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"The Role of Inspectors General: Minimizing and Mitigating Waste, Fraud, and Abuse"

Statement of

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Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee on Oversight and Investigations, House Committee on Financial Services, I appreciate the opportunity to testify today about the ongoing efforts of the Office of Inspector General (OIG) of the Board of Governors of the Federal Reserve System (Board) in minimizing and mitigating waste, fraud, and abuse, including how the mandated material loss reviews (MLRs) affect our efforts to strengthen oversight and accountability to the Congress and the public.

Overview of the Federal Reserve System

The Federal Reserve System—the nation's central bank—consists of the Board of Governors in Washington, D.C., the twelve Federal Reserve Banks with their twenty-five Branches distributed throughout the nation, the Federal Open Market Committee (FOMC), and three advisory groups—the Federal Advisory Council, the Consumer Advisory Council, and the Thrift Institutions Advisory Council. The System was created in 1913 by Congress to establish a safe and flexible monetary and banking system, and to maintain a broad perspective on economic activity in all parts of the country. Over the years, Congress has given the Federal Reserve more authority and responsibility for achieving broad national economic and financial objectives. The Federal Reserve is "independent within government."

While the Board is an agency of the federal government, the Federal Reserve Banks combine public and private elements. The twelve Reserve Banks serve as the "operating arms" of the central banking system. Each Reserve Bank has its own board of nine directors chosen from outside the Bank, as provided by law. The boards of the Reserve Banks are intended to represent a cross-section of banking, commercial, agricultural, industrial, and public sector interests within the Federal Reserve District. In 2008, the twelve Reserve Banks collectively had about 19,000 authorized positions and a budget of $3.067 billion. The network of twelve banks and their branches carry out a variety of System functions, including operating payment systems, distributing the nation's currency and coin, and supervising and regulating member banks and bank holding companies.

The Board's OIG: Mission, Staffing, and Priorities

The Board's OIG was voluntarily established in July 1987, and became a statutory OIG pursuant to the passage of the Inspector General Act Amendments of 1988, which amended the Inspector General Act of 1978 (IG Act). Consistent with the IG Act, as amended, our office conducts independent and objective audits, inspections, evaluations, and investigations of the Board's programs and operations to promote economy, efficiency and effectiveness, and to prevent and detect fraud, waste, and abuse. Our work spans the Board's mission areas, including supervision and regulation, oversight of Reserve Banks, and management of the Board's financial resources, human resources, facilities, security, and information technology resources. To achieve our mission, the OIG issued a Strategic Plan for 2008 – 2011 that sets a results-oriented, risk-focused vision for our office centered on three primary goals: meet our statutory and legislatively-mandated requirements, target areas of greatest risk, and enhance the OIG's internal operations and communications.

The Federal Reserve OIG is faced with various strategic challenges, as our office carries out its legislatively-mandated responsibilities, while addressing significant and rapid changes in the financial sector. We continue to build our staff resources and expand our expertise to meet these new demands. Currently, we have thirty-seven authorized positions: twenty-three auditors, five investigators, three information technology staff, three attorneys, and three administrative staff members. A 20 percent budget increase was just approved in April, bringing our authorized staffing level for the remainder of 2009 to 45 positions: twenty-nine auditors, six investigators, four attorneys, three information technology staff, and three administrative staff members. This budget increase also includes funding for external consulting expertise and anticipated travel expenses. With these additions, our two-year, operating budget for 2008-2009 is about $14 million, or $7 million per year. We will reassess our needs later this year in preparation for the Board's 2010 to 2011 budget cycle, and will determine what further staffing and contracting budget increases are required to effectively and efficiently carry out our mission under the IG Act.

Balancing Priorities: Growing Mandatory Requirements

One of the greatest challenges facing our office is to effectively balance our workload to address critical issues, including the current financial crisis, in light of increasing statutory requirements. Currently, about 75 percent of our audit resources focus on mandatory work required by statute. Each year, the OIG contracts for and oversees the annual financial statement audits of the Board and the Federal Financial Institutions Examination Council, a formal, interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions. Furthermore, we are required to

- review failed depository institutions supervised by the Board that result in a material loss to the Deposit Insurance Fund, pursuant to Section 38(k) of the Federal Deposit Insurance Act (typically referred to as material loss reviews);
- perform an annual independent evaluation of the Board's information security program and practices, including the effectiveness of controls for selected information systems pursuant to the Federal Information Security Management Act (FISMA); and
- serve as the External Oversight Function for the Board's law enforcement program pursuant to the USA PATRIOT Act of 2001.

