

GAO

Testimony

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FEDERAL RESERVE
SYSTEM AUDITS

Restrictions on GAO's Access

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Mr. Chairman and Members of the Committee:

We are pleased to be here to discuss the limits of our audit authority over the Federal Reserve System. My remarks principally will concern the provisions of section 3 of H.R. 28 which would remove all restrictions on our authority to examine Federal Reserve activities. Currently, we lack audit authority over the Federal Reserve's monetary policy, foreign transactions, and Federal Open Market Committee (FOMC) operations.

In responding to the Committee's request, I will first describe our existing authority and some of the work we have done under this authority. I will then examine the implications of removing all restrictions on our authority, with specific reference to several topics the Committee asked us to address. Finally, I will discuss certain safeguards that we feel would be appropriate to adopt if restrictions on our authority are to be removed.

The question of whether to lift the statutory constraints on our authority to audit the Federal Reserve System ultimately depends on what Congress wants us to do. Our access needs to be commensurate with the types of audits Congress expects us to perform.

GAO AUTHORITY UNDER THE BANKING AGENCY
AUDIT ACT AND WORK AT THE FEDERAL RESERVE

We derive our Federal Reserve audit authority from the Federal Banking Agency Audit Act of 1978. This act was passed after we did a special congressionally mandated study of the supervisory activities of all of the federal bank regulatory agencies. Before the act, our work at the Federal Reserve was mainly limited to audits of the fiscal agent functions performed by Federal Reserve banks for the Department of the Treasury. We did this work under our authority to audit the Treasury.

Although the act significantly expanded our access to the Federal Reserve System and the other bank regulatory agencies, it precluded us from auditing activities related to monetary policy, foreign transactions, and the FOMC. The exact wording of the limitation is set out in Appendix 1. The act also prohibited us from disclosing certain information identifying open financial institutions and customers. Appendix 2 describes these prohibitions in greater detail.

The act does not require us to perform any particular type of audit. This means, as is true with most of our work, that our audits are determined largely by specific congressional requests, or by our discretion under our basic legislative authority. As appropriate, we coordinate our activities with the Federal Reserve's Office of Inspector General.

Notwithstanding the limitations on our authority, in the 15 years since the act was passed, we have audited many aspects of the Federal Reserve System in areas in which our access has not been restricted. I would like to mention some of the studies we have done in a few key areas:

- Bank supervision and regulation. Much of our work in this area has included the Federal Reserve along with the other federal bank regulators. For example, our analysis of bank failures and supervisory efforts to deal with problem banks led to our recommendations that legislative efforts were needed to require prompt corrective action and other regulatory reforms. More recently, our work on examinations of banks and bank holding companies has underscored the need for the Federal Reserve and other regulators to strengthen their efforts to assess the quality of the management systems banks use to monitor and control risk. We have also studied how risk-based capital standards have been implemented in different countries around the world. Work that is unique to the Federal Reserve has included studies documenting the scope of the activities of the securities subsidiaries of bank holding companies that are supervised by the Federal Reserve under section 20 of the Glass-Steagall act. In a recent study, we pointed out that the Federal Reserve had not yet implemented the mandate in the Foreign Bank Supervision Enforcement Act of 1991 to charge for its examinations of foreign banks operating in the United States.
- Payment system activities. We have conducted several studies of Federal Reserve pricing of payments services under the Monetary Control Act of 1980. Our recommendations have, I believe, increased the Federal Reserve's awareness of how it competes with private sector banks in providing these services. We have also evaluated the implementation of the legislation on accelerated collection of checks and have made recommendations on ways to improve security procedures in Fed wire transactions.
- Government securities activities. Work we have done on the government securities market has, I believe, contributed to greater openness in the primary dealer system, particularly concerning the disclosure of price information. Our audits have also contributed to pending legislation that would help protect customers and maintain the integrity of this very important market.

Our current work that involves the Federal Reserve, either exclusively or as part of a study of all bank regulatory agencies, includes (1) studies of regulatory burden, (2) implementation of major provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991, (3) analysis of the risks and benefits of interstate banking, (4) the regulation

and supervision of derivative products, (5) an analysis of the banking industry's activities in mutual funds, (6) loan loss reserving by banks, (7) review of efforts to ensure a safe and sound international banking system through coordination among national regulators, and (8) analyses of the expenses and revenues of the Federal Reserve System as they affect the federal budget.

IMPLICATIONS OF H.R. 28

As I have indicated, section 3 of H.R. 28 would remove all of the restrictions on our authority to examine Federal Reserve activities. This would provide us with full access to FOMC transactions; to transactions for or with foreign central banks, governments, and international financing organizations; and to deliberations, decisions, and actions on monetary policy matters, including discount window operations, member bank reserves, and open market operations.

