for senior management on priority risks. In addition, the internal audit function also reports on risks.

[35]As part of the Federal Reserve's Operational Risk Management program, the Reserve Banks, product offices, and centralized service providers develop the Federal Reserve's annual operational risk profile, referred to as the Consolidated Assessment of Risk report. This report does not include an assessment of the soundness or effectiveness of supervision activities.

Because of these restrictions, the four Reserve Banks in the LISCC program are limited in their ability to use their ERM frameworks to manage regulatory capture risks. The LISCC program encompasses supervisory activities conducted by staff from four of the Reserve Banks and the Board, that supervise the largest financial institutions, as well as the OC at the Board level. The program exceeds the scope of any individual Reserve Bank's ERM framework. The Board has just recently started developing an ERM framework in 2017. As a result, the Board currently has a limited ability to manage regulatory capture risks across all areas of the LISCC program.

Board of Governors and Reserve Banks Have Policies to Mitigate Threats to Independence, but Some Related Internal Controls Have Weaknesses

The Federal Reserve has established policies that promote supervisory independence to help mitigate the risk of regulatory capture in the LISCC program. These policies include oversight of the program by the Board of Governors, horizontal examinations, and vetting of examination findings. In addition, the Federal Reserve's internal reviews of the LISCC program have included recommendations to the Reserve Banks to improve their implementation of LISCC policies, including those that promote supervisory independence. The Reserve Banks have taken steps to respond to these recommendations, but our interviews with Federal Reserve staff and review of Reserve Bank policies indicate that inconsistencies in the Reserve Banks' execution of some aspects of the LISCC program persist. Further, the Board's internal controls—in particular with respect to guidance and monitoring mechanisms—limit assurance that policies are implemented consistently and effectively across the LISCC program.

Key Features of the LISCC Program and Internal Reviews Help Mitigate Threats to Supervisory Independence

The Federal Reserve has established policies that promote supervisory independence to help mitigate the risk of regulatory capture in the LISCC program. Academic literature that we reviewed found that, among other things, effective bank supervision that is independent of inappropriate influence requires transparency and accountability and a supervisory climate that encourages discussion and dissent. In contrast, weak and insufficiently independent supervisory teams may be susceptible to regulatory capture and other threats to effective supervision. Board officials told us that they mitigate threats to supervisory independence by obtaining a range of inputs in supervisory decision making from multiple perspectives, creating strong and independent dedicated supervisory teams, conducting supervisory work on a horizontal as well as firm-specific basis, adhering to strict rules and practices concerning ethics and potential conflicts of interest, and promoting cultures of public service.

Officials said that while specific practices at a given Reserve Bank may vary, each adheres to the same principles and governing supervisory policies.[36]

Officials from the Board and the four LISCC Reserve Banks also said that specific features of the program are intended to mitigate threats to supervisory independence, including oversight by the Board, horizontal reviews, and extensive procedures for vetting Reserve Banks' ratings of supervised entities under the LISCC program.

- **Oversight by System-wide staff.** Oversight of Federal Reserve staffs' supervision of LISCC firms can mitigate threats to independence by increasing transparency and accountability. Officials we spoke with said that the dedicated supervisory and horizontal teams convey the results of their supervisory determinations to System-wide committees, such as the OC or Vetting Committee. For further vetting and discussion, Reserve Banks also present significant disagreements or close calls leading up to their supervisory findings and ratings to the OC and Vetting Committee.
- **Horizontal examinations.** Because horizontal examinations draw on staff with different expertise and experience from across the Federal Reserve, they bring a variety of perspectives to the supervision of LISCC firms. Officials said that by engaging and collaborating with peers outside of their dedicated supervisory teams, staff assigned to horizontal examinations can make optimal use of subject-matter experts and insight from multiple perspectives. They noted that these insights, coupled with increased scope of horizontal analyses of LISCC institutions, can promote independence by helping to ensure that supervisory work has consistent and accurate outcomes across the LISCC program. Furthermore, the Chair of the Federal Reserve remarked in 2015 that LISCC can help mitigate the risk of regulatory capture by ensuring that staff consider diverse views and perspectives.[37]

[36]Additionally, officials we spoke with from each Reserve Bank said that when examiners engage with bank officials frequently, a relationship may emerge that could result in examiners losing their supervisory objectivity or, inadvertently, their supervisory independence. These statements reflect concerns cited in academic studies where supervisors might lose their objectivity and independent perspective to the extent they adopt a world view shared with their regulated entities.

[37]Yellen, Janet, "Improving the Oversight of Large Financial Institutions" (speech, New York, New York, March 3, 2015), Federal Reserve Board of Governors. https://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm.

- **Vetting of examination findings.** Officials from the Federal Reserve also discussed the use of vetting as a way to mitigate threats to independence. Under the vetting process, examination findings are documented in workpapers and Reserve Bank staff are required to discuss differences and consider divergent views. These processes increase the transparency and accountability of examiners' findings and decisions by helping to facilitate better detection and deterrence of conclusions that may be affected by inappropriate influence.[38] Officials at the Board of Governors also told us that the LISCC program has focused on extensive vetting procedures to help ensure that a wide variety of stakeholders participate in analytical and decision-making discussions. Each Reserve Bank has guidelines for documentation and attendance requirements for vetting sessions.

Additionally, all Reserve Banks have a policy of rotating the managers of supervisory teams every 5 years to help ensure that the firms are reviewed by staff with "fresh eyes." Officials also said they are increasingly moving staff away from working on-site at their supervised institutions to, among other things, lessen the likelihood of cultural capture.

According to documents we reviewed, the Federal Reserve also conducts internal reviews of the Reserve Banks to monitor and evaluate the implementation and effectiveness of supervisory policies and procedures, including those that may aid in the mitigation of threats to supervisory independence within the LISCC program. Reviews may lessen the likelihood of regulatory capture by increasing accountability among Federal Reserve staff and management. These reviews are conducted both at regular intervals and on an ad hoc basis, and they originate either at the individual Reserve Banks, the Board of Governors, or the OIG. While internal reviews occur regularly, their subject-matter focus and timing for each Reserve Bank vary. This variation can lead to similar findings being addressed at Reserve Banks across different time frames. Examples of different types of internal review include the following:

[38]For example, officials we spoke with from each Reserve Bank said that when examiners engage with bank officials frequently, a relationship may emerge that could result in examiners losing their supervisory objectivity or, inadvertently, their supervisory independence. These statements reflect concerns cited in academic studies where supervisors might lose their objectivity and independent perspective to the extent they adopt a world view shared with their regulated entities. For more information on factors that can threaten supervisory independence, see appendix II.

- **Supervision and Regulation operations reviews**. According to the officials we spoke with, the Division of Supervision and Regulation's Performance Management and Assessment Section is responsible for the operations review program. Operations reviews are point-in-time assessments of whether each Reserve Bank is adequately supporting the performance of its Board-delegated responsibilities and is meeting requisite system guidance, standards, and objectives for its supervisory program on a triennial basis. The Board's operations review program has been performing reviews of the LISCC program's firm-specific supervisory work since 2013. The scope of the work has generally included the dedicated supervisory teams' proposed annual ratings and the body of work performed to support these ratings, such as firm-specific full scope and target examinations and continuous monitoring.[39]
- **Office of the Inspector General.** The OIG is an independent oversight authority. According to documentation we reviewed, its mission is to provide independent oversight by conducting audits, evaluations, and investigations.[40] In a report issued in November 2016, the OIG found that approaches by Reserve Bank management influence employees' willingness to share their views and that employees would likely benefit from a formal mechanism (as opposed to informal) to share views with system decision makers.[41] Furthermore, the report found that no forum existed to share best practices in encouraging employees to share their views. The review also found that FRBNY, due in part to its team design and proximity to such a large number of complex financial institutions, had unique challenges. Deficiencies and inconsistencies identified in the report may diminish the effectiveness of policies designed to mitigate threats to supervisory independence.
- **Board review of LISCC program.** The Board announced in 2014 that it would conduct its own review of the LISCC Reserve Banks' annual

[39]As will be discussed later in this report, the Division of Supervision and Regulation also performs reviews of the conflict-of-interest and examiner credentials program, as well as ad hoc horizontal review of post-employment rules.

[40]Among other things, the OIG uses a risk-based planning process and a hotline to determine which programs and operations to evaluate and makes recommendations intended to improve their efficiency and effectiveness.

[41]Office of the Inspector General of the Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau, "Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities." 2016-SR-B-014 (Washington, D.C.: Nov. 14, 2016).

assessment process to help ensure that LISCC decision makers were receiving appropriate information needed to make their assessments and to determine whether adequate channels were available for decision makers to become aware of examiners' divergent views on supervisory findings. This report was publicly released in 2015 though the Board also provided individual interim reports to each LISCC Reserve Bank.[42] The Board's LISCC review found that LISCC decision makers generally were receiving the information needed, but that some dedicated supervisory teams had insufficient support for findings and inconsistent practices. For these instances, reviewers could not determine if LISCC decision makers were receiving the information they needed. Furthermore, the report concluded that the inconsistencies were a result of inconsistent expectations from Reserve Bank management and ineffective Reserve Bank training. The report also found that while staff were satisfied with their ability to express divergent views, dedicated supervisory teams differed in how staff raised views and to whom they could raise them.

- **Office of Quality Management quality assurance reviews.** According to officials we spoke with and documentation we reviewed, each Reserve Bank is responsible for establishing a quality assurance program as part of the Board's quality management framework, to help ensure that Reserve Bank staff follow quality standards and processes and consistently apply them to supervisory activities. Each program conducts a series of reviews annually based on the areas presenting the highest risk to their supervision programs.

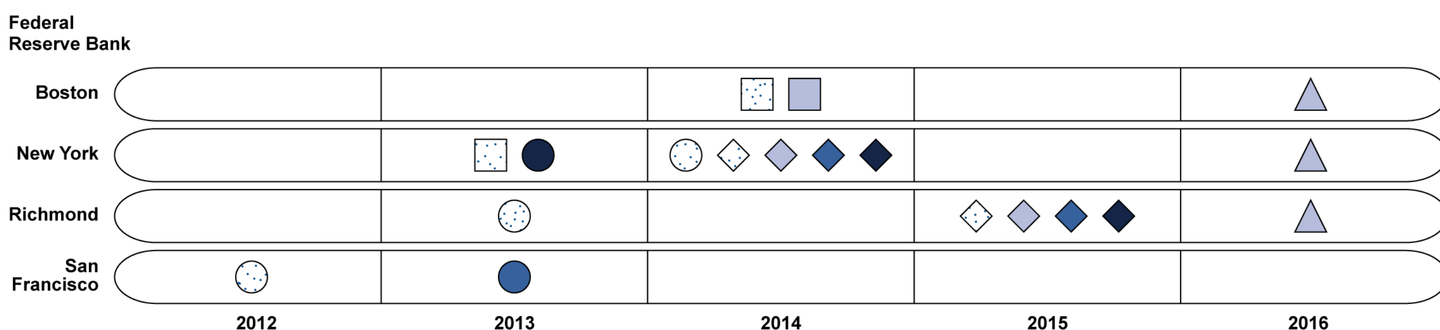
The Reserve Banks Have Taken Various Steps to Strengthen Implementation of LISCC Policies

The implementation of policies and procedures that may lessen the likelihood of regulatory capture by mitigating threats to independence for supervisory staff working on the LISCC programs varied across the four Reserve Banks and among the examination teams. Federal Reserve internal reviews found deficiencies in adherence to Board guidance, and staff we spoke with and policies we reviewed also reflected variations in the policies that Banks have in place to satisfy LISCC requirements. Internal reviews note that, as a result of inconsistent policies, the OC may be receiving inadequate information in order to make decisions regarding the rating of or recommendations to LISCC firms. In response to internal review recommendations, the four Reserve Banks have taken some steps

[42]Federal Reserve Board of Governors, "Board of Governors Review of Federal Reserve Banks' Large Institution Supervision Coordinating Committee Information Flows and Communication Channels." (Washington, D.C.: November 2015).

to strengthen their implementation of LISCC policies. We reviewed the four Reserve Banks' policies and procedures in the areas of (1) documentation of substantive discussion and divergent views during vetting discussions; (2) establishment of an effective supervisory culture; (3) onboarding[43] and training of staff; and (4) staff communication with the Board of Governors. Figure 4 summarizes findings related to LISCC policies and procedures that may mitigate threats to supervisory independence from internal reviews the Federal Reserve conducted from 2012 through 2016.[44]

Figure 4: Summary of Internal Review Findings Relevant to LISCC Policies That May Mitigate Threats to Independence, 2012–2016



Type of deficiency

- Documentation and vetting
- Establishing an effective supervisory culture
- Onboarding and training
- Communication between Reserve Banks and the Board of Governors

Source of finding

- Office of Quality Assurance Review finding
- Supervision and Regulation Operations Review finding
- Board Large Institution Supervision Coordinating Committee (LISCC) review finding
- Office of Inspector General Report (OIG) finding

Findings indicate a deficiency identified by an internal review that GAO determined related to policies that may mitigate threats to independence. According to documentation we reviewed, some findings were either addressed or in the process of being addressed. OIG recommendations were made directly to the Board of Governors, and some policy responses are being implemented across the Federal Reserve System unless otherwise indicated.

Source: GAO analysis of data from the Federal Reserve Banks of Boston, New York, Richmond and San Francisco. | GAO-18-118

[43]Onboarding is defined as the procedures used to acclimate new employees.

[44]Board officials told us that as a result of inconsistencies, the OC endorsed the development of a LISCC Program Manual. The Program Manual is expected to be final by January 2018.

Documenting Examination Findings and Vetting Discussions

Effective documentation of findings and discussions may aid in addressing regulatory capture and mitigating threats to independence by increasing transparency and accountability.[45] Federal Reserve internal reviews have found variations in the implementation of policies and procedures related to the documentation, review, and vetting of examination findings by the four LISCC Reserve Banks and dedicated supervisory teams and have made relevant recommendations.[46] Recently, internal reviews by the Board found evidence that examination teams generally considered dissenting or divergent views as part of the decision-making process, but the review also found insufficient documented support for supervisory issues at FRBNY and FRB Richmond. For FRBNY and FRB Richmond, reviewers could not identify the extent to which the Banks had documentation demonstrating that they considered and vetted divergent views, and they could not identify whether all appropriate information was being brought forward for consideration by LISCC decision makers to help ensure consistent and sound supervisory practices. In contrast, the Board LISCC review found sufficient evidence that staff at FRB Boston and FRB San Francisco both conducted vetting sessions and documented discussions and decisions resulting from these meetings, although previous internal reviews had identified areas for improvement.

The four Reserve Banks have modified their policies and procedures in response to internal review findings and recommendations. For example, our review of FRBNY policies and interviews with officials indicated that FRBNY now requires teams to use a vetting template to document changes and has created the position of Chief of Staff to help examiners adhere to documentation requirements. Similarly, we found that FRB Richmond now has an integrated supervision procedures manual that requires a scribe to attend vetting sessions to record any changes or divergent views that occur during the meeting. FRB Boston and FRB San Francisco also include vetting guidelines in their supervisory manuals. Our interviews with staff indicated that the findings and policy changes

[45] See appendix II for more information.

[46] Current Federal Reserve guidance states that management should participate in the vetting of issues from examinations and inspections and that there should be a mechanism for ensuring that management is aware of significant issues arising from examinations. Furthermore, guidance states that there should be a process for escalating issues to resolve disagreements. It also states that Reserve Banks must develop documentation, review, and approval requirements for the entire supervisory process, including scoping, workpapers, or other supervisory reports.

recommended by internal reviewers were being implemented by Reserve Banks that had received them. For example, some members of team management at FRBNY that we interviewed said that the new vetting template was helpful and more transparent in providing supporting evidence to the OC, and several said that practices of documenting examination findings and vetting discussions have improved. A few examiners at FRBNY we interviewed said that disagreements were documented during vetting sessions, and a few other examiners at FRB Richmond said they were familiar with the processes for raising dissent or divergent views.

Establishing an Effective Supervisory Culture

To help facilitate an effective supervisory culture that may aid in mitigating threats to independence and reduce the likelihood of regulatory capture, management should seek to foster an inclusive culture in which staff are able to raise divergent views and not feel threatened if they want to challenge management's views of an examination's findings and conclusions.[47] The Board LISCC Review found variation in the willingness of supervisory staff to raise divergent views and challenge management's views of examination findings and conclusions, as well as issues related to team culture and openness, although the severity of some of these issues and the processes in place varied across the four Reserve Banks and their dedicated supervisory teams. These variations can influence how effective vetting sessions are across teams, affecting whether or not system decision makers are receiving the information needed to help ensure consistent and sound supervisory decisions. The Board's LISCC review highlighted a lack of documented processes at FRB Richmond for staff to raise divergent views and recommended the use of a standardized template. The OIG report in particular focused on the cultural aspects of the supervision process, including supervision team dynamics and employees' comfort in sharing their views, citing issues at FRB Boston, FRBNY, and FRB Richmond.[48] Additionally, the OIG review found evidence that individual managers set the tone with their teams at FRBNY, creating variations in team culture across dedicated supervisory teams. The reports found that some managers were highly prescriptive, prohibited interaction with firms without their presence, and required little

[47]See appendix II for more information.

[48]Office of the Inspector General of the Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau, "Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities." 2016-SR-B-014 (Washington, D.C. November 14, 2016).

documentation, while other managers empowered their staff and encouraged open dialogue.