A significant and growing portion of our mandatory work centers on the Federal Reserve's role as the primary regulator of about 860 State Member Banks (SMB)--state-chartered, federally-insured commercial banks that are members of the Federal Reserve System. Section 38(k) of the Federal Deposit Insurance Act (FDIA) requires that we review failed SMBs that result in a material loss to the Deposit Insurance Fund (DIF). Under the current law, a loss is considered material if it is estimated to exceed $25 million or 2 percent of the institution's total assets. We are required to produce a report that includes possible suggestions for improvement in the Board's banking supervision practices within six months of the date that it becomes apparent that the loss will meet the materiality threshold.

MLRs of failed banks alone require a high percentage of OIG's audit resources. Each review involves a significant amount of data gathering and analysis, along with visits to Federal

Reserve Banks, the Federal Deposit Insurance Corporation's (FDIC) Division of Resolutions and Receivership, and the offices of State Banking Commissioners. Currently, nine staff members, almost 40 percent of our audit staff resources, are assigned to three MLRs. A fourth SMB failed in April, and we are shifting additional resources to this MLR because the projected losses exceed the current $25 million materiality threshold. The following table provides an overview of our current MLRs.

State Member Bank	**Total Assets (reported at the time of closure)**	**FDIC Projected Loss to the DIF**	**Date of Closure**
First Georgia Community Bank	$237.5 million	$72.2 million	December 2008
County Bank	$1.7 billion	$135 million	February 2009
Riverside Bank of the Gulf Coast	$539 million	$201.5 million	February 2009
Michigan Heritage Bank	$184.6 million	$71.3 million	April 2009

We are able to accommodate the current MLR workload through efficiencies gained by keeping teams relatively small (three or four staff members) to the extent possible, given the complexity of the work, and assigning each staff to work on more than one MLR. We are also leveraging information technology resources to streamline our data gathering and analysis efforts. If the current pace of State Member Bank failures continues and the materiality threshold remains at $25 million, our workload will be heavily concentrated on MLRs at a time when actions related to the current economic crisis demand our full attention.

Balancing Priorities: Addressing the Economic Crisis

The Federal Reserve has implemented a number of programs intended to support the liquidity of financial institutions and foster improved conditions in financial markets, and the OIG has initiated work to specifically address these actions and related aspects of the current economic crisis. First, we are reviewing the Board's role in a prominent Troubled Asset Relief Program (TARP) program: the Board's processing of applications from Board-supervised institutions for TARP funding under the Capital Purchase Program (CPP). In general, financial institutions request participation in the CPP by submitting an application to the appropriate federal banking agency, which reviews the application prior to Treasury's decision on whether a CPP request should be approved or denied. We are coordinating this work with the Government Accountability Office (GAO) and the FDIC OIG, as well as the Special Inspector General for TARP (SIGTARP). A public report on this audit will be issued this summer.

Second, we have initiated a broad review of the Board's oversight of the Federal Reserve's new lending facilities and special programs. In response to the financial crisis, the Board has approved the creation of various new lending facilities, such as the Term Asset-Backed Securities Loan Facility and the Commercial Paper Funding Facility. In addition, the Board has acted to provide loans to depository institutions, bank holding companies, securities dealers, and limited liability companies. Many of these new lending facilities and special programs have been established pursuant to the Board's authority under section 13(3) of the Federal Reserve Act, to authorize Federal Reserve Banks, in unusual and exigent circumstances, to extend credit to individuals, partnerships, and corporations that are unable to obtain adequate credit accommodations from other banking institutions. The objectives of this review are to obtain and analyze information on the various Federal Reserve lending facilities and special programs, and to identify risk areas for more detailed review. In addition, we are actively coordinating with SIGTARP on its TARP-related audits and investigations that also involve certain Federal Reserve programs.

Third, we have recently begun a review of the Federal Reserve's consolidated supervision of bank holding companies and financial holding companies. We are initially focusing on supervisory actions that address risk management issues facing holding companies, such as capital planning and capital adequacy, firm-wide risk identification, residential lending, counterparty credit risk, and commercial real estate concentrations. We will also address supervisory challenges that have emerged as a result of the current financial crisis, and review the Board's plans for supervising large financial firms that are in the process of becoming bank holding companies.