In considering the implications of removing restrictions, it is useful to look more closely at the types of work we do. Our audit work can be viewed as falling into two broad categories-- financial audits and performance audits. A financial audit basically sets out to verify the financial reports of an entity, including its balance sheet, income statement, and cash flows. Our financial audits also assess the systems of internal controls established by the audited institution and the institution's compliance with specific financial requirements. Performance audits are designed to assess whether an entity is achieving its stated goals, and include questions of efficiency, effectiveness, and compliance with related laws and regulations. Appendix 3 describes these types of audits in more detail.

Turning first to financial audits, the nature and volume of transactions associated with the day-to-day operations of the Federal Reserve System make financial auditing extremely important. For example, in providing services to the banking system in 1992, the Federal Reserve processed

- 20 billion checks with a value of \$14 trillion;
- 20 billion pieces of currency with a value of \$278 billion;
- 68 million electronic fund transfers for \$199 trillion; and
- 76 million issuances, redemptions, and exchanges of U.S. government securities with a value of \$143 trillion.

In 1992, the FOMC also purchased, sold, or exchanged approximately \$350 billion of securities, engaged in over \$750 billion in repurchase agreements, and conducted almost \$3

trillion in matched transactions.¹ All told, about 90 percent of the \$368 billion in assets on the combined balance sheet of the Federal Reserve banks consist of assets acquired as a result of FOMC or foreign exchange operations.² Passage of H.R. 28 would allow us access to the full range of Federal Reserve System transactions.

The nature and extent of auditing that presently takes place within the Federal Reserve System is a factor that Congress may want to consider in deciding whether to expand our authority. The Board of Governors examines the 12 reserve banks and the FOMC annually. Such examinations, which involve both financial statement audits and compliance reviews that concentrate on financial controls, are conducted by the Division of Federal Reserve Bank Operations. The Board's financial examination program involves a full-time staff of about 22 people at an annual cost of approximately \$2 million. Each Federal Reserve bank also has an internal audit department, which--in the case of the New York Federal Reserve Bank--includes examination of the activities of the FOMC.

The Board's financial examination program has been subject to some outside scrutiny by public accounting firms. Each year, the Board contracts with an outside accounting firm to review the examination program's operations. In the last letter the Board received, the outside accounting firm said that the financial examination program was effectively meeting its objectives and made some suggestions for improvement.³

The Federal Reserve's Office of Inspector General, which has an annual budget of about \$3 million, is authorized to conduct its own financial and performance audits, although the Inspector General has indicated to Congress that there are some limitations

¹Repurchase agreements essentially are transactions by which the Federal Reserve buys or sells securities for specified periods of time, typically overnight or short terms. The agreements are used by the FOMC to adjust the level of reserves in the banking system. According to Federal Reserve officials, in matched transactions the Federal Reserve essentially executes transactions that have no net effects on bank reserves or the balance sheet of the FOMC. Matched transactions are conducted principally with foreign central banks.

²The assets, with amounts as of December 31, 1992, in billions of dollars shown in parentheses, are as follows: U.S. Treasury securities (\$302), federal agency obligations (\$6), and assets denominated in foreign currencies (\$22).

³Letter to the Federal Reserve Board dated December 27, 1991, from Coopers & Lybrand.

on the office's ability to gain independent access to the reserve banks. The Inspector General has just completed a report on the Board's financial examination program. This report raises some fundamental questions about the comparability of the financial examination program to an outside audit that is geared toward certification of financial statements.⁴ The report also contains recommendations for improving the financial examination program.

For some time, the financial statements of the Board of Governors itself have been audited by an outside public accounting firm. For 1993, the Board also contracted with independent accounting firms for audits at the Kansas City and Cleveland Federal Reserve Banks. As a part of this latter experiment with engaging outside auditors, the firms were asked to comment on those aspects of the Board's financial examination program concerned with both audit of financial statements and of compliance with board policies and controls. We understand that the reports from the outside auditors for 1993 have just recently been presented to the Board.

According to Federal Reserve officials, in the Kansas City and Cleveland Reserve Bank audits, some access issues were negotiated with the accounting firms. Although these audits did not involve a full-scale audit of the System Open Market Account or foreign accounts, we understand that the auditors required some testing of the systems in these areas to determine if the allocations of assets to the particular reserve banks were appropriate.