In response to internal review findings, the four Reserve Banks have changed some of their policies and procedures to better encourage examiners to express their views. For example, FRBNY has established weekly meetings for staff discussions across supervisory teams in addition to breakfast meetings and other forums for staff to share concerns and provide feedback to management. Similarly, the FRB Richmond Supervision Procedures Manual states that skip-level meetings—meetings between leaders and their indirect reports—reinforce the expectation and provide accountability for management to engage with team members and solicit views, as well as provide a forum for staff to escalate concerns and share viewpoints. In response to a 2014 Board operations review recommendation to increase participation in vetting sessions, FRB Boston updated its procedures and incorporated those changes into additional training. Furthermore, FRBNY, FRB Richmond, and FRB San Francisco have updated performance evaluation criteria for supervisory team managers to include the extent to which the managers encourage and integrate diverse perspectives from junior staff. Additionally, LISCC staff have been involved with the System-wide strategic initiative to develop a System-wide Divergent View Program, which launched in August of 2017.[49]

Our focus groups with the four Reserve Banks' staff found that while the Banks have taken steps in response to internal review findings, some issues persist, particularly at FRBNY and FRB Richmond. Several examiners as well as some managers at FRBNY noted in their respective focus groups that the SSO sets the tone for their team's culture to encourage examiners to express their views. Additionally, two staff noted during a focus group that the findings in the 2016 OIG Report, which also found variations in team culture, were accurate and continued to be issues within their teams.[50] We discuss weaknesses in internal controls to provide reasonable assurance that policies are implemented effectively across the LISCC program later in this report.

[49]The Board released AD/CA Admin Letter 17-7, "Implementation of Divergent Views Framework" on August 10, 2017.

[50]Office of the Inspector General of the Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau, "Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities."

Onboarding and Training

Effective onboarding—that is, the procedures used to acclimate new employees—and training can help alleviate factors that may inhibit the development of an independent supervisory mindset or may prevent staff from sharing their views with management, in addition to potentially reducing information asymmetries with supervised institutions, which would reduce the likelihood of regulatory capture.[51] Federal Reserve internal reviews indicated that the effectiveness of hiring strategies, training, and onboarding programs varied across the four Reserve Banks and their dedicated supervisory teams. The effectiveness of training programs for management, including developmental programs to encourage managers to solicit staff views, also varied in effectiveness, according to internal reviews. In particular, the Board's LISCC review recommended that FRBNY and FRB Richmond strengthen their onboarding procedures, and staff we spoke with were aware of or had participated in new initiatives outlined by the Banks in response. The Board's LISCC review also found that FRB Boston had an informal onboarding process but was already in the process of formalizing it and was increasing emphasis on training and mentoring for new hires to assist in the development of an appropriate supervisory perspective. Similarly, FRB San Francisco was found to have an informal but sufficient onboarding process that includes managers meeting with new staff and providing guidance. In addition, staff we interviewed at all four LISCC Reserve Banks emphasized the importance of on-the-job training, and some said such training is the most important element of becoming an effective examiner.

In response to internal review findings, the four LISCC Reserve Banks and the Board have made changes to their training policies. For example, the FRB Richmond Supervision Procedures Manual identifies requirements for individuals to develop customized training plans, incorporating both local and Federal Reserve-wide training opportunities. The manual also outlines requirements for managers to identify development objectives as part of the new-hire onboarding process. Furthermore, according to FRBNY documentation, new initiatives include mandatory courses for all hires, specific training for each business line portfolio, and a formal new-hire orientation that includes presentations by management focusing on the importance of speaking up and sharing views. Additionally, in response to OIG report findings, Board officials said that they would work with the Reserve Banks to make onboarding more

[51] See appendix II for more information.

consistent and to develop training programs to help ensure that managers develop core skills to manage and lead employees. Board officials also said that they are in the process of strengthening their examiner commissioning and training program by developing a curriculum specifically tailored to the supervision of large financial institutions, including those in the LISCC portfolio. This change can potentially help to mitigate threats to independence by reducing potential information asymmetries by ensuring that examiners are familiar with the practices of large firms as well as Federal Reserve supervisory policies.[52] Two examiners we spoke with in a focus group with FRB Boston and FRB San Francisco noted that there was a new large bank commissioning track available in the training program.

Communication between Reserve Banks and the Board of Governors

Communication between Reserve Bank examination teams and the Board and additional layers of review for examinations can aid in reducing the likelihood of regulatory capture and mitigating threats to supervisory independence by increasing transparency and accountability.[53] The Federal Reserve designed LISCC to help ensure that diverse views and perspectives are considered in making important decisions about the supervision of systemically important firms. According to Board staff we spoke with, the Vetting Committee vets the presentations made by the dedicated supervisory and horizontal teams and typically invites the entire OC to participate. The OC makes the decisions or in certain cases recommendations to the Board about issues discussed during these meetings, including language used in the communication of findings to the firm as well as ultimate institution ratings.[54] Internal reviews found variations in the four Reserve Banks' mechanisms for staff to communicate their views to Board officials. In addition, there was variation in the extent to which staff were aware of these communication

[52]Federal Reserve guidance states that management should use resources to conduct quality supervisory activities and implement a staff development program that promotes and maintains the professional proficiency of staff. The Federal Reserve is in the process of developing an examiner commissioning program for supervisors of large financial institutions. Three courses have been completed and are available to students and the remaining courses are under development and, based on current projections, will come on-line over the remainder of 2017 and through June of 2018.

[53]See appendix II for more information.

[54]According to Board Officials, the Vetting Committee receives presentation materials from the on-site teams about 2 weeks prior to the formal vetting sessions. The on-site team leader or other key staff present their recommendation for ratings. The OC provides a memorandum following a question-and-answer session that notes requested changes, recommendations, and any editorial comments for the ratings letter to be given to the firm.

mechanisms. The Board's LISCC review found that staff at FRB Boston and FRB Richmond were not aware of mechanisms to communicate with the OC. The 2016 OIG review concluded broadly that although Federal Reserve decision makers generally obtained the information they needed, none of the four LISCC Reserve Banks had a formal mechanism for examiners to report a divergent view. Furthermore, employees the OIG interviewed expressed concerns about whether channels would truly be independent of management or if any action would be taken in response to concerns they raised.

In response to the OIG's findings, the Federal Reserve has taken or planned a number of steps, including the development of an independent channel at each Reserve Bank and within the Board's Division of Supervision and Regulation and Division of Consumer and Community Affairs, which is outside of the normal chain of command for employees to voice supervisory concerns or disagreements. If employees believe there is evidence of wrongdoing, the OIG has a hotline and offers information on whistleblower protections, and some of the Reserve Banks, such as FRB Boston and FRBNY, have additional resources and training for staff to report suspected fraud, waste, or mismanagement of supervised institutions. In addition, we found that the OC now requires dedicated supervisory teams to include a slide in their annual assessment presentations that highlights areas of disagreement or divergent views for the LISCC Vetting Committee and OC to consider. Examiners we interviewed at FRBNY told us the teams documented divergent views for the annual assessment presentations, and two examiners told us the divergent-views slide was a helpful tool to communicate these views to the OC. Officials at the OC stated that dedicated supervisory teams may reach out to the OC after receiving written follow-up to vetting sessions before the OC finalizes the letter of findings to be delivered to the firm. However, officials told us that ultimately the OC has ownership of the messaging and rating and can accept or edit any proposed changes made by the dedicated supervisory team.

Several supervisory staff members we interviewed at the four LISCC Reserve Banks stated that they participated in OC-initiated horizontal examinations but that their actual collaboration with the OC varied. In particular, our interviews indicated that of the staff who participated in horizontal examinations, few had participated in the vetting of examination findings at the OC or Vetting Committee. According to Board officials, the Vetting Committee reviews and vets findings from horizontal examinations that occur outside the CCAR, CLAR, and SRP programs. The results of all horizontal examinations are incorporated into each firms'

annual assessment. For horizontal examinations, the officials said that dedicated team CPCs or SSOs are invited to these vetting sessions, although management would have generally been working with the examination teams throughout the process.

Weaknesses in Some Internal Controls Limit Assurance That LISCC Policies Are Implemented Effectively

In response to internal review recommendations, the four individual Reserve Banks have taken steps to implement LISCC policies to help reduce the likelihood of regulatory capture and mitigate threats to independence; however, we found that weaknesses in some internal controls—in particular with respect to guidance and monitoring mechanisms—limit assurance that these policies will be implemented consistently and effectively across the LISCC program. Internal reviews by the LISCC OC and the OIG, as well as our interviews with LISCC staff, show that implementation of LISCC policies has been inconsistent across the Reserve Banks. To some extent, this inconsistency may be related to the structure of the Federal Reserve; specifically, all 12 Reserve Banks operate semi-independently from one another, which allows for differences in the effectiveness of the Reserve Banks' implementation of supervisory policies and procedures. However, under the LISCC program, the four Reserve Banks have the same program objectives in their supervision of the largest financial institutions, and the Board's LISCC review notes the importance of ensuring that LISCC supervision has consistent and accurate outcomes across the program. Areas where we noted weaknesses include the following:

Program guidance. The Board of Governors does not have program-wide guidance that documents how the Reserve Banks are to implement LISCC policies. The Board has issued broad guidance that outlines the objectives of the LISCC program and describes the program's overall governance structure, but this guidance does not specify how Reserve Banks are to implement specific LISCC policies. For example, each of the four Reserve Banks has its own vetting guidelines. The Board has also issued guidance on supervising large financial institutions, but this guidance does not address specific LISCC features, such as the documentation requirements for the vetting process and horizontal examinations. For example, reviews indicate that FRBNY has had issues with insufficient documentation of vetting sessions, whereas FRB San Francisco's documentation practices have been more effective.

According to a public supervisory letter from the Board of Governors to the Reserve Banks in 2012, the Board is taking a multistage approach to implementing the supervisory framework that includes the LISCC

program, and the letter states that the Board plans to develop additional supervisory and operational guidance.[55] Board officials we spoke with stated that the OC is in the process of drafting a program manual that is to describe all elements of the LISCC program, including minimum operating and documentation standards for supervisory activities to help ensure consistency across dedicated supervisory teams. Additionally, Federal Reserve officials have begun the process of formalizing additional expectations for both procedural and substantive elements of LISCC and that these enhancements are to take effect in 2018. Officials also said they are strengthening their examiner commissioning and training program to develop a curriculum tailored to the supervision of large institutions and overseeing the development of new training material to improve consistency of implementation of policies. Officials told us that three courses in the Large Financial Institutions Examiner Commissioning Program have been completed and are available to staff as of July 2017: Principles of Large Financial Institutions Supervision; Capital; and Liquidity. Remaining courses are under development and, based on current projections, are to come online over the remainder of 2017 and through June 2018. These remaining courses are to address recovery; governance and controls; parent and nonbank entities; resolution; and a capstone course. However, until the Board issues a program manual with specific guidance on the implementation of LISCC policies, it will continue instead to rely on dedicated supervisory teams' execution of the program.

Federal internal control standards state that management should develop policies to guide how they implement their internal controls.[56] Key attributes of effective implementation of this principle include documenting responsibilities through policies and communicating policies and procedures to personnel. In part due to the structure of the Federal Reserve system, the four Reserve Banks each have their own guidelines. However, without program-wide guidance from the Board on implementing LISCC policies, the Board may not have reasonable assurance that the Reserve Banks are effectively implementing policies that can help to mitigate threats to independence. Effective implementation of policies on documentation and vetting, in particular,

[55]The Federal Reserve announced the implementation of the Consolidated Supervision Framework for Large Financial Institutions in a multistage approach in public supervisory letter SR 12-17/ CA 12-14 on December 17, 2012.

[56]GAO-14-704G.

can help mitigate threats to independence by helping to ensure that conclusions are transparent and are based on sound evidence.

Program monitoring. While internal reviews have been effective in identifying some issues regarding the implementation of the LISCC program, the Federal Reserve does not currently have a regular mechanism to review how LISCC staff are implementing LISCC policies and achieving objectives. Quality assurance and Board operations reviews focus on Reserve Banks' general supervision practices, but they do not systematically address issues related to the LISCC program in particular. The Board's LISCC review and the OIG review both examined the LISCC program across Reserve Banks, but the Board has not replicated these efforts. Federal internal control standards state that management should establish and operate ongoing activities to monitor the internal control system and evaluate the results.[57] Federal Reserve officials told us and the documentation we reviewed outlined the process the Federal Reserve is undertaking to develop a LISCC oversight framework that will encompass all Board and Reserve Bank LISCC activities, including LISCC governance processes and the conduct of supervisory programs such as CCAR, and provide for a comprehensive assessment of program effectiveness. The officials said that this framework should be completed by the end of 2017 and that implementation will begin in 2018. However, until the Board has in place a mechanism for monitoring the LISCC program and regularly assessing the Reserve Banks' implementation of LISCC, the Board of Governors may not have reasonable assurance that policies are being implemented appropriately and effectively.

[57]GAO-14-704G.

Implementation of Policies to Identify and Mitigate Conflicts of Interest Is Hampered By Lack of Data and Program Evaluations

The Board of Governors and the four Reserve Banks that participate in the LISCC program have ethics programs intended to help ensure that individual LISCC program employees in various roles carry out their work in a way that benefits the public interest, not their private gain.[58] These programs implement federal statutes and regulations and Federal Reserve policies that are designed to prevent employee conflicts of interest and the appearance of conflicts of interest and are not focused on preventing or mitigating regulatory capture, according to OGE and Board ethics officials.[59] However, Federal Reserve officials said that these programs are another way in which they address risks related to regulatory capture and threats to independence. We found that the Board and four Reserve Banks maintain policies and procedures through multiple monitoring programs to oversee instances of conflicts of interest for various LISCC employees but limitations exist in the collection of data, including systematically maintaining data on the future employers of departing employees. We also found that some ethics program evaluations have occurred since 2011, but the Board has not carried out a self-assessment of its ethics programs, including procedures across the Board and four Reserve Banks, that apply to LISCC program employees.

The Federal Reserve Implements Ethics Policies for LISCC Employees through Multiple Programs

The Federal Reserve implements ethics policies for LISCC employees through multiple procedures and programs that the Reserve Banks, the Board Division of Supervision and Regulation, and the Board Legal Division administer. The ethics programs include procedures to comply with federal statutory and regulatory requirements on preventing specified conflicts of interest.[60] Supervisory employees—including examination

[58]Many ethics and conflict-of-interest policies are not specific to LISCC staff and may apply to other Federal Reserve employees. For the purposes of this report, we focused on policies that apply to LISCC program participants, including those that are not LISCC-specific.

[59]While conflict-of-interest and ethics policies can mitigate some threats that can lead to regulatory capture, they have limits in addressing less tangible but significant threats, such as those that arise from shared cultural values between employees of the regulating agency and the regulated institution.

[60]This report focuses on concerns related to the criminal conflict-of-interest restrictions for current employees in 18 U.S.C. § 208, the post-employment restrictions in 18 U.S.C. § 207, and the existing procedures for promoting compliance with those restrictions. We also examined Federal Reserve controls related to hiring, staffing, decision making, and employee exit procedures for supervisory personnel and officers. Our work does not address other federal ethics laws, such as those related to bribery and those involving the representation of foreign entities.

staff—are subject to specific policies to identify and mitigate conflicts of interest and are penalized for violations. These programs are among the strategies the Board and the four Reserve Banks told us they use to mitigate the risks of regulatory capture by focusing on individual employee behavior. Studies note that behavioral aspects of regulatory capture—such as long-term career ambitions, identification with the banking sector or individuals at the bank, and other threats that are not directly observable to ethics officials or even to the individual employee—are difficult to mitigate at the individual level. In addition, OGE and Federal Reserve ethics officials noted that federal statutes and regulations on conflicts of interest—and federal ethics programs—are not explicitly intended to prevent regulatory capture. Nevertheless, policies and programs that monitor and restrict observable conflicts of interest are among the tools organizations can use to help mitigate the risks of regulatory capture among individual employees.[61]

LISCC Ethics Programs and Procedures

Three Federal Reserve components—the Reserve Banks, the Division of Supervision and Regulation, and the Board's Legal Division—each maintain separate conflict-of-interest monitoring programs to oversee conflicts of interest for different types of LISCC employees.

- **Reserve Banks.** All Reserve Bank supervisory employees who conduct examinations—including LISCC program examinations—are subject to common ethics policies and procedures that their specific Reserve Bank ethics offices administer and that the Board's Ethics Office and Division of Supervision and Regulation oversee.[62]
- **Division of Supervision and Regulation.** Within the Board of Governors, the Division of Supervision and Regulation oversees the Federal Reserve Banks' conflict-of-interest and examiner commissioning and credentialing programs. This oversight role includes evaluating the execution of the Reserve Banks' conflicts of interest and examiner credentialing program, as well as ensuring conflict-of-interest reviews for all Federal Reserve staff who participate in examinations and inspections are conducted, either by designated Reserve Bank or Board staff. These conflict reviews

[61]As noted previously in this report, some steps, such as training on the supervisory mindset or reminders of employees' responsibilities, can be taken to address these unobservable issues.