Fourth, our investigators are continuing to conduct criminal, civil, and administrative investigations to detect and prevent fraud, waste, and abuse in Board-related programs and operations. Our current ongoing criminal investigative activities involve leading or participating in a number of multi-agency investigations on a variety of topics, such as alleged bank fraud, terrorist financing, money laundering, and mortgage fraud. In addition, we continue to address allegations of wrongdoing related to the Board's programs and operations. We are participating in a nationwide effort by the FBI and the United States Attorney's Office to investigate and prosecute mortgage-related crimes. Joint federal and state task forces have been established in most of the states considered hotspots for such crimes. Most recently, we referred information related to mortgage fraud to the Detroit Mortgage Fraud Task Force and have been contacted by the FBI to assist with a South Florida mortgage fraud case. Both cases are a result of ongoing investigative activity related to the program and operations of the Federal Reserve Board. We plan to work these cases jointly with the FBI and will continue to coordinate with the appropriate task force offices.

Finally, our long-standing coordination with other financial regulatory IGs has taken on added significance during the current economic crisis and has been very effective in optimizing our coverage of important issues, while avoiding overlap and duplication of effort. For example, we joined other financial regulatory IGs to participate in the "TARP IG Council" to facilitate effective communication and coordination among those entities whose oversight responsibilities relate to or affect the Troubled Asset Relief Program. In addition, the Board's OIG has coordinated with the SIGTARP in forming the Term Asset-Backed Securities Loan Facility (TALF) Task Force. The TALF is a Federal Reserve program in which the Federal Reserve Bank of New York will make loans that are secured by asset-backed securities. In the event of default, TARP funds will provide a certain level of credit protection to the TALF.

The TALF Task Force is a proactive effort to prevent and detect fraud or abuse in the TALF. In addition to the Board's OIG and the SIGTARP, the TALF Task Force comprises the Federal Bureau of Investigation, the Financial Crimes Enforcement Network, U.S. Immigration and Customs Enforcement, the Internal Revenue Service, the Securities and Exchange Commission (SEC), and the U.S. Postal Inspection Service. Representatives from each agency participate in regular briefings about the TALF program. On March 27, 2009, the TALF Task Force held its first meeting during which the Federal Reserve Bank of New York's Compliance Section gave a detailed briefing of the TALF program. After the briefing, members of the task force met to devise strategies to identify areas of fraud vulnerability within the program. In a subsequent meeting on April 27, 2009, the SEC Compliance Section provided training on Hedge Funds and Securitization. The TALF Task Force will meet on a regular basis to coordinate investigative efforts and to provide training for agents and analysts with respect to the complex issues surrounding the program.

Balancing Priorities: Planning Future Work

Looking ahead, we are concerned that an increase in the number of MLRs would not only require us to shift resources from the important ongoing work related to the financial crisis, but would also significantly reduce our ability to initiate work in other emerging areas. For example, additional risk areas for possible audit and evaluation include detailed reviews of the Board's oversight of the internal controls over each of the Federal Reserve Systems' new lending facilities; the Board's roles and responsibilities for the Capital Assistance Program under the TARP; the Board's analysis of the systemic financial risk posed by large financial services companies, and the processes for responding to such risk; the Board's efforts to improve supervision over subprime lenders; the Board's supervision over de novo state member banks; and the Federal Reserve's examination practices for detecting violations of Regulation O, which restricts loans to bank's executive officers, directors, and principal shareholders.

Raising the Materiality Threshold Increases Flexibility

My colleagues and I are appearing before you today because we believe that the current threshold, which has been in effect for about 25 years, no longer provides a reasonable "materiality" benchmark for triggering an MLR of failed financial institutions. Congress enacted section 38(k) of the FDIA to ensure that regulators learn from weaknesses associated with supervising institutions that resulted in costly failures, and possibly avoid such failures in the future. Our experience from conducting six reviews of failed financial institutions over the past fifteen years reveals that MLRs can provide insights into the effectiveness of bank supervision, and point to potential improvements in supervisory processes, policies, and procedures. As we are actively conducting the current reviews, however, we are discovering clear and repetitive patterns regarding the cause of SMB failures, consistent with what was initially discerned at the time of the closure. In addition to providing limited new insights into the cause of the failure, the current $25 million threshold is leading to a disproportionate concentration of staff resources in one issue area, which affects our ability to cover other highly relevant emerging issues.

The proposed legislation that has been offered by Chairman Moore provides IGs with the flexibility required to continue meeting the intent of Section 38(k), while managing staff and other resources to ensure that other strategic objectives are fulfilled. Among other things, the legislation raises the MLR threshold to $400 million, thereby ensuring that the most substantial failures will continue to be reviewed. With respect to failures that do not meet the new threshold, the legislation provides IGs with the flexibility to conduct a review and prepare a report when warranted by unusual circumstances. We have, in the past, initiated a review of a financial institution with losses below even the $25 million threshold, when we believed it was warranted by unusual circumstances. We reviewed the failure of the Bank of Ephraim back in late 2005 because the failure involved fraud and, in our view, the projected loss, totaling 10 percent of the institution's assets, was relatively high.