Section 3 of H.R. 28 proposes that all Federal Reserve banks, as well as the Board of Governors, be audited annually by an independent public accounting firm. I am inclined to believe that this outside review would be beneficial for both the Federal Reserve and the general public. If the restrictions on our access were removed, we would be better able to assess the quality of financial controls and auditing in the Federal Reserve System and make recommendations for improvements.

Concerning performance audits, I would like to discuss access issues by referring to the three areas we were asked to address in our testimony. These issues are

- the daily government securities auctions at the New York Federal Reserve Bank, which the Federal Reserve uses to manage the money supply;
- the Federal Reserve's interventions in foreign currency markets; and

⁴Office of the Inspector General, Board of Governors of the Federal Reserve System, Report on the Audit of the Board's Financial Examination Program, September 30, 1993.

-- safeguards in the auctions, and presumably foreign currency transactions as well, against the Federal Reserve's releasing inside information.

Our access restrictions would be a major limitation to studying any of these issues in a way that required us to analyze data on actual transactions. Although it would be necessary for us to consider the actual scope of a request before reaching a judgement in any particular case, we must recognize that the restrictions in the law are quite explicit. Therefore, with performance audits, as with financial audits, the major question is really what Congress wants us to do.

SAFEGUARDS

If Congress decides to remove the existing restrictions on our audit authority, we believe certain safeguards should be included in the legislation. These safeguards, which are similar to those that already exist under our present authority, should

- (1) prohibit us from disclosing the identity of foreign central banks or governments;
- (2) prohibit us from disclosing confidential documents and require safekeeping of confidential information; and
- (3) specify delays in our access to certain types of confidential information.

These safeguards are important because they make clear that removing our audit restrictions will not necessarily jeopardize the Federal Reserve's independence. For example, with these safeguards we could not use our expanded authority to undertake contemporaneous reviews of the Federal Reserve's monetary policy decisionmaking functions. Also, immediate disclosure of information about Federal Reserve decisions in a situation such as the stock market break of October, 1987, might not be in the public interest because it could disrupt the financial markets. Our role should be to make after-the-fact assessments of the Federal Reserve's performance, both in general and in problem situations.

SUMMARY

In summary, we have been able to do significant audits of the Federal Reserve, despite the existing limitations of our authority. Congress obviously must decide whether our audit authority should be expanded. However, if our authority is expanded, we believe measures should be included to protect against release of confidential documents and to prevent undue interference with the Federal Reserve's ongoing policymaking functions.

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This concludes my prepared statement. My colleagues and I would be pleased to answer questions.

Restrictions on GAO Audits Contained in the Federal Banking
Agency Audit Act⁵

Audits of the Federal Reserve Board and Federal Reserve banks may not include

- (1) transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization;
- (2) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;
- (3) transactions made under the direction of the Federal Open Market Committee; or
- (4) a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to items (1), (2), or (3).

⁵31 U.S.C, section 714(b). This section codifies a portion of section 2 of Public Law 95-320, July 21, 1978, which amended section 117 of the Accounting and Auditing Act of 1950.

Provisions in the Federal Banking Agency Audit Act Concerning
Disclosure of Information and Safekeeping of Records⁶

Except as provided in this subsection, an officer or employee of the General Accounting Office may not disclose information identifying an open bank, an open bank holding company, or a customer of an open or closed bank or bank holding company. The Comptroller General may disclose information related to the affairs of a closed bank or closed bank holding company identifying a customer of the closed bank or closed bank holding company only if the Comptroller General believes the customer had a controlling influence in the management of the closed bank or closed bank holding company or was related to or affiliated with a person or group having a controlling influence.

Except for the temporary removal of work papers of the Comptroller General that do not identify a customer of an open or closed bank or bank holding company, an open bank, or an open bank holding company, all work papers of the Comptroller General and records and property of or used by an agency that the Comptroller General possesses during an audit, shall remain in the agency. The Comptroller General shall prevent unauthorized access to records or property.

⁶Excerpts from 31 U.S.C. section 714 (c), (d).

Types of GAO Audits⁷FINANCIAL AUDITS

Financial statement audits determine (a) whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flow or changes in financial position in accordance with generally accepted accounting principles, (b) whether the entity has complied with laws and regulations for those transactions and events that may have a material effect on the financial statements, and (c) whether the internal controls were effective and met standards.

Other financial audits include determining (a) whether financial reports and related items, such as elements, accounts, or funds are fairly presented, (b) whether financial information is presented in accordance with established or stated criteria, and (c) whether the entity has adhered to specific financial compliance requirements.