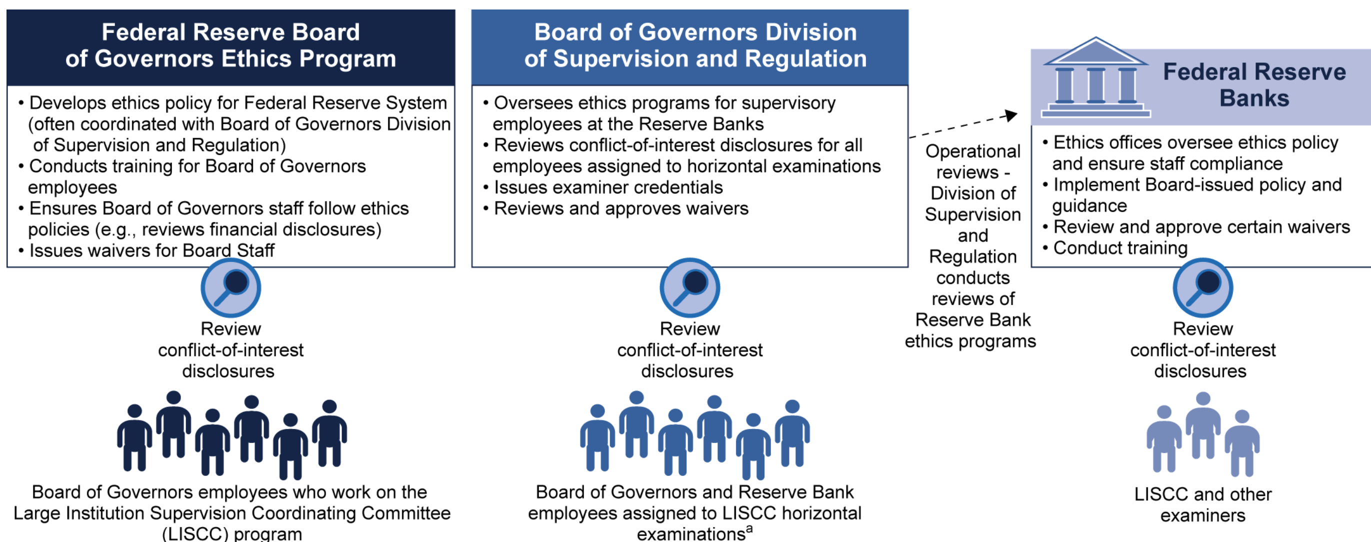
[62]The Board's Ethics Office plays a role with respect to administering certain requirements of the Board's Federal Reserve Administrative Manual.

include LISCC staff who participate in single-firm examinations and inspections, as well as horizontal examinations.

- **Legal Division.** The Board of Governors ethics office within the Legal Division implements the federal ethics program for all Board employees, including employees of the Board's Division of Supervision and Regulation. These Board employees include members of the OC and other staff who participate in the LISCC program.

Figure 5 illustrates the Federal Reserve's ethics programs as they apply to LISCC employees.

Figure 5: Federal Reserve Ethics Programs and Procedures That Apply to LISCC Employees



Source: GAO summary of information from the Board of Governors of the Federal Reserve System and the Federal Reserve Banks of Boston, New York, Richmond, and San Francisco. | GAO-18-118

[a]A horizontal examination is a comparison of selected aspects of risk management or business practices at several institutions, completed over a defined time frame, in order to provide the firms with critical assessments for management action.

Ethics Policies That Apply to LISCC Employees

Federal Reserve employees at all Reserve Banks and the Board of Governors are subject to ethics policies that implement federal conflict-of-interest laws and regulations, as well as other policies that the Board and Reserve Banks have developed to apply to employees with specific roles and responsibilities. For example, Federal Reserve employees with responsibilities for bank supervision—both staff who carry out examinations and those involved in nonexamination supervisory

matters—have some different conflict-of-interest requirements than other Federal Reserve staff.[63] These policies are among the strategies that officials at the Board and the four LISCC Reserve Banks told us they use to mitigate the risks of regulatory capture.

According to Board and Reserve Bank ethics officials, the Board develops policies on ethics and conflicts of interest for supervisory employees in coordination with the Division of Supervision and the Reserve Banks. The Board's Designated Agency Ethics Official, the chief ethics officers and other ethics staff of the Reserve Banks, and staff at the Division of Supervision and Regulation with ethics responsibilities hold quarterly teleconferences to discuss common issues. According to Federal Reserve officials, the Federal Reserve's Conflicts Community of Practice holds bimonthly calls to discuss conflict-of-interest matters. Policies are included in the principal ethics policy documents—the Federal Reserve Administrative Manual and common Reserve Bank codes of conduct—and the Board and Reserve Banks also issue supplemental guidance and policies as needed.

Key policies that apply to Federal Reserve supervisory employees include a general conflict-of-interest standard, investment and borrowing prohibitions, and restrictions on gifts, among others (see app. III for more details).

General conflict-of-interest standard. Federal Reserve employees are subject to the key federal criminal conflict-of-interest statute that prohibits a federal or Board or Reserve Bank employee, among others, from participating personally and substantially in an official capacity in a particular matter in which, to the employee's knowledge, the employee or the employee's spouse, general partner, or minor child, among others, has a financial interest, if the particular matter will have a direct and predictable effect on that interest.[64] Federal employees are also prohibited from participating in matters that would directly affect an organization with which the employee is negotiating for or has any arrangement concerning prospective employment.[65] Participation in a

[63]Some other types of Federal Reserve employees, such as staff with Federal Open Market Committee information access, and employees in FRBNY's Markets Group, are subject to separate requirements as well.

[64]*See* 18 U.S.C. § 208(a); 5 C.F.R. § 2635.402(a).

[65]*See* 18 U.S.C. § 208(a); 5 C.F.R. § 2635.402(b)(2)(v).

particular matter includes matters that involve deliberation, decision, or action that is focused upon the interests of specific persons, or a discrete and identifiable class of persons.[66] Personal and substantial participation may occur when, for example, an employee participates through decision, approval, disapproval, recommendation, investigation or the rendering of advice in a particular matter.[67]

Investment prohibitions. Federal Reserve supplemental regulations and the Reserve Banks' common code of conduct specify financial investment prohibitions for Board and Reserve Bank employees, while some supervisory employees have additional prohibitions, including a prohibition on seeking credit from institutions involved in the supervisory employee's work assignments.[68] Generally, all Federal Reserve employees are subject to prohibitions on investing in depository institutions.[69] The prohibitions also apply to an employee's spouse or minor child. For example, employees and their immediate family members generally are prohibited from holding stocks in banking institutions or investing in financial instruments such as mutual funds that have a policy of concentrating their investment in the financial services industry.[70] Upon hiring, under Federal Reserve policy, new employees must divest these holdings within 90 days.[71] In some cases, as will be discussed later in this report, employees may be permitted to retain otherwise prohibited financial interests. In such cases, they are recused (disqualified) from working on matters relating to the institution with which they have a conflicting interest.

Borrowing prohibitions and restrictions. Federal statute prohibits financial institution regulatory agency examiners from accepting loans or

[66]5 C.F.R. § 2635.402(b)(3).

[67]5 C.F.R. § 2635.402(b)(4).

[68]*See* 5 C.F.R. § 6801.106(a).

[69]*See* 5 C.F.R. § 6801.103(a)(1); Reserve Banks' common code of conduct § 5.3.

[70]*See* 5 C.F.R. § 6801.103.

[71]Federal Reserve Administrative Manual (FRAM) § 5-035 (internal policy applicable to all supervision & regulation employees incorporating 90-day divestiture policy for examiners in FRAM § 5-041); Federal Reserve Board AD letter 14-11 / CA Admin letter 14-7 (Apr. 11, 2014, internal guidance restating 90-day divestiture policy).

gratuities from a financial institution the agency oversees.[72] Under this statute, and related Federal Reserve policies, examiners (including assistant examiners) are prohibited from directly or indirectly borrowing from an institution for which the Federal Reserve is the primary supervisor (other than through certain credit cards or loans secured by their primary residence).[73] Nonexaminers may be subject to less restrictive recusal requirements and may, depending on the type of borrowing, be allowed to work on matters concerning institutions with which they have a preexisting loan. As a result, full-time examiners have more stringent borrowing restrictions than members of the LISCC OC.

Restrictions on accepting gifts. Federal Reserve Board and Reserve Bank employees who participate in the LISCC program are subject to federal laws and regulations and the Reserve Banks' common code of conduct that prohibit federal employees from accepting gifts offered because of their official positions or from "prohibited sources," a term which includes regulated entities. Federal ethics regulations applicable to Board of Governors employees and the common Reserve Bank code of conduct provide some exceptions under which nonexaminer employees may accept gifts from those firms. Such exceptions include, for example, gifts worth $20 or less and gifts given on the basis of a personal relationship. However, according to the Federal Reserve Administrative

---

[72]*See* 18 U.S.C. § 213(a). In addition, financial institutions may not make any loans or grant any gratuities to examiners who examine or have the authority to examine the institution or its branches, among other things. *See* 18 U.S.C. § 212(a).

[73]Federal criminal law prohibits an examiner from accepting a loan or gratuity from a financial institution the examiner examines (*see* 18 U.S.C. § 213(a)); Federal Reserve policy broadened that restriction to include all financial institutions for which it is the primary supervisor. The Federal Reserve is the primary supervisor for state member banks; bank holding companies; nonbank subsidiaries of bank holding companies that are not thrifts or functionally regulated subsidiaries; nonbank financial companies designated by the Financial Stability Oversight Council for enhanced supervision; Edge Act and agreement corporations; and U.S. branches and agencies, representative offices, and nonbank subsidiaries of foreign banks that are not functionally regulated subsidiaries. The Federal Reserve is not the primary supervisor for national banks, nonmember banks, limited special-purpose banks or nonbank banks authorized under section 4 of the Bank Holding Company Act (provided they are not state member banks), thrift institutions, and functionally regulated subsidiaries of bank holding companies. While the Federal Reserve may have umbrella supervisory authority over such organizations (i.e., when they are owned by bank holding companies), those institutions' primary supervisors are other federal or state regulatory agencies. Federal Reserve examiners may borrow from financial institutions for which the Federal Reserve is not the primary supervisor but are recused from examining the institution and, depending on the type of borrowing, may also be recused from examining all affiliates of the lender.

Manual and the Reserve Bank code of conduct, a Federal Reserve bank examiner may not accept a $15 sweatshirt from a bank that he or she examines, even where the common Reserve Bank code of conduct would permit other bank personnel to accept such a gift.[74]

Exemptions

Federal laws and regulations and Federal Reserve policies include exemptions to some of the prohibitions and restrictions previously noted and federal law permits agencies to waive some conflicts. For example, the key criminal conflict-of-interest statute allows for waivers for individual employees if the employee's conflict is not so substantial as to be deemed likely to affect the integrity of the services which the government may expect from such officer or employee.[75] OGE regulations also exempt certain investments from restrictions, including investments held through a diversified mutual fund or unit investment trust, an interest in any Federal Reserve retirement or thrift plan, federal government securities with maturities of 1 year or less, and U.S. Savings bonds.[76]

In addition, the Federal Reserve allows some exceptions to investment, borrowing, or gift restrictions. For example, Federal Reserve employees are not subject to any restrictions for holding credit cards or mortgages on their primary residence, although under Federal Reserve policy, examiners may not examine the legal entity that owns their primary residence's mortgage. In addition, an employee's immediate family member may be allowed to retain an otherwise prohibited financial interest, such as stock in a depository institution, if the interest was acquired before marriage or before the employee began work at the Federal Reserve and if the employee can be recused from working on matters related to the firm. Ethics officers and supervisors generally must review and approve such exceptions.

The Federal Reserve requires examiners whose conflicts qualify for an exemption from conflict-of-interest policies to be recused from working on the institution with which they have a conflict. Examiners generally face more restrictive recusal requirements than supervisory employees who do

[74]Employees may accept small items of minimal value, such as pens.

[75]*See* 18 U.S.C. § 208(b)(1).

[76]*See* 5 C.F.R. pt. 2640, subpt. B. The Director of the Office of Government Ethics may, by regulation, exempt from the general prohibition financial interests that are too remote or too inconsequential to affect the integrity of the services of the employees to which the prohibition applies. 18 U.S.C. § 208(b)(2).

not work on examinations and other Federal Reserve employees who do not participate in supervisory matters. Federal Reserve employees who are not examiners may be permitted to work on matters related to institutions with which they have an interest when the interest is de minimis, if a regulatory exemption or exception within the Reserve Banks' common code of conduct applies, or if a waiver has been granted. Generally, however, examiners and nonexaminers are recused where they have conflicting interests. See appendix III for more details about Federal Reserve conflict-of-interest investment and borrowing prohibitions for examiners and other employees and related recusal requirements.

Penalties

Federal Reserve employees who violate any of these statutes, regulations, and policies are subject to penalties under federal law or regulation, or Federal Reserve policy, depending on the violation. These penalties include prison, fines, termination, and administrative sanctions. For example, a senior examiner who violates the 1-year restriction on working for a firm he or she supervised is subject to removal from the prohibited position, as well as an industry-wide employment prohibition for up to 5 years, a civil penalty of up to $250,000, or both.[77]

The Board of Governors and Reserve Banks monitor and address violations of federal statutes, regulations, Federal Reserve ethics policies, and the Reserve Banks' common code of conduct. OGE officials told us that it is important to track and address violations, not only to help ensure that staff comply with statutory and agency requirements, but also because identifying violations is a key indicator that an ethics program is effective in uncovering problems. From 2011 through 2015, FRBNY recorded 42 violations among LISCC personnel, while two other Reserve Banks recorded no violations, and one recorded a violation of a non-LISCC program examiner. According to FRBNY ethics officials, the higher number of violations reported are due in part to the Reserve Bank's automated Personal Trading Compliance Program, which enables the ethics office to monitor employees' brokerage accounts directly.[78] In addition, officials said, the Reserve Bank's training and education on

[77]*See* 12 U.S.C. § 1820(k).

[78]FRBNY's automated Personal Trading Compliance Program requires employees to disclose their brokerage accounts and to pre-clear transactions in those accounts. According to FRBNY, pre-clearance gives employees assurance that their trades conform to the bank's investment rules and reminds them not to trade on nonpublic information. The Personal Trading Compliance Program is similar to trading compliance systems found at investment banks, broker dealers, and institutions supervised by the Federal Reserve.

ethical values encourages employees to self-report violations. Another reason FRBNY may have recorded more violations among LISCC program employees than other Reserve Banks is that the Reserve Bank employs the majority of the examiners who work on the LISCC program. The Board of Governors also reported no violations of Division of Supervision and Regulation staff from 2011 through 2016.

Of the 42 violations by LISCC staff at FRBNY from 2011 through 2015, the Reserve Bank's Personal Trading Compliance Program identified 34 violations. The remaining 8 violations were identified principally through employee self-disclosure to the Ethics Office, including the Ethics Office's review of employee financial disclosures. In all cases, employees were required to divest their prohibited holdings. Most of the violations were one-time violations, but 6 employees had more than one violation. Of these 6 employees, 1 was terminated, 1 received an official warning, 2 were told to make sure their financial advisors were aware of the Federal Reserve's rules, 1 was told to switch financial advisors because of the advisor's repeated violations of Federal Reserve rules, and 1 left the bank voluntarily.

Employee Waivers from Certain Prohibitions

Federal statutes and regulations and Federal Reserve policies permit supervisory employees to receive temporary waivers from certain prohibitions under extenuating circumstances.[79] The Board of Governors Designated Agency Ethics Official, in consultation with the relevant division head, may issue waivers for Board employees for certain prohibitions, including financial-interest or borrowing prohibitions.[80] Federal Reserve officials clarified that these waivers only allow an individual to maintain an impermissible holding or investment; they do not waive restrictions. Examples of conflicts that may be eligible for waivers include situations in which an employee holds restricted stock or stock options as part of his or her compensation from a prior financial industry

[79] *See, e.g.,* 18 U.S.C. § 208(b). The restrictions regarding personal financial interest do not apply if the employee advises the appointing government official about the particular matter, makes a full disclosure of the financial interest, and receives in advance a written determination by such official that the interest is not so substantial as to be deemed likely to affect the integrity of the services which the government may expect from the employee.

[80] *See* 5 C.F.R. § 6801.103(c) and § 6801.106(d).

employer that cannot be divested until a future date without forfeiting the investment.[81]

Any waiver granted to an examiner must be in writing, consider whether the conflict would interfere with the examiner's duties, and take into account the potential appearance of a conflict of interest. In the case of a financial interest waiver because of a restricted stock holding, the employee must be recused from working on matters related to the financial institution in which he or she holds the restricted stock, including horizontal matters related to the institution. Reserve Banks also may issue waivers from recusal requirements—for example, in cases in which an employee's immediate family member works at a supervised firm. In addition, examiners and other division staff with waivers may not be eligible to participate on horizontal examinations, depending on the circumstances of the waiver.[82]

The Federal Reserve amended its waiver policy in 2014 to eliminate permanent financial interest waivers for supervisory employees to better meet the Federal Reserve's goal of preventing both actual and apparent conflicts of interest, and in turn help mitigate risks of regulatory capture. Prior to that policy change, Federal Reserve supervisory staff could, for example, receive a waiver allowing them to hold prohibited investments in a financial firm indefinitely as long as they were recused from working on matters affecting that firm. Since 2014, Federal Reserve staff have been required to divest these prohibited holdings within a fixed time period.[83]

We received 62 waivers granted from 2011 through December 2015 (the most recent available at the time of our review) for LISCC employees of

---

[81]Examples include restricted stock and investments that have not vested, have no market value, are under litigation, are held jointly with other family members, or are in trusts for dependent children or other beneficiaries. Restricted stock are securities sold by an issuer to an individual that are subject to a holding period before the individual can sell the securities to the public.