We endorse the proposed legislation, and believe that it provides a reasonable approach to resolving the problems created by the current MLR threshold. We look forward to working with the Committee as it continues to develop a more efficient and effective legislative framework for conducting MLRs.

Oversight of the Federal Reserve System

In light of the financial crisis and the Board's related actions concerning lending facilities established under Section 13(3) of the Federal Reserve Act, this Subcommittee has asked about oversight of the Federal Reserve System, including the role of our office in providing this oversight. We must ensure that these unprecedented actions are subject to objective and independent oversight, while protecting and preserving the independence of the nation's central bank. To achieve this delicate balance requires understanding the current oversight of the Federal Reserve, the guiding principle of independence, and the authority of the OIG and GAO.

The Current Oversight Framework

The current oversight framework for the Federal Reserve is closely related to the structure of the Federal Reserve System which includes, as noted earlier, the Board of Governors in Washington, D.C., and the twelve Federal Reserve Banks with their twenty-five Branches distributed throughout the nation. The IG Act defines our role as the Inspector General for the Board of Governors. Pursuant to the IG Act, we may conduct audits related to any Board program or operation, including any Board delegated function conducted by a Federal Reserve Bank. This work includes assessing how well the Board carries out its general program oversight and supervision of the Reserve Banks. The OIG also contracts for and oversees the annual independent financial statement audit of the Board, which includes a report on compliance and on internal control over financial reporting in accordance with government auditing standards. Each OIG audit, inspection, and evaluation report—as well as informative summaries of any restricted report on specific information technology or other security-related processes or controls—are available on our public website at http://www.federalreserve.gov/oig/. In addition, we provide a complete summary of our work—including completed investigations and our legal and regulatory review—in our semiannual reports to Congress.

The Board contracts for the annual independent financial statement audit of the Reserve Banks, including an evaluation of internal controls over financial reporting. Each Reserve Bank publishes its audited financial statements, and the Board of Governors publishes the audited combined Reserve Bank financial statements and the Board's financial statements in its annual report to Congress. The independent public accounting firm also audited the financial statements of the consolidated limited liability companies (LLC) that the Federal Reserve established in 2008, and each of its reports are available on the Board's public website. The Reserve Banks, including the consolidated LLCs, are subject to oversight by the Board.

Each Reserve Bank has a General Auditor, who reports to the audit committee of the Bank's board of directors. This internal audit function is responsible for identifying risks and assessing the effectiveness of the Reserve Bank's risk management, control, and governance processes. As noted above, the Reserve Banks are subject to general supervision by the Board and, in certain matters, the Board's specific authorization or approval. The Board's oversight includes (1) assessing whether Reserve Bank strategies, objectives, and other matters are reasonable and consider all significant and relevant issues and (2) monitoring and reviewing ongoing operations and the implementation of major initiatives.

Furthermore, GAO has audit jurisdiction over the entire Federal Reserve System (both the Board of Governors and the Reserve Banks), as set forth in the Federal Banking Agency Audit Act. Moreover, SIGTARP has audit cognizance over TARP-related activities pertaining to the Federal Reserve.

Independence: A Guiding Principle

The Federal Reserve Act, which created the Board, was carefully crafted by the Congress to control monetary policy free from political influence. The legislative history of the Act and the writings of most economic scholars have reiterated the importance of this independence throughout history. This view was memorialized by Carter Glass, one of the primary framers of the Federal Reserve Act, on Page 43 of the House Report on the original Act. The Report states, "It cannot be too emphatically stated that the Committee regards the Federal Reserve Board as a distinctly nonpartisan organization whose functions are to be wholly divorced from politics."

To achieve the objective of independence, the Federal Reserve Act includes specific provisions designed to separate the Board from political pressure. The Banking Acts of 1933 and 1935 added provisions that gave the Board independence from the executive and legislative branches. These provisions help to ensure that the Board is independent within the federal government to a much greater extent than most other independent agencies. Section 10 of the Act provides that the Governors of the Federal Reserve Board are appointed by the President, with Senate confirmation, to serve fourteen-year, staggered terms. These terms are the longest statutory tenure in government, other than that of the Comptroller General, and are meant to span the timeframe of several administrations. The Federal Reserve Act also precludes the President from removing a Governor other than for cause. To further provide a high degree of independence from the executive branch, unlike most other government entities, no other officers or employees of the Board are politically appointed. Moreover, the provisions of the Federal Reserve Act insulate the Board from the influence of the legislature. Section 10 of the Act provides that the Board has independent authority to employ, set salaries, and exempt Board employees from the classified civil service. In addition, the operations and expenses of the Board are to be paid through assessments levied on the Federal Reserve Banks, as opposed to Congressional appropriations.