Financial audits include an assessment of internal control risks related to the scope of the audits. In the internal control phase, the auditor should obtain evidence about the effectiveness of internal controls to (1) form an opinion on internal controls as of the end of the audit period and (2) assess control risk and the effectiveness of budget and compliance controls during the audit period. Control risk is a factor in determining the nature, timing, and extent of substantive procedures for the testing phase.

PERFORMANCE AUDITS

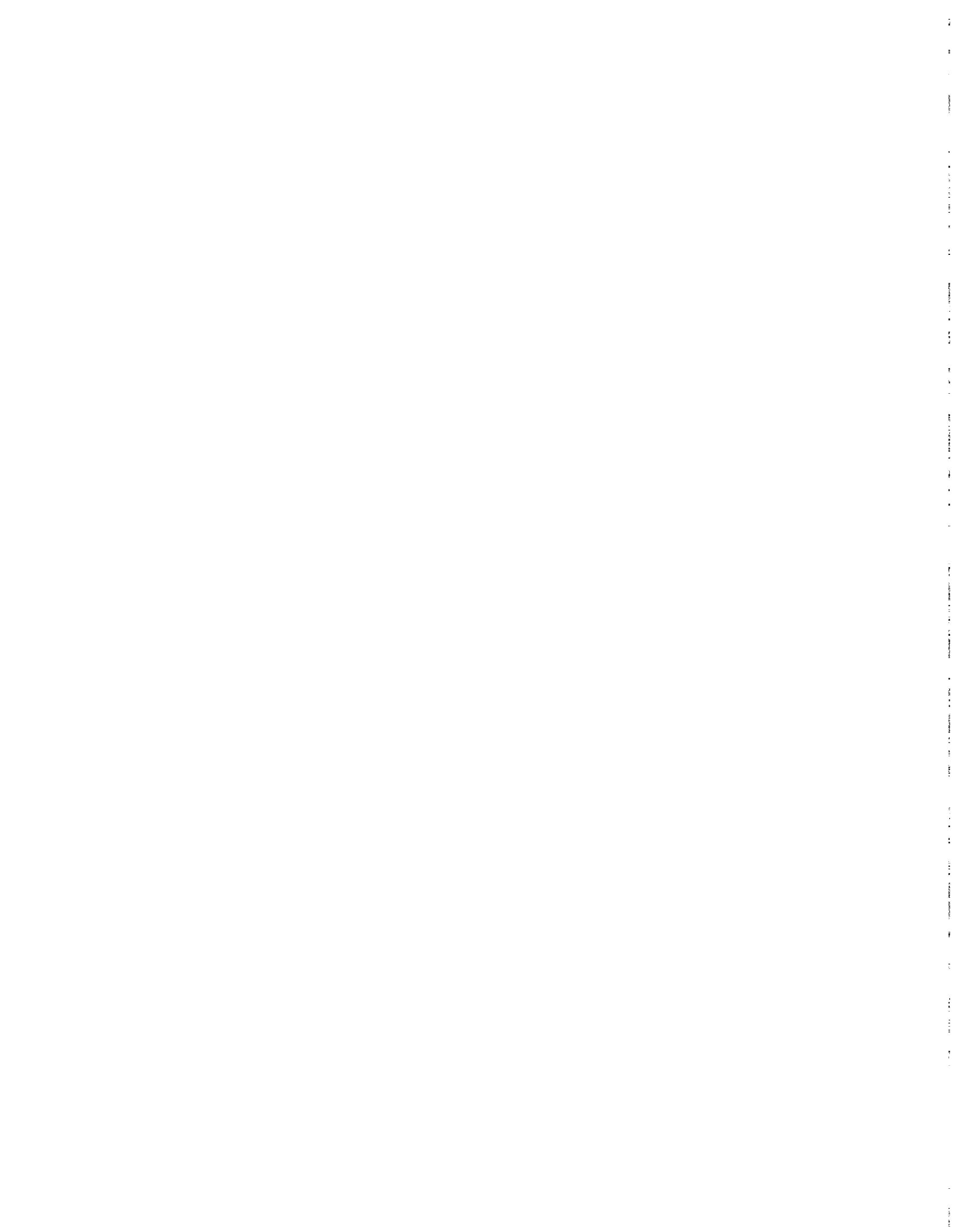
Economy and efficiency audits include determining (a) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (b) the causes of inefficiencies or uneconomical practices, and (c) whether the entity has complied with laws and regulations concerning matters of economy and efficiency.

Program audits include determining (a) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (b) the effectiveness

⁷These definitions are taken from Government Auditing Standards, U.S. General Accounting Office, 1988 revision, and the GAO Financial Audit Manual, June 1992.

of organizations, programs, activities, or functions, and (c) whether the entity has complied with laws and regulations applicable to the program.

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