[82]When Federal Reserve employees from outside of the Division of Supervision and Regulation are assigned to participate in supervision and regulation matters, they also become subject to these same waiver and recusal requirements that apply to examiners or supervisory personnel.

[83]Staff who held permanent financial waivers at the time of the policy change were required to divest their holdings within 2 years and provide proof of divestment.

the four Reserve Banks.[84] Of the 62 waivers, 56 waivers focused on federal financial conflict-of-interest prohibitions, 5 waivers focused on a relative's employment with a supervised firm, and 1 related to prior employment.

Of the 62 waivers we reviewed, 10 were granted in 2014 and 2015, after the elimination of permanent waivers related to financial interests. We found that 6 of the 10 waivers were temporary waivers related to restricted stock. In these cases, the employee was recused from working on matters related to the firm with which the employee had the conflict. In 2 cases, a waiver was granted for the employee's child's investments; in 1 case, an employee received a waiver for a pre-existing pension; and in another case, a conditional waiver was granted permitting an employee to work on matters affecting an institution that employed the employee's spouse. Generally, the waivers reflected OGE regulations and Federal Reserve policy. Specifically, the waivers stated that they were based on OGE guidelines; were reviewed by the Reserve Bank's ethics office and senior management at the Reserve Bank or the Board of Governors; and were made in consultation with the employee's supervisor.

In addition to the 62 waivers issued for Reserve Bank employees, we also requested waivers issued by the Board of Governors for the 13 OC members who are Board employees (the remaining OC members are Reserve Bank employees). According to the Board, no waivers were issued during the period of our review, 2011–2016.[85]

[84]For example, OGE regulations state that waivers may take into account the nature and importance of the employee's role in a matter, including the extent to which the employee is called upon to exercise discretion in the matter; the matter's sensitivity; difficulty of reassigning the matter to another employee; and possible adjustments that may be made in the employee's duties that would reduce or eliminate the likelihood that the integrity of the employee's services would be questioned by a reasonable person. *See* 5 C.F.R. § 2635.502(d). A few waivers granted at FRBNY documented voluntary divestitures and waivers of conflicts previously granted. However, no waivers of this type had been issued since the 2014 policy change.

[85]The Board reported 1 waiver that was dated from 2008—prior to the start of the LISCC program—for conflicts that the Board documented were resolved by 2012.

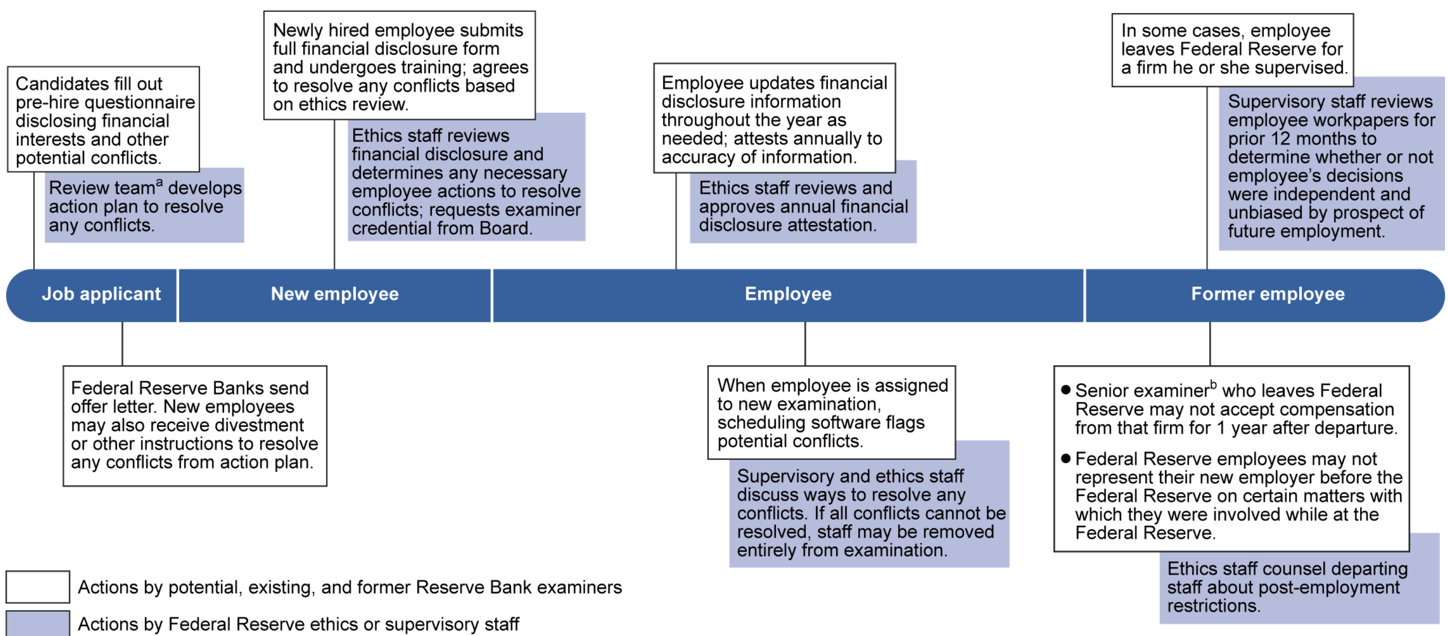
LISCC Employee Conflict-of-Interest Review Information Is Collected in a Manner That Does Not Facilitate the Review Process

Our review of the processes used to review conflicts of interest for LISCC program participants found that the Reserve Banks, Division of Supervision and Regulation, and Board of Governors generally collect the information necessary to complete these reviews. However, we also found that they collect and store this information inconsistently because of the different requirements for different types of LISCC program participants. These differences may hinder the efficiency and effectiveness with which the Board uses the data to oversee its conflict-of-interest review processes as they apply to LISCC employees.

Conflict-of-Interest Reviews for Full-time Examination Staff at Reserve Banks

All Reserve Banks are responsible for implementing ethics policies and procedures for their supervisory employees, including those who participate in the LISCC program. As of July 2016, the LISCC program included approximately 469 full-time examiners at the four LISCC Reserve Banks. Generally, Reserve Bank ethics officials follow a common process for monitoring conflicts of interest throughout a supervisory employee's tenure (see fig. 6).

Figure 6: Conflict-of-Interest Disclosure and Review Process for Reserve Bank Examiners



Source: GAO summary of information from the Board of Governors of the Federal Reserve System and the Federal Reserve Banks of Boston, New York, Richmond, and San Francisco. | GAO-18-118

[a]The Review team is a group of Division of Supervision and Regulation and Reserve Bank ethics staff who review pre-hire questionnaires.

[b]Senior examiners include those who served as central point of contact or lead on a single supervisory team.

Candidates for hire fill out a pre-hire questionnaire that includes questions about financial and other potential conflicts of interest. A team of reviewers, made up of division staff and rotating ethics staff from the Reserve Banks, reviews these questionnaires and develops an action plan that it returns to relevant Reserve Bank staff. This plan details any actions the candidate would need to take to resolve conflicts upon hiring. Once hired, the candidate must fill out a full disclosure form, which the relevant Reserve Bank ethics staff review, generally within the first week of the candidate's hiring.

A Federal Reserve electronic data system—known as the Conflict-of-Interest (COFI) application—stores financial disclosure and other information about potential or actual conflicts, such as employment of a spouse at a supervised firm, for examiners at all Reserve Banks, including the four LISCC Banks.[86] This COFI application is linked with the Division of Supervision and Regulation's electronic scheduling software system, which manages staff assignments to examinations.[87] When an employee is assigned to an examination that involves a firm with which the employee has a conflict, the conflict is flagged and the schedulers are alerted.[88] This alert system prompts discussion regarding the conflict with the employee, the employee's manager, and ethics staff, as appropriate, and may result in the employee being removed from the examination, according to division officials.

Before performing any examination or inspection work, newly hired Federal Reserve employees must obtain a credential from the Board of Governors. This credential serves in part as an internal control to help ensure that examination staff are free of conflicts of interest. Both the

[86]The COFI application enables employees to update their financial disclosure and other potential conflict-of-interest information throughout the year as needed and enables ethics officials and conflicts staff to review this information.

[87]A designated Federal Reserve staff member is responsible for entering examination assignments into this software application, which is used to schedule examinations.

[88]As part of its role overseeing the Federal Reserve's general supervision program across the 12 Reserve Banks, the Board's Division of Supervision and Regulation has implemented common systems to help Reserve Banks collect information for, and monitor, conflicts for all supervisory staff.

Reserve Banks and the Board review employee disclosures and then, if appropriate, the Board issues an examiner credential.[89]

During an employee's tenure, the employee is responsible for notifying ethics officials of potential conflicts and for updating the COFI application throughout the year with any changes. The employee must attest annually to the accuracy of the disclosure information in the COFI application. Ethics office staff at each Reserve Bank must review these attestations and follow up with employees to resolve any issues. When an employee is assigned to a new firm for examination, the Federal Reserve's scheduling software alerts schedulers about any conflicts related to the firm.

We reviewed COFI application data for examiners who participated in the LISCC program from 2011 through July 2016 to assess the extent to which the application and data reflected the Federal Reserve's policies. We found that the application maintains information in a format that allows ethics officials to monitor and address conflicts across Reserve Banks for full-time examination staff. The application also allows officials to aggregate and analyze data to assess ethics program effectiveness. These features demonstrate the internal control component of monitoring, which highlights the importance of embedding tools for the ongoing monitoring of controls and notes that automated tools can improve efficiency.[90]

We analyzed conflict data for 469 LISCC program employees in the four Reserve Banks by type of conflict from 2011 through July 2016 (see app. IV for more information). On average, employees had approximately two active conflict types from 2011 through July 2016. The most common types of conflicting interest were mortgages or insurance plans; conflicts

[89]While the existence of a conflict would not bar an employee from receiving a standard credential, the employee would be recused from participating in any matter related to the institution with which they had a conflict. In cases in which a newly hired examiner must divest certain financial holdings, the examiner has 90 days to do so. During that period, the Board grants the examiner a credential with an expiration date to help ensure the examiner resolves the conflict. In some cases, a newly hired examiner may hold restricted stock that cannot be divested until a specific date in the future. In these cases, the examiner receives a credential with a stated expiration date, which is only renewed after the date the stock is divested. The examiner is also provided with a waiver that permits the examiner to retain the stock temporarily, provided that the examiner is recused from working on the firm with which he or she has a conflict.

[90]GAO-14-704G.

related to an employee or family member's financial interests; and auto or student loans, business loans, or mortgages or lines of credit secured by nonprimary residences. To address such conflicts of interest, generally employees must divest such interests or be recused from matters affecting the firm in which they have the interests, depending on the policy requirements and ethics officials' review.[91]

Conflict-of-Interest Reviews for Staff Assigned to Horizontal Examinations

Horizontal examinations entail reviews of common functions across LISCC firms, and Federal Reserve employees assigned to horizontal examinations are generally assigned temporarily—as these examinations generally take less than a year—and have other responsibilities when not working on these examinations. Staff who participate in these examinations include Reserve Bank credentialed, full-time examiners; Board Division of Supervision and Regulation staff; and nonsupervisory Board employees from other divisions, such as Financial Stability and Legal.[92] The division does not maintain a comprehensive roster of Board employees who are LISCC participants but provided us with aggregated data for Board staff who worked on the LISCC program. According to the data, out of 480 division employees, approximately 80 staff and managers worked full-time on the LISCC program in 2016, and 191 division staff worked part-time on horizontal examinations.[93] In addition, approximately 196 Board employees worked on LISCC matters.[94]

Nonsupervisory employees assigned to a horizontal examination must fill out a conflict-of-interest disclosure form different from the one completed

[91]As noted previously in this report, approximately 62 employees received waivers between 2011 and 2015 (most due to conflicting financial interests) although the Reserve Banks granted only 10 waivers in 2014–2015, after the Federal Reserve amended its waiver policy to eliminate permanent waivers for conflicts of financial interests.

[92]Supervisory employees at Reserve Banks who are full-time examiners on a dedicated supervisory team may be assigned to a horizontal examination. If so, they undergo a second conflict-of-interest review by Division of Supervision and Regulation staff before they are approved to work on the horizontal examination.

[93]We did not analyze data for nonsupervisory staff assigned to horizontal examinations because the scope of our review included full-time supervisory staff and officials in the LISCC program. In addition, LISCC program representatives said they did not maintain a roster of employees who worked on all horizontal examinations during the period of our review, 2011 through 2016, although they provided us with aggregated data on the number of staff, responsibilities, and estimates of proportion of staff time devoted to horizontal examinations.

[94]Board of Governors employees totaled 2,789 in 2016.

by full-time examination staff, which division staff review.[95] Some of these employees may not need credentials, but others may require temporary credentials to carry out horizontal examination work. Those who require credentials generally must meet the same conflict-of-interest standards as full-time examiners. Division staff told us that one 2016 horizontal examination—the CCAR examination—included approximately 120 nonsupervisory Board staff without credentials out of a total of 900 staff assigned to that examination. According to division staff, the conflict-of-interest disclosure form differs from the form full-time examiners fill out in the COFI application in that it focuses only on ensuring that nonsupervisory employees assigned to the horizontal examination are free of conflicts with the specific firms they will be examining.[96] In contrast, the full-time examiner disclosure must include information about all financial firms with which examiners may have conflicts. Division staff members told us that the division stores these horizontal examination staff conflict-of-interest forms in a separate part of COFI because these employees are only assigned to horizontal examinations temporarily and are not subject to the annual attestation process that the COFI application is designed to facilitate.

Board of Governors Ethics Program

The Board's ethics program is led by an Assistant General Counsel in the Legal Division and is subject to OGE requirements and program guidance. As required by OGE regulations, the Board of Governors maintains a process for reviewing the conflicts of newly hired Board employees, training employees on ethics policies, and reviewing annual financial disclosures. The Board's ethics program administers the OGE-required annual financial disclosure process and collects more than 1,200 financial disclosure forms from Board of Governors employees, including Division of Supervision and Regulation employees. These division employees include members of the LISCC OC who file annual public financial disclosures and others who are required to file confidential financial disclosures. OGE requires senior federal executive branch employees who are required to file public financial disclosures to use

[95]For example, examiners and employees working on other supervisory matters may not seek credit from any of the particular institutions they are examining or otherwise supervising during the examination or matter and for 3 months following its conclusion. This policy includes any Federal Reserve employee assigned to a horizontal examination.

[96]According to division staff, the Division of Supervision and Regulation also has controls in place to prevent CCAR examination staff members from gaining access to horizontal examination workpapers and data until after the conflict-of-interest review has been completed and all conflicts have been resolved.

OGE's Integrity online filing system, and the Board of Governors ethics program uses Integrity in this way.[97] OGE officials told us they also recommend that ethics programs with more than five employees required to file public disclosures have their own electronic systems to track financial disclosures, and the Board ethics program has such an electronic system. The tracking system does not store the disclosure information, however; information on these employees is stored separately from that of supervisory employees, in hard copy.

In addition to reviewing data from the COFI application for full-time examiners, we analyzed data on the annual financial disclosures filed by the 13 LISCC OC members employed at the Board of Governors from 2013 through 2016.[98] We found that one OC member had a mortgage on a rental property from a LISCC bank, but according to Board officials, because the OC member is not a full-time examiner, he is not subject to the federal statutory restrictions on borrowing by examiners. Rather, according to Board officials, he was subject to Federal Reserve policy requiring recusal from supervisory matters other than examinations and inspections related to the LISCC bank. This policy permits him to retain the loan.

The Board of Governors ethics program stores financial disclosure information for LISCC program participants in the same hard-copy format as that of other Board employees, which is consistent with OGE requirements but is not compatible with the electronic COFI application used for examiners. Specifically, the conflicts information of Board of Governors employees required to file public financial disclosure forms is submitted using Integrity, because of statutory requirements. These disclosure forms are stored in hard-copy format, which OGE permits, although OGE encourages use of electronic filing formats.

Federal internal control standards state that management should use quality information to achieve the entity's objectives. As noted, full-time examination staff conflict information is stored electronically in the COFI application and is linked with the division's scheduling software, which

[97]Confidential financial disclosure forms are submitted using OGE Form 450. With OGE approval, agencies are permitted to store confidential financial disclosure information in their own electronic systems.

[98]The remaining OC members were based at Reserve Banks, so their information was included in the conflict-of-interest data discussed previously if they worked at FRB Boston, FRBNY, FRB Richmond, or FRB San Francisco.

automatically alerts staff responsible for scheduling of conflicts when an employee is assigned to an examination. In contrast, the division relies primarily on manual checks for Board nonsupervisory staff, whose conflict-of-interest disclosure information is stored separately. These manual steps reduce operational efficiencies and may expose the LISCC program to the potential that conflicts will be missed. Further, in part because LISCC program participants are based in different divisions at the Board and at different Reserve Banks, the division does not maintain a comprehensive roster of Board staff who participate in the LISCC program, which may make it difficult for the division staff who review conflict-of-interest disclosures to have a full understanding of LISCC program participants' responsibilities. Such an understanding is necessary to assess, for example, whether participating in a particular matter may constitute a conflict of interest.

