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Statement by

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Vice Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Currency and Housing

House of Representatives

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Mr. Chairman and members of the Subcommittee, I welcome the opportunity you have afforded me to present the views of the Board of Governors on H. R. 4316, a bill to authorize and direct the General Accounting Office to audit the Federal Reserve Board, the Federal Advisory Council, the Federal Open Market Committee, and Federal Reserve Banks and their branches.

The bill would authorize the General Accounting Office to conduct an annual audit, and in so doing, the Comptroller General would be accorded access to such records, including reports of examinations of member banks, from whatever source, as he finds necessary for the conduct of the audits. The Comptroller General would be required to submit a report of each audit to Congress.

As we understand the bill, the Comptroller General would be granted virtually unrestricted authority to look into the financial and operational aspects of the Federal Reserve System, and would thus have the authority to review and evaluate all aspects of Federal Reserve activities, including formulation and implementation of monetary policy.

The Board of Governors over the years has consistently opposed such proposals. Our objections stem not from any reservations about the General Accounting Office, which enjoys

a well deserved reputation for competence and integrity. Rather, our objections stem from a basic concern about the optimal functioning of the nation's money and credit system.

In summary, the Board believes:

1. An audit by GAO of the Federal Reserve's accounts and expenditures, compliance with applicable laws and regulations, and efficiency and economy of operations would be a needless duplication of present efforts and would result in unnecessary additional expenditures.
2. To go further, and authorize GAO to audit Federal Reserve policies, including the processes by which those policies are reached, would unwisely inject a third party into the sensitive area of monetary policy. This would run contrary to congressional decisions over the years based on the view that noninterference with the internal management of the Federal Reserve would, in the long run, provide better monetary and credit policies. We believe Congress has acted prudently, and that the System should not be inhibited, directly or indirectly, from exercising its best professional--and entirely independent--judgment.
3. The recent passage of H. Con. Res. 133 by the Congress has sharply altered the context in which the question of GAO audit must be considered. As you know, this resolution provides for a direct "audit" of Federal Reserve policy by the Congressional principals--the Committee on Banking, Currency and Housing in the House and its counterpart in the

Senate. Thus, a policy audit by GAO could not only fault public policy but it literally would be redundant to the action taken by the Congress this year.

4. Certain functions and activities of extreme sensitivity having to do with bank examinations and international monetary relations would be or would need to be substantially modified, were a GAO review put into effect. The need for exclusion of these activities was recognized to some degree in the bill (H.R. 10265) reported by the full Committee on Banking and Currency in the 93rd Congress, and to a greater extent in the bill finally adopted by the House last year.

With your permission, I'd now like to sketch briefly the background on this subject.

- 1) From its establishment in 1913 until 1921, the Board of Governors was audited by the Treasury.
- 2) Congress created the General Accounting Office in 1921. For the next twelve years, the Board of Governors, but not the Federal Reserve Banks and branches, came under the GAO's scrutiny.
- 3) The Banking Act of 1933 provided that the Board's funds should not be construed to be "Government funds or appropriated moneys." In this Act, Congress deliberately voted to remove the Board from the jurisdiction of the

General Accounting Office. The purpose, described in a Committee report, was to "leave to the Board the determination of its own internal management policies."

- 4) In the years between 1933 and 1952, audit teams from Federal Reserve Banks performed the audit of the Board's books.
- 5) Beginning in 1952 and continuing up to this time, the Board, using the discretion Congress provided, voted to employ nationally recognized public accounting firms to perform this function in order to assure an independent oversight of the Board's administrative activities. Each year the audit report is reproduced in the Board's annual report, and copies of the audit report are furnished to this Committee and to the Senate Committee on Banking, Housing and Urban Affairs.
- 6) Meanwhile, year in and year out, the Board's examiners have examined the Reserve Banks. Since 1952, the procedures used by the Board's examination staff have been observed by the outside accounting firms employed to audit the Board's books. This provides an external evaluation of the adequacy and effectiveness of the examination procedures. A copy of the latest such report, from Touche Ross and Company, was recently transmitted

to this Committee and the Senate Committee on Banking, Housing and Urban Affairs, along with a response to the report prepared by the Board's staff.

