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# FEDERAL RESERVE SYSTEM

## Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance

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# Highlights

Highlights of GAO-11-696, a report to congressional addressees

### Why GAO Did This Study

The Dodd-Frank Wall Street Reform and Consumer Protection Act directed GAO to conduct a one-time audit of the emergency loan programs and other assistance authorized by the Board of Governors of the Federal Reserve System (Federal Reserve Board) during the recent financial crisis. This report examines the emergency actions taken by the Federal Reserve Board from December 1, 2007, through July 21, 2010. For each of these actions, where relevant, GAO's objectives included a review of (1) the basis and purpose for its authorization, as well as accounting and financial reporting internal controls; (2) the use, selection, and payment of vendors; (3) management of conflicts of interest; (4) policies in place to secure loan repayment; and (5) the treatment of program participants. To meet these objectives, GAO reviewed program documentation, analyzed program data, and interviewed officials from the Federal Reserve Board and Reserve Banks (Federal Reserve System).

### What GAO Recommends

GAO makes seven recommendations to the Federal Reserve Board to strengthen policies for managing noncompetitive vendor selections, conflicts of interest, risks related to emergency lending, and documentation of emergency program decisions. The Federal Reserve Board agreed that GAO's recommendations would benefit its response to future crises and agreed to strongly consider how best to respond to them.

View GAO-11-696 or key components.
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### What GAO Found

On numerous occasions in 2008 and 2009, the Federal Reserve Board invoked emergency authority under the Federal Reserve Act of 1913 to authorize new broad-based programs and financial assistance to individual institutions to stabilize financial markets. Loans outstanding for the emergency programs peaked at more than $1 trillion in late 2008. The Federal Reserve Board directed the Federal Reserve Bank of New York (FRBNY) to implement most of these emergency actions. In a few cases, the Federal Reserve Board authorized a Reserve Bank to lend to a limited liability corporation (LLC) to finance the purchase of assets from a single institution. In 2009 and 2010, FRBNY also executed large-scale purchases of agency mortgage-backed securities to support the housing market. The table below provides an overview of all emergency actions covered by this report. The Reserve Banks' and LLCs' financial statements, which include the emergency programs' accounts and activities, and their related financial reporting internal controls, are audited annually by an independent auditing firm. These independent financial statement audits, as well as other audits and reviews conducted by the Federal Reserve Board, its Inspector General, and the Reserve Banks' internal audit function, did not report any significant accounting or financial reporting internal control issues concerning the emergency programs.

The Reserve Banks, primarily FRBNY, awarded 103 contracts worth $659.4 million from 2008 through 2010 to help carry out their emergency activities. A few contracts accounted for most of the spending on vendor services. For a significant portion of the fees, program recipients reimbursed the Reserve Banks or the fees were paid from program income. The Reserve Banks relied more extensively on vendors for programs that assisted a single institution than for broad-based programs. Most of the contracts, including 8 of the 10 highest-value contracts, were awarded noncompetitively, primarily due to exigent circumstances. These contract awards were consistent with FRBNY's acquisition policies, but the policies could be improved by providing additional guidance on the use of competition exceptions, such as seeking as much competition as practicable and limiting the duration of noncompetitive contracts to the exigency period. To better ensure that Reserve Banks do not miss opportunities to obtain competition and receive the most favorable terms for services acquired, GAO recommends that they revise their acquisition policies to provide such guidance.

FRBNY took steps to manage conflicts of interest for its employees, directors, and program vendors, but opportunities exist to strengthen its conflict policies. In particular, FRBNY expanded its guidance and monitoring for employee conflicts, but new roles assumed by FRBNY and its employees during the crisis gave rise to potential conflicts that were not specifically addressed in the Code of Conduct or other FRBNY policies. For example, FRBNY's existing restrictions on its employees' financial interests did not specifically prohibit investments in certain nonbank institutions that received emergency assistance. To manage potential conflicts related to employees' holdings of such investments, FRBNY relied on provisions in its code that incorporate requirements of a federal criminal conflict of interest statute and its regulations. Given the magnitude of the assistance and the public's heightened attention to the appearance of conflicts related to Reserve Banks' emergency actions, existing standards for managing employee conflicts may not be sufficient to avoid the appearance of a conflict in all situations. As the Federal Reserve System considers revising its conflict policies given its new authority to regulate certain nonbank institutions, GAO recommends it consider how potential conflicts from emergency lending could inform any changes. FRBNY managed vendor conflict issues through contract protections and actions to help ensure compliance with relevant contract provisions, but these efforts had limitations. For example, while FRBNY negotiated important contract protections, such as requirements for ethical walls, it lacked written guidance on protections that should be included to help ensure vendors fully identify and remediate conflicts. Further, FRBNY's on-site reviews of vendor compliance in some instances occurred as far as 12 months into a contract. FRBNY implemented a new vendor management policy but has not yet finalized another new policy with comprehensive guidance on vendor conflict issues. GAO recommends FRBNY finalize this new policy to reduce the risk that vendors may not be required to take steps to fully identify and mitigate all conflicts.