A significant number of Board staff work on LISCC program activities. Without consistent systems for collecting and storing conflict-of-interest data, the efficiency and effectiveness with which the Board uses these data to ensure that Board employees are free of conflicts of interest in the LISCC program may be limited.

Federal Reserve Policies and Data Collection Procedures May Not Fully Mitigate Risk Associated with the Revolving Door

The Federal Reserve has policies in place that are intended to mitigate what is commonly known as the revolving door—the risk that an employee may place the interests of supervised financial institutions ahead of the public mission of the Federal Reserve, due to the employee's prior employment or prospect of future employment by a financial firm—but the policies do not address regulatory capture risks to the fullest extent possible, and the Reserve Banks and the Board have not systematically collected post-employment data. Specifically, although the four Reserve Banks and Board of Governors ethics staff generally have recorded an employee's previous employer or employers when hired, two of the four Reserve Banks and the Board have not systematically recorded departing employees' future employer, if any, when they leave the Federal Reserve. Such information is not legally required, but two LISCC Reserve Banks and other federal financial regulators have procedures to systematically record such information. Without systematically collecting and maintaining post-employment information, the Board and Reserve Banks may not be able to implement post-employment policies effectively for the LISCC program.

Policies on pre- and post-employment (revolving door)

The Federal Reserve has policies in place that are intended to mitigate revolving-door risk. However, these policies may not fully mitigate risks of regulatory capture.

Federal statute restricts contacts between former and current Federal Reserve employees, and Federal Reserve policies reflect these statutes.[99] Employees who leave the Federal Reserve face restrictions on engaging in certain employment activities with supervised firms. Specifically, all Federal Reserve employees are subject to federal restrictions that prohibit them from representing their new employer before the Federal Reserve regarding particular matters with which they were involved while at the Federal Reserve. Federal Reserve employees, like all federal employees, also are prohibited from participating in any work on a financial institution with which they are seeking employment. In addition, the Intelligence Reform and Terrorism Prevention Act of 2004 and implementing regulations prohibit an examiner who served as the "senior examiner" for a depository institution or depository institution holding company for 2 or more months during the examiner's final 12 months of employment from working for that depository institution or holding company, or certain related entities, for 1 year.[100]

In addition to these requirements, the Federal Reserve implements policies that apply to supervisory staff and officers. For example, supervisory employees hired from firms in the financial industry are subject to a 1-year recusal from working on matters specifically involving the firm from which they were hired, and Reserve Banks have the discretion to extend the recusal if an employee's position warrants further restrictions. Further, if an examiner leaves for a firm he or she examined in the previous 12 months, the Federal Reserve is to review the employee's workpapers from the previous 12 months related to his or her

---

[99]*See* 18 U.S.C. § 207(a)(1)-(2). Former Board personnel are permanently barred from communicating with or appearing before, with the intent to influence, their former agency on behalf of their new employer for particular matters on which they were personally and substantially involved, which involved a specific party or parties at the time of such participation. For 2 years after leaving federal service, former Board personnel may not communicate with or appear before, with the intent to influence, their former agency on behalf of their new employer on particular matters that were pending under their official responsibility in their last year of service, which involved a specific party or parties at the time it was pending, even if the employee was not directly involved with the matter.

[100]*See* Pub. L. No. 108-458, § 6303(b), 118 Stat. 3638, 3751 (codified at 12 U.S.C. § 1820(k)); 12 C.F.R. § 264a.3.

new employer to help assure that the employee was not influenced by the prospect of future employment.[101]

In 2016, the Federal Reserve expanded the types of senior examiners subject to the post-employment prohibition established in the Intelligence Reform and Terrorism Prevention Act of 2004, in part to better mitigate the risk of regulatory capture. Prior to this expansion, only the senior-most examiner—the senior supervisory officer or central point of contact—was subject to this prohibition, although FRBNY extended the prohibition to deputy senior supervisory officers in 2012. However, each examination team includes other senior managers with key decision- making responsibilities. Therefore, to mitigate regulatory capture more effectively, a broader application of the policy was needed, according to one Reserve Bank ethics official. The expanded policy applies to these other examiners and includes any examiner who is serving as the dedicated central point of contact, deputy central point of contact, enterprise risk officer, senior supervisory officer, deputy senior supervisory officer, or supervisory team leader for a single depository institution, group of affiliated depository institutions, or depository institution holding company.

We found that Federal Reserve policies generally reflect federal post-employment requirements, but they may not fully mitigate threats to independence posed by the revolving door. For example, the Federal Reserve's expanded application of the rule restricting employment of senior examiners at firms they supervised excludes those leading horizontal examinations.[102] Specifically, the Federal Reserve policy applies only to an individual serving in a leadership role who is dedicated to supervising a single depository institution (or group of affiliated depository institutions) or depository institution holding company for 2 or more months during the examiner's final 12 months of employment with a Reserve Bank. It excludes examiners who serve in a leadership role for

[101]Federal Reserve officials told us that the Board has interpreted these policies to apply to nonbank supervised firms, such as nonbank SIFIs.

[102]The restriction applies to a covered individual for 1 year after the individual terminates his or her employment with the Reserve Bank. If an examiner violates the 1-year restriction, the statute requires the appropriate federal bank regulatory agency to seek an order of removal and industry-wide employment prohibition for up to 5 years, a civil money penalty of up to $250,000, or both. *See* 12 U.S.C. § 1820(k). In special circumstances, the Chairman of the Board of Governors may waive the restriction for a "senior examiner" of the Federal Reserve by certifying in writing that granting the individual a waiver of the restriction would not affect the integrity of the Federal Reserve's supervisory program. *See* 12 C.F.R. § 264a.4(b).

multiple institutions at the same time or who perform only periodic, short-term examinations that last less than 2 months in a year to that institution. However, these examiners may face similar revolving-door risks to those who work on single-firm examinations. Without assessing these policies in light of the Federal Reserve's increasing reliance on horizontal examinations, the Board may be missing opportunities to improve the policies' effectiveness in mitigating the risk of regulatory capture.[103]

Limited Data on Prior and Subsequent Employment

We requested data from the four Reserve Banks and the Board of Governors on the prior and subsequent employment of LISCC staff from 2011 through July 2016 and found that the four Reserve Banks and the Board generally collect data on the hiring and departure dates of employees and prior employers of newly hired Federal Reserve employees. However, we also found that two of the four Reserve Banks and the Board did not systematically record the future employers of departing Reserve Bank examiners.

The four Reserve Banks have used the COFI application among other electronic systems to store information on the hiring and departure dates and the previous employers of current staff since 2013. Data from the four Reserve Banks showed the total number of examination staff hired and total number who departed from 2011 through July 2016, as well as data on prior and subsequent employers for employees who began employment with the Reserve Banks between 2011 and July 2016. We found that FRBNY and FRB Richmond maintain their own electronic systems to record the prior and subsequent employers of employees who enter and leave the bank. FRBNY routinely requests that departing employees provide the name of their new employer, though FRBNY was not able to provide us with complete data for departed FRBNY LISCC staff because some employees did not provide information on their future plans at the time of their departure.[104] In contrast, FRB Boston did not collect this information (though manually compiled data for us) and FRB San Francisco tracked only whether an employee left for a supervised firm. FRB San Francisco officials told us in October 2017 that they recently began to request information about future employers from all departing employees.

[103]We discuss the need for an assessment of ethics policies in greater detail later in this report.

[104]For example, according to FRBNY staff, some departing employees, such as retirees, did not have future employment plans.

Table 1 presents a summary of available pre- and post-employment information for Reserve Bank LISCC program examiners from 2011 through July 2016. Although the Reserve Banks recorded the date of hire and date of departure of employees during this period, some data were missing for the future employers of departed examiners. In addition, the table shows total numbers of employees in each category. Some of the employees hired from 2011 through July 2016 still worked at the Reserve Banks as of July 2016; some who departed during this period were hired prior to 2011.

Table 1: Summary of Available Pre- and Post-Employment Information of Federal Reserve Bank LISCC Program Examiners Employed 2011–July 2016

Reserve Bank	Total employed in LISCC supervision	Employees hired from financial industry firms (of those, hired from LISCC firm)[a]	Total employees who departed	Employees who departed for financial industry firms (of those, departed to LISCC firm)[b]	Employees who did not identify their future employer[c]
FRB Boston	53	19 (2)	15	5 (0)	2
FRB New York	514	131 (52)	143	69 (34)	54
FRB Richmond	52	7 (2)	25	4 (2)	5
FRB San Francisco	63	27 (7)	15	2 (1)	10
Totals	**682**	**184 (63)**	**198**	**80 (37)**	**71**

Source: GAO analysis of Federal Reserve Bank data. | GAO-18-118

Notes: Although the Reserve Banks recorded the date of hire and date of departure of employees during this period, there were significant numbers of employees for whom either no information was available about either their prior or future employers, or their hiring or departure occurred outside of the date GAO requested. In addition, the table shows only total numbers of employees in each category. Some of the employees hired from 2011 through July 2016 are still working at the Reserve Banks; some who departed during this period were hired prior to 2011. As such, the table represents results from the data that were available. Because of the limited nature of the available data, our analysis cannot be generalized to the entire LISCC program or to the Federal Reserve supervisory program as a whole.

LISCC = Large Institution Supervision Coordinating Committee.

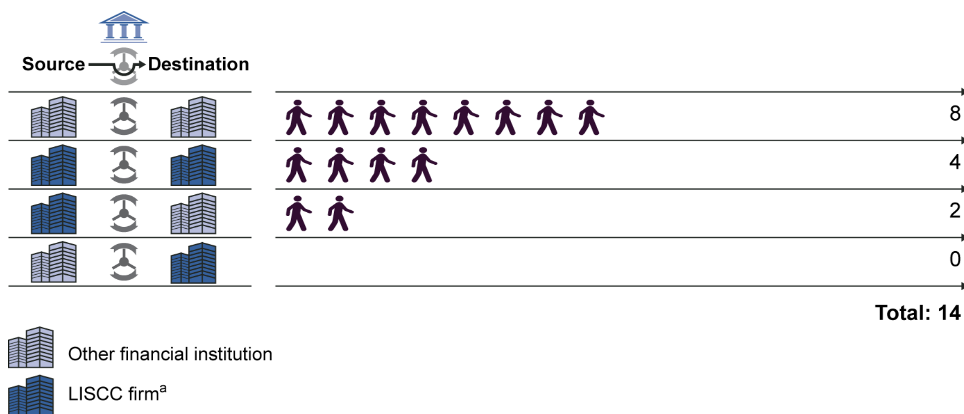
[a]For the purposes of this analysis, we defined a “financial industry” company as any company that explicitly operates within the financial industry or in a financial capacity. This includes law firms, accounting firms, or consulting firms in addition to banks or securities brokers, that list in their company description that the services they provide primarily engage with other financial firms or operate within financial markets, including banking, investments, or insurance.

[b]Officials in FRB Boston and FRB San Francisco told us they did not systematically record departing employees’ destination when they leave the Federal Reserve. FRB San Francisco tracked only whether an employee left for a supervised firm and FRB Boston manually compiled the data for us. FRBNY told us that some data were missing because some of those employees may have retired or otherwise left FRBNY without a plan for immediate future employment.

[c]Total number of missing data fields for future employer information.

We analyzed the data from the Reserve Banks to identify Reserve Bank staff who were hired from the financial industry and who subsequently left the Federal Reserve for a financial institution from 2011 through July 2016. We found that 14 out of 198 former Reserve Bank examiners for whom we had data were hired from, and departed for, financial institutions during this period. Of these, 8 were hired from and departed for financial institutions that are not part of the LISCC program (see fig. 7).[105] We found that 4 LISCC program staff hired from a LISCC firm eventually left for a position at a LISCC firm. However, because the information is limited, a comprehensive analysis was not possible.

Figure 7: Summary of Available Data on Federal Reserve Bank LISCC Examiners Hired from the Financial Industry Who Left Reserve Banks for the Financial Industry, 2011–July 2016



Source: GAO analysis of Federal Reserve Bank data. | GAO-18-118

Note: Of the 682 examiners employed in the Large Institution Supervision Coordinating Committee program from 2011 through July 2016, information on the name of the employee's prior employer was not provided for 320 staff because their hiring occurred outside of the 2011–July 2016 period GAO requested. Of the 198 who departed during this period, the name of the departed employee's future employer was not provided for 71 staff. Because of the limited nature of the available data, our analysis cannot be generalized to the entire LISCC program or to the Federal Reserve supervisory program as a whole.

[a]LISCC = Large Institution Supervision Coordinating Committee. For the purposes of this analysis, we defined a "financial industry" company as any company that explicitly operates within the financial industry or in a financial capacity. This includes law firms, accounting firms, or consulting firms in addition to banks or securities brokers, that list in their company description that the services they provide primarily engage with other financial firms or operate within financial markets, including banking, investments, or insurance.

[105]Because of the limited nature of the available data, our analysis cannot be generalized to the entire LISCC program or to the Federal Reserve supervisory program as a whole.

While we were able to analyze some of the data from the Reserve Banks, we were unable to conduct a similar analysis for Board-based LISCC staff because the Board does not collect information systematically for LISCC program staff. Instead, the Board collects information for Board employees required to file public or confidential financial disclosures, regardless of whether they work on the LISCC program.[106] According to Board officials, for instance, the Board of Governors ethics program collects pre-employment information for Board employees who file public financial disclosure forms and must report the source of income received (and thus prior employers) during the previous calendar year and the current year up to the date of filing. Further, Board ethics officials told us that they learn about post-employment plans in the course of counseling employees about the restrictions related to seeking employment and conflicts, but they do not routinely collect this information for departing employees. In addition, Board employees who file public financial disclosures must file a statement with the Ethics Office within 3 business days of commencing employment negotiations with a nonfederal employer.[107]

Without systematically collecting post-employment information, the Board and the Reserve Banks may not be able to implement post-employment policies effectively for the LISCC program. For example, as noted, the Board requires a 12-month workpaper review for examiners who leave the Federal Reserve to work at a financial institution they examined in the year prior to their departure. In addition, federal regulation prohibits examiners who served as the "senior examiner" for a depository institution or depository institution holding company for 2 or more months during the examiner's final 12 months of employment from working for that depository institution or holding company, or certain related entities, for 1 year.[108] The Federal Reserve's 2016 policy change that expanded the definition of senior examiners subject to this 1-year post-employment restriction on working for a firm they supervised also includes a requirement that Reserve Banks maintain such information

[106]As noted previously, the Board Division of Supervision and Regulation does not maintain a roster of LISCC employees.

[107]This notification is mandated by the Stop Trading on Congressional Knowledge Act of 2012, Pub. L. No. 112-105, § 17(a); 126 Stat. 291, 303 (codified at 5 U.S.C. app. 101 note).

[108]*See* 12 C.F.R. § 264a.3.

electronically.[109] As noted, systematic collection of pre- and post-employment information is not legally required, but FRBNY and FRB Richmond, as well as the Securities and Exchange Commission, have collected such information.[110] In addition, internal control standards emphasize the importance of collecting quality information. Until the Federal Reserve implements mechanisms that systematically collect and maintain both pre- and post-employment information at all four LISCC Reserve Banks and the Board, the Federal Reserve is limited in its ability to implement revolving door policies effectively.

Board of Governors Has Not Assessed Ethics Policies and Procedures That Apply to LISCC Program Participants

We found that the Division of Supervision and Regulation conducted operations reviews of Reserve Bank ethics offices during the period of our review, 2011 through 2016, and that OGE reviewed the Board of Governors ethics program in 2014. However, although the development of the LISCC program entailed changes to ethics policies and procedures, the Board of Governors has not carried out a self-assessment of its ethics program and procedures during this period. OGE regulations state that agency ethics officials are responsible for periodically carrying out self-assessments, which are in addition to external evaluations or investigations by OGE and others.[111] In addition, internal control standards emphasize the importance of identifying, analyzing, and responding to significant changes.

Reserve Bank Ethics Program Assessments

The Division of Supervision and Regulation and Reserve Banks conducted a periodic operation or internal quality assurance review, respectively, of each of the four LISCC Reserve Banks' ethics offices during 2011 through 2016, the period of our review, as part of their oversight roles. These reviews found areas for improvement, which the

[109]In October 2017, the Board Division of Supervision and Regulation provided us with a May 2017 report in which the division recommended changes to the COFI application, including adding the ability to record the future employer of departing Reserve Bank examiners. As noted, information about departing Board employees is not included in the COFI application.

[110]We reported in 2011 that among financial regulatory agencies, only the Securities and Exchange Commission systematically collected and maintained a database of where employees went after leaving the agency. See GAO, *Securities and Exchange Commission: Existing Post-Employment Controls Could Be Further Strengthened*, GAO-11-654 (Washington, D.C.: July 12, 2011).