- 7) In 1945 during hearings on the Government Corporation Control Act, the General Accounting Office expressed the view that the Reserve Banks should be excluded from the Act because they are examined frequently and thoroughly by examiners under the direction of the Board of Governors.
- 8) In 1954 at hearings on Bill H.R. 7602, the Bureau of the Budget stated that the independence of the Federal Reserve System was "an important cornerstone of the Administration's fiscal and monetary policies."

The Integrity of the Central Bank

This brief chronology indicates, among other things, that both the Board of Governors and the boards of directors of the Federal Reserve Banks have traditionally been committed to thorough audits of System activities. We are so committed because the Federal Reserve System has the responsibility, above everything else, of maintaining the integrity of its operations as the nation's central bank.

These audits not only serve to meet the responsibility Congress has placed on the Federal Reserve, but they also serve to remove any doubt, throughout a world which uses the dollar as a

reserve and a vehicle currency, as to the integrity of the System's accounts. This involves a full and prompt disclosure of Federal Reserve assets and liabilities and the assurance, given the powers Congress has conferred upon it, that the Federal Reserve stands ready and able to meet the commitments on its balance sheet at home and abroad.

In 1974, the Reserve Banks handled 21.8 billion pieces of currency and coin having a value of \$63.9 billion. Of the 26 billion checks written in 1974, 11.7 billion checks passed through the System in the amount of \$4.4 trillion. 14.5 million wire transfers were handled and they moved \$30 trillion, and 2.5 billion food coupons were redeemed and destroyed, having a value of \$5.6 billion. To perform these functions along with the numerous transactions in securities,* also involving billions of dollars, with a minimum loss or defalcation, requires a comprehensive control and audit program. If we have erred in the extent of control, it has been toward over-control, and it has been intentional. No system is perfect, and we have had our occasional difficulties and problems which have not been hidden from public view; but the record shows a high rate of success in preventing irregularities.

We believe that a GAO audit would duplicate the audit costs and resources the Federal Reserve must, by its nature, incur regardless of any audit activity on the part of the GAO. The System spends \$8.5 million annually for auditing the Reserve Banks and the Board.

* See attachment for information on volume of securities transactions.

While this is a large sum of money, it is less than 1-1/2 per cent of the total expenses of the System and is miniscule in comparison with either the assets or the transactions the audit program is designed to protect.

Congress originally established the Board of Governors, which is an agency of the Government, as the organizational unit designated by the Congress to review the operations of the Reserve Banks. The record clearly shows the Board is continuing to fulfill this charter.

The Federal Reserve System Audit Program

Let me briefly summarize our audit program. First, we have audits of financial operations and legal compliance. Audits of this type are performed on an unannounced basis in the various departments of each Bank and branch by the internal auditors on a frequency schedule agreed to by the System's Conference of General Auditors and approved by the Board's staff. Also, once each year, the Board's examiners perform a financial examination, in each Bank and branch, which includes a review of compliance with approved procedures, policies, and regulations. Thus, at least twice each year the assets and liabilities of each Bank and branch are verified or confirmed. Going beyond this, policies, procedures, and transactions are reviewed at each location by internal auditors to evaluate how well the organization carries out its programs and activities and

how well it uses its financial, property, and personnel resources. There is latitude in the scope of these reviews because it can always be expanded if conditions warrant a review in greater depth. To provide further assurance, at least once in three years the Board's Operations Analysts review the operating functions of each Bank and each branch. These reviews are more than a routine, periodic check, for their scope and frequency reflect deficiencies observed by the Board's financial examiners, deficiencies or problems reported by internal auditors, the occurrence of irregularities, the conditions found at the previous review performed by the Operations Analysts, requests from Bank management or Boards of Directors, and other situations. In most cases, the reports comment on management attention, planning, sufficiency and effectiveness of supervision, adequacy of staff, staff knowledge, procedures employed, adequacy of facilities, and operating problems. Also, recommendations are made to improve procedures either to increase efficiency or to provide better controls.

H.R. 4316 provides specific authority for GAO to audit both the Federal Open Market Committee and the System Open Market Account. The Committee by statute is exclusively a policy making body. The Committee has designated the Federal Reserve Bank of New York to carry out transactions, including open market operations in domestic securities markets and foreign currency transactions, for the twelve Reserve Banks. The annual examination of

the New York Bank includes a comprehensive examination of the accounts relating to these transactions. The internal auditors in the New York Reserve Bank also conduct a continuous audit of these transactions. Both the audits and the examinations include procedures to determine that open market operations are consistent with directives from the Federal Open Market Committee.