Authority of the OIG and GAO

While our office and GAO share oversight functions in certain areas, we also have certain noteworthy distinctions. The IG Act defines our role as the Inspector General for the Board of Governors. As such, the OIG may conduct audits and investigations related to any Board program or operation, including any Board-delegated function conducted by a Federal Reserve Bank. While we are not authorized to directly audit the Reserve Banks, our jurisdiction does include assessing how well the Board carries out its general program oversight and supervision of the Reserve Banks.

The Board's OIG is also authorized to audit and investigate the monetary policy programs and operations of the Board. However, this access can be limited, in part, by section 8G(g)(3) of the IG Act. These provisions state that the Board's IG may be placed under the direction and control of the Chairman of the Federal Reserve Board, if such control is necessary to prevent the disclosure of any information concerning decisions or deliberations on policy matters, the disclosure of which could reasonably be expected to have a significant influence on the economy or market behavior, or if such disclosure would constitute a serious threat to national security. In these cases, the agency head has the ability to prohibit such an audit or investigation, if the agency head determines that such prohibition is necessary to prevent significant impairment to the national interests of the United States. If such authority is exercised, the Chairman is required to provide his reasons, in writing, to the Board's IG, and the IG must then transmit a copy of these reasons to the relevant Congressional committees within thirty days of receipt. This provision has never been used by a Chairman of the Federal Reserve Board.

Under the Federal Reserve Act, the FOMC is an entity that is separate and distinct from the Board of Governors. In addition, the operations of the FOMC are not considered a "Board program or operation" for purposes of the IG Act. While we are not authorized to audit the FOMC's operations, our office may audit Board programs that support the FOMC. For example, the Board's IG can audit the use of Board funds, facilities, or personnel supporting the FOMC.

The Federal Banking Agency Audit Act, 31 U.S.C. 714, authorizes the GAO to audit both the Board and the Federal Reserve Banks. GAO may also carry out an onsite examination of an open insured bank or bank holding company, but only if the appropriate agency has consented in writing. However, under this Act, GAO is precluded from conducting an audit of the Board or the Reserve Banks concerning: (1) transactions for or with a foreign central bank, government of a foreign country, or non-private 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 FOMC; and (4) a part of a discussion or communication among or between members of the Board and officers and employees of the Federal Reserve System related to these areas.

As you know, GAO is a legislative branch agency that serves as the "investigative arm of Congress" and the "Congressional watchdog." It performs a substantial number of audits within the Federal Reserve System each year. These audits relate to the many functions performed by the Federal Reserve that have little direct relation to monetary policy. As of March 31, 2009, the Board reports that GAO had twenty engagements underway, seventeen of which were initiated by Congress.

Clearly, maintaining Federal Reserve independence, particularly in monetary policy matters, is a critical factor in assessing whether GAO's audit coverage should be expanded to include the areas that are currently restricted. The legislative history (Senate Report 723) of the Federal Banking Agency Act states that, "the Federal Reserve Board must be able to independently conduct the Nation's monetary policy and thus [the Act] excludes monetary policy deliberations, decisions or implementation from GAO audit." Federal Reserve independence continues to be an important consideration today.

Our office is uniquely positioned to conduct independent audits of the Federal Reserve. Congress' original decision to establish the Board's IG as a designated federal entity appointment versus a Presidential appointment was well-founded, considering the Board's independence and unique mission. Congress took a very measured and careful approach in establishing OIGs at designated federal entities (DFE) including the Board and, with the recent passage of the IG Reform Act, has continued to ensure the independence of DFE IGs. Over many years, our audits, inspections, evaluations, and investigations have been conducted without any regard to political influence, in full compliance with the IG Act and applicable standards.

Finally, our office currently has jurisdiction over the Board's oversight and supervision of the lending facilities that GAO is currently restricted from reviewing. We also actively coordinate with SIGTARP, as it audits and investigates TARP-related funding of certain Federal Reserve lending facilities. Our office is an independent, non-partisan, external audit entity that brings a depth of first-hand experience to the table.

Closing

In closing, Chairman Moore, I would like to thank you and the Subcommittee for holding this hearing on the role of Inspectors General in minimizing and mitigating waste, fraud, and abuse. Our office takes its mission and authority very seriously and remains committed to promoting integrity, efficiency, and effectiveness in the Board of Governors of the Federal Reserve System. I would be happy to respond to any questions that you or other members of the Subcommittee may have.