[111]*See* 5 C.F.R. § 2638.104(c)(16).

four Reserve Banks subsequently addressed, according to the Board, the Reserve Banks, and our reviews. For example:

- **Policies and procedures.** Three of the four Reserve Banks (FRB Boston, FRBNY, and FRB Richmond) did not have a procedure under which ethics officials reviewed individual conflict-of-interest disclosures of examination staff prior to these employees' assignments to new examinations. One Reserve Bank (FRB San Francisco) did not ensure that internally transferred examiners were properly credentialed prior to being staffed on an examination. The four banks took steps to address these deficiencies, according to Reserve Bank and our reviews.
- **Training.** In addition, the division found that three Reserve Banks (FRB Boston, FRBNY, and FRB Richmond) lacked sufficient training of supervision managers or staff about conflict-of-interest requirements and staff compliance responsibilities. These banks have subsequently added training in these areas, according to Reserve Bank and our reviews.
- **Post-employment policy.** One Reserve Bank (FRB San Francisco) was found not to have fully complied with the Federal Reserve System policy requirement for a workpaper review of all examiners who leave the Federal Reserve for a financial firm they supervised. In response, the Reserve Bank immediately amended its internal written policies to ensure that the policies covered all of its examiners.
- **Use of the COFI application.** One bank (FRB Boston) did not maintain accurate information on conflicts in the Federal Reserve's COFI application and did not undertake supervisory review of staff financial disclosure forms. FRB Boston officials told us that this information is now routinely collected and forms are now reviewed and approved at the officer level.

OGE Assessment of the Board of Governors Ethics Program

In 2014, OGE carried out its most recent periodic review of the Board of Governors ethics program. The review found that the Board's ethics program met key indicators for program design and implementation. For example, OGE reported that the Federal Reserve maintains an ethics handbook, which the Board provides to new employees, as well as the procedures for the Board's administration of the financial disclosure process. The handbook includes an introductory letter from the Board Chair emphasizing the importance of impartiality; the key federal criminal statutes and OGE regulations that employees must follow; a summary of conflict-of-interest exemptions; and contacts for Board ethics officials. Board of Governors' annual responses to the OGE questionnaires, which we reviewed for 2011 through 2016, included basic information on the

program, such as the number of employees who file financial disclosures, the number of Board staff who review these disclosures, and key challenges for their work. For example, among the challenges they listed were continuing to provide quality advice and counseling in a shifting regulatory environment and the implementation of the OGE Integrity public disclosure filing system.

However, an OGE official confirmed that the 2014 Federal Reserve review did not include the Division of Supervision and Regulation or Reserve Bank ethics programs or procedures related to supervisory personnel. Another OGE official told us that OGE does not oversee implementation of Board supplemental regulations or federal statutes that apply to specific agencies or agency activities—such as federal borrowing restrictions for examiners or the federal law restricting for 1 year employment of senior examiners at firms they supervised.[112]

Lack of Self-Assessment of Board Ethics Procedures

OGE regulations state that, as of January 1, 2017, agency ethics officials are responsible for periodically evaluating agency ethics programs, among other responsibilities. However, the Board stated in annual survey responses submitted to OGE between 2011 and 2016 that it had not assessed its ethics procedures. Board ethics officials noted that, prior to January 1, 2017, agency self-assessments were not required by OGE. However, OGE reported in 2016 that 60 percent of federal agencies undertook such self-assessments in 2015.

OGE provides suggested self-assessment methods, such as administering questionnaires to agency staff. Further, the OGE annual questionnaire that agencies submit asks agencies to describe the purpose of their self-assessment (if they have undertaken one) and lists the following among the potential answers: assessing employee perceptions about the ethics program; employee knowledge of ethics rules; employee perceptions about the agency's ethical culture; evaluation of compliance with applicable ethics laws and regulations;

[112]The Board of Governors submits responses to OGE's annual questionnaire to federal agency ethics officials. The annual questionnaire to the Board of Governors ethics officials does not include details about the ethics programs of Reserve Banks.

assessment of employee knowledge before or after training; and assessment of employee satisfaction with training offered.[113]

Internal control standards for monitoring highlight the value of not only separate, external evaluations, but also internal assessments. In addition, internal control standards state that management should identify, analyze, and respond to significant changes. The development of the LISCC program included some changes to ethics policies and procedures, and the lack of a comprehensive evaluation of ethics policies and procedures means that the Board cannot be assured of effectively meeting its objectives for ethical behavior in the LISCC program. For example, as noted, the Board recently revised its policies restricting employment of senior examiners at firms they supervised, in part to mitigate regulatory capture risks, but this change excludes examiners leading horizontal examinations. The LISCC program also increasingly relies on horizontal examinations, which heightens the need for employees to fully understand financial restrictions. Without a comprehensive evaluation of these and other policies and procedures—and employee perceptions and knowledge of ethics policies and procedures—the Board may be missing opportunities to help ensure that ethics and conflict-of-interest policies are as effective as possible at mitigating risks of regulatory capture.

Conclusions

The Board of Governors established the LISCC program to respond to risks that the largest financial institutions pose to the financial system. The program's effectiveness depends, in part, on addressing the risk of regulatory capture and maintaining independence throughout the supervisory process. One means of addressing the risk of regulatory capture is through an ERM framework. The Board began to develop an ERM framework in 2017, but has not yet implemented this framework and has not developed key framework elements identified by OMB. Although the Reserve Banks' ERM frameworks can be used to mitigate risks associated with regulatory capture through policies in supervision and ethics functional areas, these policies were not designed to address this risk. Moreover, the Board is still developing an ERM framework and has

[113]In October 2017 the Board provided us with documentation that showed that Board ethics staff monitor some aspects of its ethics program for Board employees, such as ensuring that employees file required financial disclosure forms and updating the Board's intranet site with information on ethics policies and procedures. Based on our review, the Board did not assess LISCC program employees' knowledge or understanding of ethics policies and procedures or perceptions of the Federal Reserve's ethical culture.

not had the ability to comprehensively review supervision and ethics functions to identify, assess, and monitor sources of reputational risk—including the risk of regulatory capture.

In addition, while the LISCC program includes policies that can help to mitigate threats to supervisory independence if implemented effectively, weaknesses in some related internal controls impact the effectiveness of these policies. First, the Board has not finalized and implemented minimum operating and documentation standards for supervisory activities, and it does not have a regular mechanism for monitoring Reserve Banks' implementation of LISCC policies. Until these initiatives are completed, the Board will have limited assurance that LISCC policies are being effectively implemented to mitigate the risk of regulatory capture and threats to independence.

Finally, the Federal Reserve has ethics policies and procedures to help ensure that employees act in the public interest rather than in their own personal interest. Because these policies and procedures were designed to prevent conflicts of interest rather than to prevent regulatory capture, they have some inherent limitations. For example, the Board does not systematically collect the post-employment information for LISCC program participants that would be necessary to mitigate the revolving door threat. In addition, the Board has not conducted a self-assessment of the effectiveness of ethics and conflict-of-interest procedures for the LISCC program. As a result, the effectiveness of these policies in helping to ensure the independence of LISCC employees, and mitigating regulatory capture, may be limited.

Recommendations for Executive Action

We are making the following six recommendations to the Board of Governors of the Federal Reserve System. Specifically:

- As the Board of Governors implements plans to develop an ERM framework, it should include a component to identify and assess risks of regulatory capture across the LISCC program. (Recommendation 1)
- The Board of Governors should finalize and implement program-wide guidance for the LISCC Reserve Banks on implementing LISCC policies. (Recommendation 2)
- The Board of Governors should finalize and implement a mechanism to monitor and regularly assess Reserve Banks' implementation of LISCC policies and procedures. (Recommendation 3)

- The Board of Governors should streamline its conflict-of-interest disclosure review process for participants in the LISCC program, such as by storing disclosure information in compatible electronic systems. (Recommendation 4)
- The Board of Governors should systematically collect and maintain information on the institutions supervisory employees work for before they are hired by the Federal Reserve and their employment destination when they leave. (Recommendation 5)
- The Board of Governors should conduct a periodic self-assessment of ethics programs, policies, and procedures that apply to LISCC program participants. (Recommendation 6)

Agency Comments and Our Evaluation

We provided a draft of this report to the Board of Governors for review and comment. The Board provided written comments that we have reprinted in appendix V. The Board also provided technical comments that we have incorporated, as appropriate.

In its overall comment, the Board noted that we did not find evidence of regulatory capture in our review. However, the scope of this engagement did not include assessing evidence for the presence or absence of regulatory capture. As we noted in the report, regulatory capture is a complex and significant threat to effective regulation that takes many forms and can result in biases in judgment that are difficult to identify definitively. Our review examined the Federal Reserve policies and procedures to identify and manage threats to supervisory independence and risks of regulatory capture across the Federal Reserve LISCC program. We found weaknesses in the Federal Reserve's mitigation strategies and practices which, if left unaddressed, expose the Federal Reserve to risks of regulatory capture.

In its written comments, the Board neither agreed nor disagreed with the report's six recommendations. The Board provided the following comments:

- Regarding our recommendation to include a component to identify and assess risks of regulatory capture across the LISCC program as the Board implements plans to develop an ERM framework, the Board notes in its letter that it is developing an ERM framework that would provide a strategic view for comprehensively managing all material risks faced by the Board that would provide additional executive attention for their management. In its comments, the Board said that

the ERM framework will assess all strategic risks, including regulatory capture.

The letter further notes that the Board believes that it is already effectively managing the risks of regulatory capture in the supervision of large financial institutions through day-to-day management of these risks under the LISCC program and does not expect the ERM framework to significantly alter the way it manages the risk of regulatory capture. As we noted in the report, capture is a complex and significant threat to effective regulation, and the potential negative effects of capture on bank regulation and supervision require well-designed preventative measures by prudential banking regulators. As a result, we maintain that the LISCC program can be enhanced by an effective ERM to mitigate the risk of regulatory capture. We also noted in the report, that the Federal Reserve already has in place local mechanisms to help manage these risks at the Reserve Banks. However, the Board has not yet implemented an ERM framework to identify and assess the combined impact of risks as an interrelated portfolio. Unless the Board uses its ERM framework to assess its supervision, ethics, and other functions across the Federal Reserve System, it will miss an opportunity to enhance its ability to mitigate regulatory capture. We plan to continue to monitor the development and implementation of the framework to determine whether it ultimately addresses our recommendation.

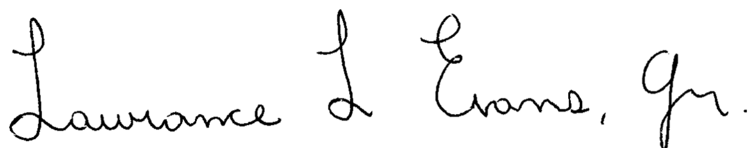
- Regarding our recommendation to finalize and implement program-wide guidance for the LISCC Reserve Banks on implementing LISCC policies, the Board agreed with the importance of written program-wide policies and procedures to ensure all staff working on the LISCC program have clarity on their roles and responsibilities and to minimize threats to independence of supervisory staff. The Board notes that during the course of our review it was memorializing aspects of the LISCC program in a LISCC program manual that describes the objectives and organization of the program as well as its governance structure. We have noted this in our report. Additionally, the Board notes that it has recently established an additional framework to further develop policies, procedures, and guidance for LISCC staff on documentation, deliverable requirements, and other areas, which it expects to take effect in 2018. It will be important for the Board to follow through on its plans to implement the LISCC program manual, as well as additional planned policies, procedures, or other guidance. This is necessary to provide reasonable assurance that the Reserve Banks are effectively implementing policies that can help mitigate threats to independence to LISCC supervisory staff.

- Regarding our recommendation to finalize and implement a mechanism to monitor and regularly assess Reserve Banks' implementation of LISCC policies and procedures, the Board noted that although it has a continuous oversight program that assesses the effectiveness of the Reserve Banks' supervision functions, including their adherence to System guidance, formalizing the monitoring and assessment of the LISCC program would provide greater assurance on the implementation of LISCC guidance. The Board stated that it is in the process of augmenting its oversight program through the development of a LISCC-specific oversight framework that is to encompass all Board and Reserve Bank LISCC activities and provide for a comprehensive assessment of program effectiveness for implementation in 2018. Until this framework is put into place, the Board may not have reasonable assurance that policies are being implemented appropriately and effectively.
- Regarding our recommendation to streamline the conflict-of-interest disclosure review process for participants in the LISCC program, such as by storing disclosure information in compatible electronic systems, the Board noted that it would explore options for streamlining its approach, including assessing the feasibility of integrating existing systems.
- Regarding our recommendation to systematically collect and maintain information on the institutions where supervisory employees worked before they are hired by the Federal Reserve and their employment destination when they leave, the Board agreed that "revolving door" risk can pose a threat to supervisory objectivity. The Board said it would assess how existing practices could be modified to ensure a more systematic approach to collecting pre- and post-employment data, including through the use of electronic systems. The Board noted that, as we acknowledge in our report, departing employees have no obligation to disclose their destination.
- Regarding our recommendation to conduct a periodic self-assessment of ethics programs, policies, and procedures that apply to LISCC program participants, the Board agreed that self-assessment plays an important role in ensuring a healthy and robust program. It noted that its ethics office has approached the Division of Supervision and Regulation to explore potential avenues for conducting periodic reviews of the ethics program as applied to LISCC participants. However, we noted in our report that the Board's annual survey responses submitted to OGE between 2011 and 2016 stated that it had not conducted a self-assessment of its ethics procedures since the start of the LISCC program. In October 2017, the Board provided

additional information to us about its ethics program monitoring efforts, which it highlights in its letter, and we have added this new information to our report. The Board's letter states that OGE told the Board that these monitoring efforts satisfy OGE's new self-evaluation requirements. However, based on our review, this information largely describes monitoring activities rather than a comprehensive self-assessment of ethics program policies and procedures. We subsequently clarified in our report that without a comprehensive evaluation of Board and Reserve Bank ethics policies and procedures—and of employee perceptions and knowledge of ethics policies and procedures—the Board may be missing opportunities to help ensure that ethics and conflict-of-interest policies are as effective as possible at mitigating the risk of regulatory capture.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the House Committee on Financial Services and the Federal Reserve. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or evansl@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix VI.



Lawrance L. Evans, Jr
Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope and Methodology

This report examines the Federal Reserve System's (Federal Reserve) policies and procedures for (1) managing risks of regulatory capture across the Large Institution Supervision Coordinating Committee (LISCC) program using an enterprise risk management (ERM) approach; (2) identifying and mitigating conflicts of interest among supervisory personnel in the LISCC program; and (3) identifying and mitigating threats to supervisory independence for the LISCC program.

We conducted background research to understand the potential for regulatory capture to compromise effective regulation and identify ways in which banking supervisors might experience regulatory capture and strategically mitigate it. Specifically, we reviewed and summarized academic studies that provided definitions of regulatory capture and discussed with academic experts how regulatory capture might operate in banking supervision. Additionally, we reviewed and summarized academic literature to identify mitigation strategies to reduce threats to bank supervisory independence and regulatory capture. See appendix II for a brief summary of the results of our literature review.

To assess the extent to which the Federal Reserve manages risks of regulatory capture across the LISCC program using ERM, we reviewed and analyzed documents provided by the four Reserve Banks related to their ERM frameworks. Those Reserve Banks are the Federal Reserve Banks of Boston (FRB Boston), New York (FRBNY), Richmond (FRB Richmond), and San Francisco (FRB San Francisco).[1] We also interviewed senior risk management officials at the Banks and senior officials at the Board of Governors of the Federal Reserve System (Board of Governors or Board). We assessed the extent to which the frameworks included a mechanism to address risks of regulatory capture across the supervisory and ethics functions.

In order to gather information related to supervisory policies and procedures and their implementation, we visited the four Federal Reserve Banks that supervise at least one LISCC firm. To describe the policies and procedures the Reserve Banks use to supervise LISCC firms, we reviewed relevant supervisory manuals and interviewed officials prior to our visits. We also reviewed Federal Reserve internal review documentation for 2012 through 2016, including reviews of the LISCC program conducted by the Reserve Banks and by the Board of Governors. We also interviewed LISCC Operating Committee (OC) staff

[1]FRB Richmond's field office in Charlotte, North Carolina houses the majority of the team that supervises Bank of America.

and other Board of Governors staff who execute policies and procedures related to the LISCC program.

To examine the implementation of the Federal Reserve's policies and procedures for mitigating threats to supervisory independence, we conducted individual interviews with LISCC supervisory staff at the Reserve Banks. We conducted approximately 77 interviews with Federal Reserve staff on 9 of the 13 LISCC firm dedicated supervisory teams.[2] For selecting interviewees at FRB Boston, FRB San Francisco, and FRB Richmond, we randomly selected from all LISCC supervisory staff. For FRBNY, due to the larger number of LISCC firms it supervises, we judgmentally selected five LISCC dedicated supervisory teams. In selecting these teams, we considered total assets and primary lines of business of the supervised firms, and we included one foreign banking organization in this group of five. We requested lists of all staff on each firm dedicated supervisory team for each LISCC Reserve Bank, in addition to their title and whether or not they were staff on a horizontal exam. After receiving the information, we used a random selection method to determine which individuals to speak with based on our designation of staff into the categories of examiners, examiners who had or were currently engaged on horizontal examination work, and management. We assigned random numbers to the staff members of each category and selected those with the largest numbers for interviews. We selected approximately the same number of staff from each category. In addition, to ensure that every category we assigned had staff available to interview, where necessary, we selected alternates. Reserve Bank management noted that they needed some flexibility in the event that staff who were selected were unable to participate due to vacation, training, or other scheduling conflicts. We compiled responses to our questions and used a content analysis process to define themes that emerged.

