U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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Comptroller General
of the United States

Accessible Version

June 3, 2022

The Honorable Jerome H. Powell
Chair
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave., NW
Washington, D.C. 20551

Priority Open Recommendations: Board of Governors of the Federal Reserve System

Dear Mr. Chairman:

The purpose of this letter is to provide an update on the overall status of the Board of Governors of the Federal Reserve System's (Federal Reserve) implementation of GAO's recommendations and to call your personal attention to open recommendations that should be given high priority.[1] In November 2021, we reported that on a government-wide basis, 76 percent of our recommendations made 4 years ago were implemented.[2] The Federal Reserve's implementation rate was 81 percent. As of March 2022, the Federal Reserve had 15 open recommendations. Fully implementing the open recommendations could significantly improve the Federal Reserve's efforts to more effectively oversee risks to consumers and the safety and soundness of the U.S. banking system.

Since our May 2021 letter, the Federal Reserve has not implemented our three priority recommendations, and we have not added any priority recommendations for this year. We ask your continued attention to the remaining three priority recommendations, which are related to financial technology (fintech) and stress testing. (See enclosure for the list of recommendations and actions needed to implement them.)

Financial technology.

In December 2018, we reported that the Federal Reserve, other federal banking regulators, and the Consumer Financial Protection Bureau (CFPB) needed to communicate the appropriate use of alternative data in the underwriting process with banks that engage in third-party relationships with fintech lenders. By implementing the recommendation, federally regulated banks may be better able to manage the risks associated with partnering with fintech lenders that use these data.

[1]Priority recommendations are those that GAO believes warrant priority attention from heads of key departments or agencies. They are highlighted because, upon implementation, they may significantly improve government operation, for example, by realizing large dollar savings; eliminating mismanagement, fraud, and abuse; or making progress toward addressing a high-risk or duplication issue.

[2]GAO, *Performance and Accountability Report: Fiscal Year 2021*, GAO-22-4SP (Washington, D.C.: Nov. 15, 2021).

Stress testing of banking institutions.

In November 2016, we reported that the Federal Reserve needed to improve its ability to manage model risk and stress testing of banking institutions. These improvements included designing and implementing a process to communicate information about the uncertainty surrounding post-stress capital ratio estimates during capital analysis and review deliberations. They also included implementing a process to articulate tolerance levels for key risks identified through sensitivity testing and for the degree of uncertainty in the projected capital ratios. Implementing the two recommendations in this area could help the Federal Reserve manage the risks in its models and account appropriately for uncertainty and sensitivity of model results.

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As you know, in March 2021, we issued our biennial update to our High-Risk-List, which identifies government operations with greater vulnerabilities to fraud, waste, abuse, and mismanagement or the need for transformation to address economy, efficiency, or effectiveness challenges.[3] One of our high-risk areas—modernizing the U.S. financial regulatory system—centers directly on the Federal Reserve.

Several other government-wide high-risk areas also have direct implications for the Federal Reserve and its operations. These include (1) improving the management of information technology acquisitions and operations, (2) improving strategic human capital management, (3) managing federal real property, (4) ensuring the cybersecurity of the nation,[4] and (5) government-wide personnel security clearance process. Progress on high-risk issues has been possible through the concerted actions and efforts of Congress, the Office of Management and Budget, and the leadership and staff in agencies, including within the Federal Reserve. In March 2022, we issued a report on key practices to successfully address high-risk areas, which can be a helpful resource as your agency continues to make progress to address high-risk issues.[5]

We are sending copies of this report to the Director of the Office of Management and Budget and appropriate congressional committees, including the Committees on Appropriations, Banking, Housing, and Urban Affairs, Budget, and Homeland Security and Governmental Affairs, United States Senate; and the Committees on Appropriations, Budget, Financial Services, and Oversight and Reform, House of Representatives. In addition, the report will be available on the GAO website at https://www.gao.gov.

I appreciate the Federal Reserve's commitment to these important issues. If you have any questions or would like to discuss any of the issues outlined in this letter, please do not hesitate to contact me or Daniel Garcia-Diaz, Managing Director, Financial Markets and Community Investment, at garciadiazd@gao.gov or 202-512-8678. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Our

[3]GAO, *High-Risk Series: Dedicated Leadership Needed to Address Limited Progress in Most High-Risk Areas*, GAO-21-119SP (Washington, D.C.: Mar. 2, 2021).