In the last few years, with the advent of extensive use of computers, the Board's staff and the audit departments in the Reserve Banks have developed a comprehensive electronic data processing review procedure. In late 1974, the Board employed a nationally recognized consulting firm to review our staff's procedures and make recommendations for further improvements. The following statement was included in the report prepared by the consultants:

"I am very impressed with the quality of the staff you have organized. They have a good appreciation of the balance needed between management concerns, audit requirements, and complex technical analysis in the EDP area. We have worked with many organizations on EDP audits in the past few years. Your organization matches the very best that we have worked with in large commercial banks, financial institutions, and multi-divisional corporations. I am pleased to see that the

Federal Reserve System is in the forefront of this previously neglected, but critical, area of EDP operational audit."

Another examination activity performed by the Board's staff covers the internal audit departments in the Reserve Banks. Our staff not only reviews the monthly reports of audit activities and findings prepared by the Bank's General Auditors, but on-site visits are made to review and observe programs and practices. The competence and effectiveness of the staff and supervisors are also appraised during these visits and an evaluation is made concerning the independence of the General Auditor from Bank management.

Organizationally, the audit function in a Reserve Bank is independent of the Bank's management as the General Auditor is the only individual in a Bank, except for the President of the Bank, who reports directly to the Chairman of the Board of Directors. In addition, each Bank's Board of Directors has an Audit Committee which meets frequently with the General Auditor to discuss his reports. Well before it was a general practice for Directors of private enterprises to have an audit committee, the Reserve Banks had this feature in their organization. The independence of the General Auditor is further strengthened by the fact that appointments to the position are made by each Bank's Board of Directors, not Bank management, and approved by the Board of Governors. Likewise, salary adjustments

for incumbents in the position are recommended by the Board of Directors at each Bank and approved by the Board of Governors.

Thus, there are at least three lines of defense at the Reserve Banks against irregularities. The first is the operating management of the Bank; the second is the internal auditing staff directed by the Bank's board of directors; and the third is the examination staff which works under the direction of the Board of Governors. Each of these groups are also committed to improving operating effectiveness.

From time to time, Boards of Directors of individual Banks have also had public accounting firms review their auditing departments for further assurance that the programs and personnel are effective and up-to-date. In these cases, the primary difference in the recommendations made by the outside firms and the Board's staff is that the Board's staff has insisted on either more frequent or more in-depth audits than have the outside firms.

Economy and Efficiency of Operations

Now, let me comment on the System's commitment to economy and efficiency of operations. While the integrity of Federal Reserve System statements and accounts relating to assets, liabilities, and operations is of paramount importance to the Board of Governors, the prospective expenditures of the Banks also receive continuous scrutiny and attention. Budgets are initially prepared by management

in the Banks under general guidelines from the Board of Governors. The budgets are then reviewed by each Bank's Board of Directors and adjusted if, in the judgment of the Directors, such adjustment is needed. The staff of the Board of Governors also reviews the budgets and resolves issues related to unusual requests and adherence to guidelines. This review incorporates a detailed analysis of rates of expense growth in the Banks arising from new initiatives, volume increases, and increasing operating costs in order to satisfy the Board as to the reasonableness of the projected expenditures. Final approval, in light of the foregoing review, is given by the Board of Governors.

During recent years, the volume of operations in the Reserve Banks has grown significantly, and several new areas of responsibilities have been added to our work load. As you know, Congress has given the Federal Reserve increased, or new, responsibilities for supervision and regulation of Bank Holding Companies, Truth in Lending, Fair Credit Billing, Equal Credit Opportunity, and "unfair or deceptive" practices. We have also lived up to our assurances to Congress to reduce float in the payments mechanism. Through changes in Regulations, improvements in the check transportation system, and establishment of Regional Check Processing Centers and automated clearing houses, average daily payments mechanism float has been reduced from \$3.5 billion in 1969 to \$2.3 billion in 1974. Without the improvements initiated by the Federal Reserve System, the float would now be in the range of \$5.6 billion.