While the Federal Reserve System took steps to mitigate risk of losses on its emergency loans, opportunities exist to strengthen risk management practices for future crisis lending. The Federal Reserve Board approved program terms and conditions designed to mitigate risk of losses and one or more Reserve Banks were responsible for managing such risk for each program. Reserve Banks required borrowers under several programs to post collateral in excess of the loan amount. For programs that did not have this requirement, Reserve Banks required borrowers to pledge assets with high credit ratings as collateral. For loans to specific institutions, Reserve Banks negotiated loss protections with the private sector and hired vendors to help oversee the portfolios that collateralized loans. The emergency programs that have closed have not incurred losses and FRBNY does not project any losses on its outstanding loans. To manage risks posed by these new lending activities, Reserve Banks implemented new controls and FRBNY strengthened its risk management function. In mid-2009, FRBNY created a new risk management division and enhanced its risk analytics capabilities. But neither FRBNY nor the Federal Reserve Board tracked total exposure and stressed losses that could occur in adverse economic scenarios across all emergency programs.  Further, the Federal Reserve System's procedures for managing borrower risks did not provide comprehensive guidance for how Reserve Banks should exercise discretion to restrict program access for higher-risk borrowers that were otherwise eligible for the Term Auction Facility (TAF) and emergency programs for primary dealers. To strengthen practices for managing risk of losses in the event of a future crisis, GAO recommends that the Federal Reserve System document a plan for more comprehensive risk tracking and strengthen procedures to manage program access for higher-risk borrowers.

While the Federal Reserve System took steps to promote consistent treatment of eligible program participants, it did not always document processes and decisions related to restricting access for some institutions. Reserve Banks generally offered assistance on the same terms to institutions that met announced eligibility requirements. For example, all eligible borrowers generally could borrow at the same interest rate and against the same types of eligible collateral. Reserve Banks retained and exercised discretion to restrict or deny program access for institutions based on supervisory or other concerns. For example, due to concerns about their financial condition, Reserve Banks restricted TAF access for at least 30 institutions. Further, in a few programs, FRBNY placed special restrictions, such as borrowing limits, on eligible institutions that posed higher risk of loss. Because Reserve Banks lacked specific procedures that staff should follow to exercise discretion and document actions to restrict higher-risk eligible borrowers for a few programs, the Federal Reserve System lacked assurance that Reserve Banks applied such restrictions consistently. Also, the Federal Reserve Board did not fully document its justification for extending credit on terms similar to the Primary Dealer Credit Facility (PDCF) to affiliates of a few PDCF-eligible institutions and did not provide written guidance to Reserve Banks on types of program decisions that would benefit from consultation with the Federal Reserve Board. In 2009, FRBNY allowed one entity to continue to issue to the Commercial Paper Funding Facility, even though a change in program terms by the Federal Reserve Board likely would have made it ineligible. FRBNY staff said they consulted the Federal Reserve Board regarding this situation, but did not document this consultation and did not have any formal guidance as to whether such continued use required approval by the Federal Reserve Board. To better ensure an appropriate level of transparency and accountability for decisions to extend or restrict access to emergency assistance, GAO recommends that the Federal Reserve Board set forth its process for documenting its rationale for emergency authorizations and document its guidance to Reserve Banks on program decisions that require consultation with the Federal Reserve Board.