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

[5]GAO, *High-Risk Series: Key Practices to Successfully Address High-Risk Areas and Remove Them from the List*, GAO-22-105184 (Washington, D.C.: Mar. 3, 2022).

teams will continue to coordinate with your staff on all 15 open recommendations, as well as those recommendations in the high-risk areas for which the Federal Reserve has a leading role.

Thank you for your attention to these matters.

Sincerely yours,

Gene L. Dodaro
Comptroller General
of the United States

Enclosure – 1

cc: The Honorable Shalanda Young, Director, Office of Management and Budget

Enclosure I - Priority Open Recommendations to the Board of Governors of the Federal Reserve System (Federal Reserve)

Financial Technology

***Financial Technology: Agencies Should Provide Clarification on Lenders' Use of Alternative Data.* GAO-19-111. Washington, D.C.: December 19, 2018 (reissued with revisions on March 12, 2019).**

Recommendation: The Chair of the Board of Governors of the Federal Reserve System (Federal Reserve) should, in coordination with the other federal banking regulators and the Consumer Financial Protection Bureau (CFPB) and with input from relevant stakeholders, communicate in writing to banks that engage in third-party relationships with fintech lenders on the appropriate use of alternative data in the underwriting process, including issues to consider when selecting types of alternative data to use.
Action Needed: The Federal Reserve agreed with the recommendation. In December 2019, the Federal Reserve and other banking regulators issued an interagency statement on the use of alternative data in credit underwriting, but it does not provide firms or banks with specific direction on the appropriate use of those data. In July 2021, the banking regulators issued proposed third-party risk management guidance for comment, which discusses several issues associated with the use of alternative data. In December 2021, the banking regulators told us they were collaborating on the next steps for the proposed guidance on third-party risk management, but they did not have a time frame for completing the guidance.
To fully implement our recommendation, the Federal Reserve needs to provide—in coordination with other federal banking regulators and CFPB—finalized written communication that gives banks that engage in third-party relationships with fintech lenders specific direction on the appropriate use of alternative data in the underwriting process. Clear communication on appropriate use of alternative data would give fintech lenders greater certainty about their compliance with consumer protection laws and help banks manage the risks associated with partnering with fintech lenders.
Director: Michael E. Clements, Financial Markets and Community Investment
Contact information: clementsm@gao.gov or 202-512-8678

Stress Testing of Banking Institutions

***Federal Reserve: Additional Actions Could Help Ensure the Achievement of Stress Test Goals.* GAO-17-48. Washington, D.C.: November 15, 2016.**

Recommendation: To improve the Federal Reserve's ability to manage model risk and ensure that decisions based on supervisory stress test results are informed by an understanding of model risk, the Federal Reserve should design and implement a process to communicate information about the range and sources of uncertainty surrounding the post-stress capital ratio estimates to the Board during Comprehensive Capital Analysis and Review deliberations.
Action Needed: The Federal Reserve agreed with the recommendation. In January 2019, it initiated a project to design and implement a process for communicating uncertainty surrounding the post-stress capital ratio estimates. To fully implement our recommendation, the Federal Reserve needs to complete its process for communicating uncertainty surrounding the post-stress capital ratio estimates to the governors of the Federal Reserve. Until this process is completed, the Federal Reserve may miss important connections between elements of component models, which in turn may limit understanding of risks inherent in their modeling choices.

Recommendation: To improve the Federal Reserve's ability to manage model risk and ensure that decisions based on supervisory stress test results are informed by an understanding of model risk, the Federal Reserve should design and implement a process for the Board and senior staff to articulate tolerance levels for key risks identified through sensitivity testing and for the degree of uncertainty in the projected capital ratios.
Action Needed: The Federal Reserve agreed with the recommendation. In February 2022, the Federal Reserve provided information about its process to communicate model risk and approve supervisory stress test models. To fully implement our recommendation, the Federal Reserve needs to complete this process. Without assessing risks to the post-stress capital ratios posed by the Federal Reserve's approach to modeling, the Federal Reserve may limit its ability to understand, communicate, and manage the risks and reliability of its supervisory stress test results.

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

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(Job Code: 105605)