To examine Reserve Bank LISCC supervisory staff views on the implementation of policies and procedures, we conducted focus groups. We conducted a series of 9 focus groups with approximately 81 Federal Reserve staff on 9 of the 13 LISCC firm dedicated supervisory teams. For FRB Boston, FRB San Francisco, and FRB Richmond, we sampled all supervisory staff. For FRBNY, due to the larger number of LISCC firms it supervises, we judgmentally selected staff from five LISCC dedicated supervisory teams. Again, in selecting these teams, we considered total

[2] Following the conclusion of our audit work on September 29, 2017, FSOC voted to de-designate AIG as a Non-Bank SIFI; as a result, AIG is no longer subject to supervision by the Federal Reserve.

assets and primary lines of business of the supervised firms, and we included one foreign banking organization in our sample. We requested lists of all staff for each LISCC Reserve Bank with three categories of identification to be used in selection: 1) being on a firm dedicated supervisory team, 2) their title, and 3) whether or not they were staff on a horizontal exam. After receiving the information, we used a random sample method to select individuals to participate in the focus groups based on our designation of staff into categories of examiners, examiners who had or were currently engaged on horizontal examination work, and management. We assigned random numbers to each category of staff and selected for our focus groups those with the largest number that had not participated in our interviews. We selected approximately the same number of staff from each category. In addition, to ensure that every category we assigned had staff available to participate in our focus groups, where necessary, we selected alternates. Reserve Bank management noted that they needed some flexibility in the event that staff who were selected were unable to participate due to vacation, training, or other scheduling conflicts. We conducted focus groups on-site for staff on supervisory teams located at FRBNY and FRB Richmond. Staff at FRB Boston and FRB San Francisco participated in focus groups together over a shared videoconference line. Staff at FRB Boston and FRB San Francisco were sampled together and were selected based on the designation of staff into the categories described previously in order to obtain representation from each supervisory firm team. In addition, to ensure that every asset class represented had a participant in the focus group, where necessary, we selected alternates.

A GAO methodologist facilitated each focus group. Our discussion topics focused on the following:

- the supervisory process and circumstances that may arise related to threats to independence;
- supervisory procedures and how staff implement them and;
- staff's ability to raise divergent views and team dynamics with management.

GAO staff took notes, which we used to prepare records of discussion that were content analyzed to develop our findings. Results from the focus groups were also used to corroborate information we obtained in our interviews regarding the supervisory process, supervisory procedures and their implementation by staff, and staff's ability to raise divergent views on supervisory topics. Throughout this report, we use certain qualifiers when describing results from focus groups and interview participants, such as "a couple," "some," and "several." We define a couple as two; some as three or four; and several as more than four.

While the information we collected from the focus groups provided context on the issues discussed, it was not generalizable to the entire population of LISCC supervisory staff.

To assess the Federal Reserve's policies and procedures for identifying and mitigating conflicts of interest among individual supervisory employees, we reviewed federal statutes and regulations, the Federal Reserve Administrative Manual and supplemental guidance, the Reserve Banks' codes of conduct, and other documentation and training materials. We collected and analyzed data from the Reserve Banks about LISCC staff conflicts of interest from 2011 through July 2016. We assessed these data and determined that they were sufficiently reliable for the purposes of our analysis. We also collected and analyzed financial disclosure information for the members of the OC from 2013 through 2016. We also collected and analyzed information on waivers issued to Federal Reserve employees to enable them to continue working on supervisory matters in spite of conflicts of interest. We collected and analyzed available data on where Federal Reserve employees worked prior to joining the Federal Reserve and where employees went to work after leaving the Federal Reserve. We analyzed information about violations of Federal Reserve ethics policies. Finally, we also interviewed ethics officials at the Board of Governors and the four Reserve Banks.

We conducted this performance audit from February 2016 to November 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Literature on Regulatory Capture in Financial Banking Supervision

A wide body of academic literature has focused on factors that can increase the risks of regulatory capture in the banking system and identified various strategies to mitigate these risks. While there is no set definition of regulatory capture that is used throughout the literature, in general, regulatory capture occurs when a regulator acts in service of private interests at the expense of the public interest.[1]

Factors That Can Increase the Risk of Regulatory Capture and Threats to Supervisory Independence

Asymmetry in information and participation. Information asymmetry refers to an imbalance in relevant information between two parties to a transaction or interaction. Some scholars argue that information asymmetry can facilitate threats to supervisory independence and increase the risk of regulatory capture by enabling supervised firms to hide information from the supervisory agency.[2] This information differential can mean that supervisors are dependent on supervised firms for information and may be unable to view that information skeptically or effectively. For example, large complex banks have significantly more resources and expertise than their supervisors and can present obstacles for supervisors to examine them effectively. This informational imbalance and dependence on the regulated entity for the relevant information may also result in relationship dynamics that lead to a decline in professional skepticism. A number of studies also argue that asymmetric participation may pose a risk of regulatory capture.[3] These studies explain that in the financial sector, compared to smaller and less capitalized firms, large and powerful firms have more resources and incentives to overcome collective action obstacles, hire experts, and lobby effectively. The research also acknowledge that some firms may be seen as being so structurally important to the economy that they receive differential treatment by the regulator.

Asymmetry also can occur when regulators and industry have differing degrees of access to expertise. Several articles argued that regulated firms have more expertise than regulatory agencies because firms

[1]See, for example, D. Carpenter and D. A. Moss, *Preventing Regulatory Capture: Special Interest Influence and How to Limit it.* (New York, NY: Cambridge University Press, 2014).

[2]See, for example, D. Carpenter and D. A. Moss (eds.), *Preventing Regulatory Capture*, 71-98.

[3]See, for example, S. Pagliari, *Making Good Financial Regulation: Towards a Policy Response to Regulatory Capture,* (United Kingdom: Grosvenor House Publishing, Limited, 2012).

generally have more resources.[4] According to these articles, an agency's lack of expertise can limit a regulator's ability to evaluate industry practices. According to these articles, the experts agencies hire typically come from the regulated industry, which has likely affected their views.

Revolving door. A situation in which personnel move back and forth between an industry and a regulator is known as a "revolving door." The movement may occur because of a salary differential between the supervised industry and supervisory agency, where a regulated firm can offer regulators higher salaries. Such situations may threaten supervisory independence by making regulators less willing to challenge firms. Several articles note that a salary differential between the regulated industry and regulatory agency contributes to the revolving door.[5] The articles note that the revolving door can result in social ties that can threaten supervisory independence because firms may take advantage of social ties to pressure regulators in a particular direction. Former regulators who have been hired by firms may have lingering social ties and insight into the regulatory agency, which they may use to exert influence over the regulator. Shared social ties may also simply give the regulated firms additional access to regulatory agencies. Moreover, the literature explains that this mobility of workers may contribute to a narrow social network that promotes regulators' shared way of thinking or limits their objectivity. However, a few articles caution that the existence of a revolving door does not mean that an agency is captured; indeed, a revolving door may enhance a regulator's ability to serve the public interest and improve the performance and stability of regulated firms.[6]

Cultural capture. The supervisory process also may be subject to capture through the shared world view of participants, sometimes called cultural or intellectual capture. Some studies indicate that a regulatory agency can come to share the beliefs, views, and perspectives of the regulated industry.[7] Additional studies state that supervisors come to

[4]See, for example, S. Gadinis, *From Independence to Politics in Financial Regulation* (Berkeley, Ca.:Berkeley Law Scholarship Repository, April 2013).

[5]See, for example K. Dowd, M. Hutchinson, S. Ashby, and J. Hinchliffe, *Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation*, Policy Analysis No. 681 (Washington, D.C.: CATO Institute, July 2011).

[6]See, for example, D. Lucca, A. Seru, and F. Trebbi, *The Revolving Door and Worker Flows in Banking Regulation*, Federal Reserve Bank of New York Staff Report No. 678 (New York, NY: Federal Reserve Bank of New York, June 2014).

[7]See, for example Carpenter and Moss, *Preventing Regulatory Capture,* 71-98.

value relationships developed through repeated interactions and may avoid making decisions that could deteriorate those relationships.[8] Two articles note that past employment or a shared professional background can also facilitate cultural capture and affect the regulator's confidence in and trust of the regulated industry. Similarly, some studies note that shared educational background and social networks can lead regulators to identify closely with the regulated industry.[9] According to this literature, when a regulatory agency lacks a clear mission to pursue and prioritize public interests, there is a risk of regulatory capture in which agencies become passively persuaded by regulated parties.

Agency funding structure. How an agency is funded can affect the agency's risk of regulatory capture. Regulators may be funded through legislative appropriations (e.g., the Commodities Futures Trading Commission), where funding levels are determined through the legislative process, or through the agencies' process, in the form of fees and assessments to regulated parties (e.g., the Office of the Comptroller of the Currency and Federal Reserve System). Regulatory capture may occur in either case. For example, in the former, lobbyists may pressure legislators to restrict funding, while in the latter regulated parties may choose to change regulators by selecting different charters. Where there is a risk of regulatory shopping or arbitrage, regulators may feel pressured to promote legislation or make decisions that favor regulated firms in order to attract and retain the regulated entities. For example, to the extent that a regulated entity may choose one agency or another as its regulator, the entity could "charter shop" and choose as its regulator the agency that promotes regulatory or supervisory decisions that favors the entity.

External pressure. External pressure, such as from the political sphere, is another factor that can subject the financial institution supervisory process to regulatory capture.[10] Political or electoral factors can put pressure on regulators or lead political actors to distance themselves from a regulatory agency. Regulators may avoid decisions that could upset

[8]See, A. Baker, "Restraining Regulatory Capture: Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance," *International Affairs,* vol. 86, no. 3 (2010) and Pagliari, *Making Good Financial Regulation*.

[9]See, for example, Carpenter and Moss, *Preventing Regulatory Capture,* 71-98.

[10]See, for example, K. Young, "Policy Takers or Policy Makers? The Lobbying of Global Banking Regulators," *Business Horizon*, vol. 56, (2013).

politicians or distract from important problems. In addition, regulated firms may be influential campaign donors with the ability to pressure politicians when they disagree with the regulators. Two articles also note that the level of external pressure may vary depending on the salience of the issue.[11]

Strategies for Mitigating the Risk of Regulatory Capture

Our review identified various strategies that can help mitigate threats to supervisory independence and risks of regulatory capture.

Increase transparency and accountability. Studies indicate regulators can mitigate threats to supervisory independence and risks of regulatory capture by increasing the transparency of supervisory accountability. A regulator can adopt several strategies for doing this, including making more visible its movement of supervisory staff to the industry, operating procedures, and key decisions.[12] In addition, a regulator could conduct additional legal and external third-party reviews of its decisions. Such accountability can facilitate better detection of, deterrence of, and responses to abuse of supervisory authority.

Strategically manage supervisory teams. Some studies propose practices that regulators may use to manage, hire, and organize their supervisory teams to reduce the risk of threats to supervisory independence and regulatory capture.[13] For example, depending on the regulator, such practices might include more frequently rotating those in key decision-making roles, hiring additional staff, limiting its use of external contractors, hiring a more diverse workforce, and including at least two supervisory staff when conducting site visits of supervised firms.

Reduce risk from agency funding structure. Various steps can reduce the likelihood of capture due to agency funding structure.[14] For example,

[11]See, for example, Baker, "Restraining Regulatory Capture."

[12]See, for example, B. Quinn, "Governance of the Regulatory Decision Making Process," *Financial Markets, Institutions & Instruments*, vol. 17, no. 1 (2008) and Pagliari, *Making Good Financial Reg*ulation.

[13]See, for example, Pagliari, *Making Good Financial Regulation*, and F. Boehm, *Regulatory Capture Revisited: Lessons from Economics of Corruption, Anti-Corruption Training & Consulting, and Research Center in Political Economy*, Working Paper (CIEP, Universidad Externado de Colombia, July 2007).

[14]See, for example, N. Bagley, "Response: Agency Hygiene," *Texas Law Review*, vol. 89, no. 1 (2010).

where a regulator is funded by appropriations, the risk of capture can be reduced by effective legislative oversight.

Reduce risk from revolving door. Several studies note that higher salaries and better career advancement opportunities for supervisors can help attract high-quality employees and increase their retention.[15] Many articles also discuss a cooling-off period—barring certain employees from employment at or representation before their former agencies—to mitigate risks associated with staff movement through the revolving door, but there is some uncertainty about what this period should look like. One article argues for a cooling-off period scaled to seniority. Another article argues that the ban on working and communication should apply both when moving into and out of the regulated industry. Still another article argues that the cooling-off period should extend to 2 years because contacts may still be relevant after just 1 year, and that the ban should apply to lobbying activities as well. Others express reservations about a cooling-off period altogether, because it may limit career advancement of regulator staff, make it more difficult for a regulator to attract and retain high-quality staff, and it may not account for the differential in benefits to staff offered by a regulator and a firm.[16]

Counter cultural capture. Some studies indicate that hiring staff from diverse backgrounds, instituting contrarian roles in the decision-making process, incorporating incentive structures to help ensure that incentives are aligned with the public interest, providing training related to capture, and protecting whistleblowers can help to mitigate cultural capture.[17] Some studies also indicated that a clear mandate, tone at the top from management, and statutory independence of the supervisory agency may also counter the risk of cultural capture.[18]

[15]See, for example, Pagliari, *Making Good Financial Regulation*.

[16]See, for example, Lucca, Seru and Trebbi, *The Revolving Door*.

[17]See for example, Pagliari, *Making Good Financial Regulation*; Boehm, *Regulatory Capture Revisited*); Baker, “Restraining Regulatory Capture;” and Carpenter and Moss, *Preventing Regulatory Capture*.

[18]See for example, S. Hempling, “*’Regulatory Capture’: Sources and Solutions*,” *Emory Corporate Governance and Accountability Review*, vol. 1 (2014): 23, 25.

Reduce asymmetries. Several studies indicate that facilitating increased engagement by other groups, such as consumer advocacy groups, to balance industry engagement, can help reduce asymmetries of influence.[19] An agency also may reduce information asymmetry by increasing the amount of data it collects from the supervised firms.[20]

Reduce undue external pressure. According to some studies, several mitigation strategies exist to address the risk of capture posed by external pressures. For example, studies suggest that fixed term limits can reduce political pressure on regulatory agency directors.[21] In addition, greater information sharing between Congress and the agency can improve transparency.

[19] See, Boehm, *Regulatory Capture Revisited,* and Baker, "Restraining Regulatory Capture."

[20] See Boehm, *Regulatory Capture Revisited*.

[21] See, for example, Quinn, "Governance of the Regulatory Decision Making Process."

Appendix III: Summary of Federal Reserve Investment and Borrowing Prohibitions for Examiners and Other Types of Employees

Federal Reserve System (Federal Reserve) examiners and other supervisory employees are subject to federal statutory and regulatory restrictions, as well as various Federal Reserve policies, intended to prevent conflicts of interest or the appearance of conflicts of interest. In cases where an employee is permitted to hold a prohibited financial interest, the employee is generally recused (disqualified) from working on the particular matter regarding the financial institution with which the employee has a conflict.[1] Table 2 summarizes the investment and borrowing prohibitions and situations requiring recusal for examiners, employees working on other supervisory matters, or rulemaking and other matters. Some of these prohibitions are required by federal statute and regulation; others are required by Federal Reserve policy.

Table 2: Federal Reserve Guide to Investment and Borrowing Prohibitions and Situations Requiring Recusal

Type of potentially conflicting interest	Investment and borrowing prohibitions	Recusal requirements		
		Examinations of a bank or holding companies or affiliates	Other supervisory matters involving entity and all affiliates[a]	Rulemaking/matters of general applicability[b]
Financial interests				
Financial Interest of employee, spouse, dependent child, or related party: • Stock, stock options, Employee stock ownership plans • Debentures/bonds	May not own debt or equities issued by a depository institution.	Recusal required.	Recusal required.	Recusal required if the market value of investment exceeds: $25,000 in any one such entity. $50,000 in all affected entities.
Pensions	None.	Recusal not required.	Recusal not required.	Recusal not required.
Mutual funds	May not hold an interest in a financial services sector fund.[d]	Recusal required if examination focuses on bank whose stock is held by financial services sector fund and employee owns more than $50,000 of fund.	Recusal required if examination focuses on bank whose stock is held by financial services sector fund and employee owns more than $50,000 of fund.	Recusal not required.
Borrowings[c]				
Credit cards and debit cards	None.	Recusal not required.	Recusal not required.	Recusal not required.

[1]In certain limited circumstances, the Federal Reserve Board or Reserve Banks may issue waivers to examiners that permit them to carry out their examination work while having such conflicts.

Type of potentially conflicting interest	Investment and borrowing prohibitions	Recusal requirements		
		Examinations of a bank or holding companies or affiliates	Other supervisory matters involving entity and all affiliates[a]	Rulemaking/matters of general applicability[b]
Overdraft lines of credit	Prohibited where the Federal Reserve is the primary supervisor.	Recusal required from entity that extended the credit. May examine any other affiliate.	Recusal not required.	Recusal not required.
Mortgage loans and home equity lines secured by principal residence	None.	Recusal required from legal entity that extended the credit only. May examine any other affiliate.	Recusal not required.	Recusal not required.
Mortgage loans and home equity lines secured by property other than principal residence	May not obtain from an institution for which the Federal Reserve is the primary supervisor.	Recusal required from the legal entity that extended the credit and any of its affiliates.	Recusal not required.	Recusal not required.
Auto loans and leases	May not obtain from an institution for which the Federal Reserve is the primary supervisor.	Recusal required from legal entity that extended the credit and any of its affiliates.	Recusal not required.	Recusal not required.
Student loans	May not obtain from an institution for which the Federal Reserve is the primary supervisor.	Recusal required from legal entity that extended the credit and any of its affiliates.	Recusal not required.	Recusal not required.
Margin accounts (Broker/dealer loans)	May obtain from functionally regulated security broker/dealer.	Recusal required from legal entity that extended the credit and any of its affiliates.	Recusal not required.	Recusal not required.
Loans secured by life insurance policies	None.	Recusal required from legal entity that extended the credit only. May examine any other affiliate.	Recusal not required.	Recusal not required.
Checking and savings accounts	None.	Recusal required from legal entity and any of its affiliates if deposit exceeds FDIC insured amounts.[e]	Recusal required from legal entity and any of its affiliates if deposit is in excess of FDIC insured amounts.	Recusal not required.