**List of Federal Reserve Emergency Programs and Assistance Covered by this GAO Review**

| Dollars in billions | | | |
|---|---|---|---|
| **Programs and Assistance** | **Peak dollar amount outstanding** | **Balance as of 6/29/11** | **Description** |
| **Broad-based programs** | | | |
| TAF - Term Auction Facility (Dec. 12, 2007–Mar. 8, 2010) | $493 | $0 | Auctioned one-month and three-month discount window loans to eligible depository institutions |
| Dollar Swap Lines (Dec. 12, 2007–Feb. 1, 2010[a]) | 586 | 0 | Exchanged dollars with foreign central banks for foreign currency to help address disruptions in dollar funding markets abroad |
| TSLF - Term Securities Lending Facility (Mar. 11, 2008–Feb. 1, 2010) | 236 | 0 | Auctioned loans of U.S. Treasury securities to primary dealers against eligible collateral |
| PDCF - Primary Dealer Credit Facility (Mar. 16, 2008–Feb. 1, 2010) | 130 | 0 | Provided overnight cash loans to primary dealers against eligible collateral |
| AMLF - Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Sept. 19, 2008–Feb. 1, 2010) | 152 | 0 | Provided loans to depository institutions and their affiliates to finance purchases of eligible asset-backed commercial paper from money market mutual funds |
| CPFF - Commercial Paper Funding Facility (Oct. 7, 2008–Feb. 1, 2010) | 348 | 0 | Provided loans to a special purpose vehicle to finance purchases of new issues of asset-backed commercial paper and unsecured commercial paper from eligible issuers |
| MMIFF - Money Market Investor Funding Facility (Oct. 21, 2008 but never used) | No loans provided | 0 | Created to finance the purchase of eligible short-term debt obligations held by money market mutual funds |
| TALF - Term Asset-Backed Securities Loan Facility (Nov. 25, 2008–June 30, 2010) | 48 | 13 | Provided loans to eligible investors to finance purchases of eligible asset-backed securities |
| **Assistance to Individual Institutions** | | | |
| Bear Stearns Companies, Inc. acquisition by JP Morgan Chase & Co. (JPMC) | | | |
| Bridge Loan (Mar. 14, 2008–Mar. 17, 2008) | 13 | 0 | Overnight loan provided to JPMC subsidiary, with which this subsidiary made a direct loan to Bear Stearns Companies, Inc. |
| Maiden Lane (Mar. 16, 2008) | 29 | 22 | Special purpose vehicle created to purchase approximately $30 billion of Bear Stearns's mortgage-related assets |
| AIG Assistance | | | |
| Revolving Credit Facility (Sept. 16, 2008–Jan. 14, 2011) | 72 | 0 | Revolving loan for the general corporate purposes of AIG and its subsidiaries, and to pay obligations as they came due |
| Securities Borrowing Facility (Oct. 8, 2008–Dec. 12, 2008) | 21 | 0 | Provided collateralized cash loans to reduce pressure on AIG to liquidate residential mortgage-backed securities (RMBS) in its securities lending portfolio |
| Maiden Lane II (Nov. 10, 2008) | 20 | 9 | Special purpose vehicle created to purchase RMBS from securities lending portfolios of AIG subsidiaries |
| Maiden Lane III (Nov. 10, 2008) | 24 | 12 | Special purpose vehicle created to purchase collateralized debt obligations on which AIG Financial Products had written credit default swaps |
| Life Insurance Securitization (March 2, 2009 but never implemented) | Not used | 0 | Authorized to provide credit to AIG that would be repaid with cash flows from its life insurance businesses |
| Loans to affiliates of some primary dealers (Sept. 21, 2008–Feb. 1, 2010) | 41 | 0 | Loans provided to broker-dealer affiliates of four primary dealers on terms similar to those for PDCF |
| Citigroup Inc. lending commitment (Nov. 23, 2008–Dec. 2009) | No loans provided | 0 | Commitment to provide non-recourse loan to Citigroup against ring-fence assets if losses on asset pool reached $56.2 billion |
| Bank of America Corporation lending commitment (Jan. 16, 2009–Sept. 2009) | No loans provided | 0 | Commitment to provide non-recourse loan facility to Bank of America if losses on ring fence assets exceeded $18 billion (agreement never finalized) |
| **Open Market Operations** | | | |
| Agency Mortgage-Backed Securities purchase program (Nov. 25, 2008–Mar. 31, 2010) | $1,250 total purchases | $909 (remaining principal balance) | Purchased agency mortgage-backed securities to provide support to mortgage and housing markets and to foster improved conditions in the financial markets more generally |

Source: Federal Reserve Board Statistical Release H.4.1 and Federal Reserve Board documents

Note: Dates in parentheses are the program announcement dates, and where relevant, the date the program or assistance was closed or terminated. On October 3, 2008, the Federal Reserve Board authorized the Direct Money Market Mutual Fund Lending Facility (DMLF) and rescinded this authorization one week later. DMLF was not implemented.

[a]Some dollar swap lines reopened in May 2010.