Type of potentially conflicting interest	Investment and borrowing prohibitions	Recusal requirements		
		Examinations of a bank or holding companies or affiliates	Other supervisory matters involving entity and all affiliates[a]	Rulemaking/matters of general applicability[b]
Business loans	May not obtain from an institution for which the Federal Reserve is the primary supervisor.	Recusal required from legal entity that extended the credit and any of its affiliates.	Recusal required from legal entity that extended the credit and any of its affiliates.	Recusal not required.
Other situations				
Employment of family member (spouse/parent/sibling/child)	Not applicable.	Recusal required from legal entity and any of its affiliates.	Recusal required from legal entity and any of its affiliates	Recusal not required.
Prior employment	Not applicable.	Recusal required from legal entity and any of its affiliates for a minimum of 1 year. Management may require longer recusal period from matters closely related to the employee's prior responsibilities.	Recusal required from legal entity and any of its affiliates for a minimum of 1 year. Management may require longer recusal period from matters closely related to the employee's prior responsibilities.	Recusal not required.

Source: Board of Governors of the Federal Reserve System. | GAO-18-118

[a]A particular matter includes an application, audit, review (including report review), investigation, institution-specific analysis or surveillance, action, and enforcement, but does not include rulemaking or financial analysis broadly affecting financial institutions. A particular matter also includes credit review, collateral analysis, and lending decisions pertaining to the discount-window function.

[b]The value of securities owned by the employee, his or her spouse and minor children must be aggregated.

[c]The "borrowing prohibitions" apply to a loan obtained by examiners and by their spouses or dependent children, unless it is supported solely by their income or independent means. Examiners may not seek or accept any type of credit from an institution during an examination and for 3 months thereafter.

[d]Financial services sector fund is a mutual fund that has a stated policy of concentrating in the financial services industry.

[e]FDIC = Federal Deposit Insurance Corporation.

Appendix IV: Federal Reserve Bank Examination Staff with Active Conflicts of Interest, 2011–July 2016

All Federal Reserve Banks (Reserve Bank) are responsible for implementing ethics policies and overseeing ethics procedures for their supervisory employees, including those who participate in the Large Institution Supervision Coordinating Committee (LISCC) program, which supervises the largest bank holding companies. The Reserve Banks store this information in a common electronic system.[1] We analyzed conflict data for 469 LISCC program employees at the four Reserve Banks that participate in LISCC—the Reserve Banks of Boston, New York, Richmond, and San Francisco—by type of conflict from 2011 through July 2016. On average, employees had approximately two active conflict types from 2011 through July 2016. The most common types of conflicting interest were mortgages or insurance plans; conflicts related to an employee or family member's financial interests; and auto or student loans, business loans, or mortgages or lines of credit secured by nonprimary residences. To address such conflicts of interest, generally employees must divest such interests or be recused from matters affecting the firm in which they have the interests, depending on the policy requirements and ethics officials' review.[2]

Table 3: Federal Reserve Examination Staff Working on Large Institution Supervision Coordinating Committee (LISCC) Examinations with Active Conflicts of Interest, 2011–July 2016

Type of interest	Prohibition	Recusal required from legal entity and any or all affiliates	Number of active LISCC employees with at least 1 conflict in this category with a LISCC firm[d]
Financial interests[a]			
Employee, employee's spouse, or dependent child: • ownership of stocks, • stock options, • pensions, • 401(k) plans	May not own assets from a financial institution; must divest any prohibited assets within 90 days of hiring.	Yes	112

[1]Conflict-of-interest data for Federal Reserve Board of Governors staff who participate in the LISCC program and other nonsupervisory Federal Reserve System staff assigned to LISCC program examinations are collected and stored separately.

[2]As noted previously in this report, approximately 62 employees received waivers between 2011 and 2015 (most due to conflicting financial interests) although the Reserve Banks granted only 10 waivers in 2014–2015, after the Federal Reserve amended its waiver policy to eliminate permanent waivers for conflicts of financial interests.

Type of interest	Prohibition	Recusal required from legal entity and any or all affiliates	Number of active LISCC employees with at least 1 conflict in this category with a LISCC firm[d]
Borrowing[b]			
Overdraft lines of credit	May not obtain from an institution for which the Federal Reserve is the primary supervisor.	Yes - from legal entity that extended the credit only. May examine any other affiliate.	76
• Mortgage loans and home equity lines secured by principal residence or • life insurance policies and loans secured by life insurance policies	None.	Yes - from legal entity that extended the credit only. May examine any other affiliate.	214
• Auto loans and leases; • business loans; • student loans; or • mortgage loans and home equity lines secured by property other than principal residence	May not obtain from an institution for which the Federal Reserve is the primary supervisor.	Yes.	95
Checking and savings accounts	None.	Yes - if deposit is in excess of Federal Deposit Insurance Corporation insured amounts.	11
Other situations			
Employment of family member in a supervised institution[c]	Not applicable.	Yes.	77
Prior employment	Not applicable.	Yes - for a minimum of 1 year. Management may require longer recusal period foe matters closely related to the employee's prior responsibilities.	33
Gifts	May not accept gifts of any value.	Not applicable.	0
Secondary employment	Must disclose and obtain approval	Not applicable.	0
Seeking Outside Employment	Must disclose and obtain approval	Yes	0

Source: GAO analysis of Federal Reserve Bank data. | GAO-18-118

[a]18 U.S.C. § 208.

[b]The "borrowing prohibitions" apply to a loan obtained by examiners and by their spouses or dependent children, unless it is supported solely by their income or independent means. Examiners may not seek or accept any type of credit from an institution they are examining and for 3 months after the examination has ended.

[c]This may include family members outside of immediate family (e.g. uncle, brother-in-law).

[d]We analyzed 469 examiners employed on LISCC examinations between 2011–July 2016. Of these, 346 had active types of conflicts. On average, employees had approximately 2 conflict types over the 2011–July 2016 period of our analysis. This column summarizes individual employees by category of conflicting interest. Because an employee may have had more than one conflict over the period of our analysis, the total number of conflicts is greater than the number of employees whose data we analyzed.

Appendix V: Comments from the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF
SUPERVISION AND REGULATION

October 19, 2017

Lawrance Evans, Jr.
Director
Financial Markets and Community Investment
United States Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Evans:

Thank you for providing the Board of Governors of the Federal Reserve System ("Federal Reserve" or "Board") with an opportunity to review the final draft of the Government Accountability Office ("GAO") report titled: *Large Bank Supervision: Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence* (GAO-18-118). We appreciate the report's recognition of the Federal Reserve's work to mitigate threats to independence for supervisory staff and implement various conflict-of-interest and other ethics policies for LISCC examiners and other types of supervisory employees.

The draft report discusses a number of characteristics of the Federal Reserve's LISCC program that are designed to promote independence of staff and sound decision making. For example, in the LISCC program, major supervisory decisions are subject to thorough vetting by oversight bodies that are comprised of senior staff from multiple disciplines within the Federal Reserve, including supervision, policy, economic research, and legal. Further, the Federal Reserve conducts annual horizontal assessments to complement the work of dedicated supervisory teams. During all supervisory vettings, staff that conducted horizontal work as well as staff from dedicated supervisory teams are invited to share their independent

www.federalreserve.gov

conclusions and views to promote dialogue and informed decision making. The Board is continuing to refine the LISCC program and is taking steps to improve the program, including in areas highlighted in this draft report. In addition, the Board is developing an enterprise risk management program that, in time, will assess all strategic risks including regulatory capture. Notably, after conducting 77 interviews with Federal Reserve staff, including 9 focus groups consisting of approximately 120 Federal Reserve supervisory staff, the draft report does not identify any instances of regulatory capture.

The GAO's report makes six recommendations to the Federal Reserve:

- As the Board of Governors implements plans to develop an ERM framework, it should include a component to identify and assess risks of regulatory capture across the LISCC program. (Recommendation 1)
- The Board of Governors should finalize and implement program-wide guidance for the LISCC Reserve Banks on implementing LISCC policies. (Recommendation 2)
- The Board of Governors should finalize and implement a mechanism to monitor and regularly assess Reserve Banks' implementation of LISCC policies and procedures. (Recommendation 3)
- The Board of Governors should streamline its conflict-of-interest disclosure review process for participants in the LISCC program, such as by storing disclosure information in compatible electronic systems. (Recommendation 4)
- The Board of Governors should systematically collect information on the institutions supervisory employees work for before they are hired by the Federal Reserve and their destination when they leave. (Recommendation 5)
- The Board of Governors should conduct a periodic self-assessment of ethics programs, policies, and procedures that apply to LISCC program participants. (Recommendation 6)

Finalize and Implement Program-wide Guidance for the LISCC Reserve Banks on Implementing LISCC Policies

The Board agrees that, in addition to program design, it is important to have written program-wide policies and procedures for the LISCC program

2

to ensure all staff working on the program have clarity on their roles and responsibilities and to ensure that the program continues to operate in a manner that minimizes threats to independence of supervisory staff. During the course of the GAO's review, the Federal Reserve continued the process of memorializing all aspects of the LISCC program in the LISCC program manual. The manual, which is in near-final form pending public comment on a proposal to revise the Federal Reserve's supervisory rating system, describes the objectives and organization of the program as well as its governance structure.[1] Going forward, all aspects of the program will be governed by System-wide multidisciplinary steering committees beginning in 2018, and the overall program will continue to be overseen by the Director of Supervision and Regulation at the Board of Governors in consultation with the LISCC.

The manual will establish the overall areas of assessment for each of the core programs: (1) capital, (2) liquidity, (3) recovery and resolution, (4) governance and controls, and (5) monitoring and analysis, and requires those programs to be executed through both horizontal and firm-specific reviews. Specifically, each chapter describes the programs' governance structure and roles and responsibilities; the focus for the year-round horizontal activities and ongoing firm-specific supervisory work; the expected role that the dedicated supervisory teams have in relation to the execution of the program work; the documentation and deliverable requirements for activities and supervisory work, including electronic storage requirements; vetting, divergent views, and decision-making process; ratings process; and external communication requirements.

In addition to oversight by a multi-disciplinary steering committee, starting in 2018, each program will have a program leadership group that is responsible for managing the day-to-day work of the horizontal and dedicated teams assigned to execute the annual body of work in that area.

Beyond the manual, the Federal Reserve has also recently established an Office of the Operating Committee for the LISCC program that is tasked with working with each of the core program steering committees to further develop and distribute policies, procedures, and guidance for LISCC staff related to documentation and deliverable requirements; automated storage requirements for horizontal and firm-specific work documentation; supervisory cycle timing, planning, and deliverable requirements; and other

[1] Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 158, 39049 (proposed Aug. 17, 2017) (to be codified at 12 C.F.R. pts. 211 and 238).

3

areas. Throughout 2018, in support of the manual, we plan to issue operating manuals, policies, procedures, and other guidance for the day-to-day functioning of the program to ensure all LISCC program staff operate in an independent manner and consistent with the expectations of the LISCC program.

Monitor and Assess Implementation of LISCC Policies and Procedures

While the GAO's report acknowledges that internal reviews have been effective in identifying some issues regarding implementation of the LISCC program, it recommends that the Federal Reserve finalize and implement a mechanism to monitor and regularly assess Reserve Banks' implementation of LISCC policies and procedures. The Federal Reserve currently assesses the effectiveness of Reserve Bank supervision functions, including their adherence to System guidance, through a continuous oversight program. However, we recognize that, in this instance, the recommendation to formalize the monitoring and assessment of the LISCC program would provide greater assurance regarding the implementation of LISCC guidance. As noted in the report and discussed above, the Federal Reserve is in the process of augmenting the oversight program through the development of a LISCC-specific oversight framework that will encompass all Board and Reserve Bank LISCC activities, and provide for a comprehensive assessment of program effectiveness. We plan to complete this framework by year-end 2017 and begin implementation in 2018.

Streamline Conflicts of Interest Reviews

The report recommends that the Federal Reserve streamline its conflict-of-interest disclosure review process for participants in the LISCC program by, for example, storing disclosure information in compatible electronic systems. The report indicates that different parties involved in the conflicts review process collect and store information differently, which may hinder how efficiently and effectively this information is used in the review process. As described in the report, our objective is to effectively identify and manage conflicts of interest when supervisory staff join the Federal Reserve, during their tenure as supervisors, and when they leave the organization. We appreciate the observations provided in the report and intend to explore options for streamlining our approach, to include, among other things, assessing the feasibility of integrating existing systems.

Systematically Collect Pre- and Post-Employment Data

4

The Federal Reserve has implemented policies intended to mitigate the risk that an employee may be influenced by prior employment or the prospect of future employment and place his or her private interests ahead of the organization's supervisory mission. For instance, the Federal Reserve recently broadened the scope of post-employment restrictions applicable to senior examiners. The report recommends that the Federal Reserve could do more to mitigate this risk, specifically by systematically collecting pre-and post-employment information from supervisory employees. We agree that "revolving door" risk can pose a threat to supervisory objectivity and we will assess how existing practices could be modified to ensure a more systematic approach to collecting pre- and post-employment data, including through the use of electronic systems. With respect to the collection of post-employment information, it is important to note that departing employees have no obligation to identify their future employer.

Conduct a Periodic Self-assessment of Ethics Programs, Policies, and Procedures That Apply to LISCC Program Participants

The Board agrees that self-assessment plays an important role in identifying potential problems and ensuring a robust and healthy ethics program. Accordingly, for years the Board's ethics office has continuously performed various modes of self-evaluation that the Office of Government Ethics ("OGE") has confirmed satisfy its recently-issued regulatory requirement, which went into effect on January 1, 2017. For example, the Board's ethics office staff hold weekly ethics meetings during which data regarding the status of various program requirements is analyzed; generate monthly (weekly or daily during financial disclosure season) reports of the financial disclosure, post-employment counseling, and ethics training data contained in its electronic tracking database to confirm that all employees required to file forms or receive training have done so; collect survey data from Human Resources regarding the effectiveness of new employee ethics training; review the number of employees who read the periodic "Ethics Reminders" posted on the Board's intranet site; attend monthly meetings with other agencies' ethics program staff to discuss and compare ethics programs and issues; and regularly collect and analyze program data to respond to OGE questionnaires. In addition, the Board's ethics office has approached the Division of Supervision & Regulation to explore potential avenues for conducting periodic reviews of the ethics program as applied to LISCC participants.

5

Develop ERM Framework to Include a Component to Identify and Assess Risks of Regulatory Capture across the LISCC Program

The Board believes that we are effectively managing the risks of regulatory capture in the supervision of large financial institutions. The day-to-day management of these risks has been, and will continue to be, with the processes the Board and System have in place under the LISCC program. The enterprise risk management ("ERM") framework being developed by the Board will provide a strategic view for comprehensively managing all material risks faced by the Board, providing additional executive attention for their management. Because the Board believes that regulatory capture risk is being effectively managed already, the Board does not expect that its ERM framework will significantly alter the way we manage the risk of regulatory capture.

I have consulted with the Chief Operating Officer and General Counsel of the Board on this reply to your report, and they concur in this response. We appreciate the GAO's review of the Federal Reserve's processes for mitigating threats to independence for supervisory staff and for the opportunity to comment.

Sincerely,

Michael S. Gibson

6

Appendix VI: GAO Contact and Acknowledgments

GAO Contact

Lawrance L. Evans, Jr. (202) 512-8678, evansL@gao.gov

Staff Acknowledgments

In addition to the contact named above, John Forrester (Assistant Director), Akiko Ohnuma (Analyst in Charge), Jordan Anderson, Bethany Benitez, Abby Brown, Rudy Chatlos, Rachel DeMarcus, Catherine Gelb, Farrah Graham, John Karikari, Jim Lager, Marc Molino, Roberto Pinero, Jennifer Schwartz, and Melia Ungson made key contributions to this report.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's website (http://www.gao.gov). Each weekday afternoon, GAO posts on its website newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to http://www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's website, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

Connect with GAO

Connect with GAO on Facebook, Flickr, LinkedIn, Twitter, and YouTube. Subscribe to our RSS Feeds or E-mail Updates. Listen to our Podcasts. Visit GAO on the web at www.gao.gov and read The Watchblog.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Website: http://www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Katherine Siggerud, Managing Director, siggerudk@gao.gov, (202) 512-4400, U.S. Government Accountability Office, 441 G Street NW, Room 7125, Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

Strategic Planning and External Liaison

James-Christian Blockwood, Managing Director, spel@gao.gov, (202) 512-4707
U.S. Government Accountability Office, 441 G Street NW, Room 7814, Washington, DC 20548

Please Print on Recycled Paper.