Even with the added assignments, the budget discipline imposed within the Federal Reserve System has held growth in its expenses to reasonable dimensions. During the period 1970 through 1973, total System expense growth averaged 15 per cent per year. A report on Reserve Bank expenses for 1974, which represented further improvement, was recently transmitted to this Committee and the Senate Committee on Banking, Housing and Urban Affairs. That report showed an increase in expenses in 1974 of 12.1 per cent over the expenses in 1973. We believe this is an excellent record in light of our expanding responsibilities and the cost trends in the economy. Moreover, the System's approved total expense budget for 1975 represents a targeted increase of only 10.3 per cent above 1974 expenses.

In addition to the programs carried on by internal auditing departments in the Reserve Banks and by the Board's staff of Operations Analysts for improving operating procedures and making them more effective and efficient, the Conferences of Reserve Bank Presidents and First Vice Presidents have developed an effective program which focuses upon improving the efficiency of operations. Bank planning departments, inter-Bank operations research groups, and task forces with Board staff participation are working out most of the technological adaptations needed in the System's electronic accounting, automated currency handling, and electronic fund transfer systems. Outside consultants are employed on an ad hoc basis as needs develop.

Capacity for Independent Judgment

Let me say a word now about the need to maintain the present capacity of the System to exercise, within the government, its best judgment regarding monetary policy without it being unduly affected by external pressures. Even many who oppose this or that action of the Federal Reserve willingly concede that the maintenance of independent judgment by the nation's central bank is essential if monetary policy is to play its proper role in achieving economic stability and growth, a high level of employment, and stability in the purchasing power of the dollar. This independence is not absolute, of course. Since the System is a creation of the Congress, it is clearly accountable to it, and we attempt to meet our responsibilities to the Congress and the public fully and conscientiously.

Besides publishing more detailed information about its activities than any other central bank in the world, the Federal Reserve furnishes a steady flow of information to Congress. Our release of data about Federal Reserve operations is continuous and wide-ranging, covering transactions on a daily, weekly, monthly, quarterly, annual, and ad hoc basis. Members of the Board testify frequently at Congressional hearings on the System's policies and operations, and the Board responds promptly to the Congressional inquiries that come to us every working day. In the past, when requested, we have provided Congressional committees, on a confidential basis, with volumes of materials pertaining to audit and examination procedures as well as reports of examinations of Federal Reserve Banks.

It is clear that Congress and its committees have the right to inquire into the effectiveness with which the System is discharging its responsibilities. And, as I have already noted, today's discussion occurs in a framework entirely different from that which prevailed in 1973 and 1974. By the adoption of House Concurrent Resolution 133, Congress has established a systematic mechanism for the review of Federal Reserve monetary policy. Under the terms of the resolution, the full Committee on Banking, Currency and Housing will hold semiannual hearings in conjunction with its Senate counterpart to hear "the Board of Governors' and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates in the upcoming twelve months." In short, the Congress has established a policy "audit" of monetary policy in the most direct and responsible manner through the expedient of the congressional oversight hearing. We have every confidence that the two Banking Committees will do an exemplary job in overseeing monetary policy. (I should note that the first of these hearings was held on May 1.)

Access to Certain Information

My final point goes to the System's concern about the access by any outside organization to certain System records,

operations and transactions. These records include examination reports of commercial banks, transactions conducted with and on behalf of foreign central banks, and information about open market and lending operations.

The record of the Federal Reserve in making information relative to its operations available should demonstrate that we do not begin with any bias for secrecy per se. In fact, a great deal of effort is required to properly protect certain information. We recognize, too, that GAO now is accorded access to highly sensitive information, in the Department of Defense and in other departments and agencies, and that no compromise of security results from these arrangements. Nevertheless, we firmly believe that there are compelling reasons which argue for the maintenance of certain information in the possession of the Federal Reserve from access by any outside organization. Public knowledge that GAO--or anyone else--had review powers over such information could have an adverse effect on the bank supervisory process, would alter our relationships with foreign governments and central banks, and might necessitate a change in our open market and discount functions.

An audit by the General Accounting Office of foreign accounts held by the Federal Reserve System, we believe, would

jeopardize the existing relationships between foreign monetary institutions, the Federal Reserve and the United States Treasury. It could, as a result, aggravate the nation's international finance relationships.

Foreign monetary authorities channel a substantial proportion of their dollar transfers and U. S. dollar reserve holdings through their accounts with the Federal Reserve Banks. Nearly 130 foreign central banks, foreign governments, and international financial institutions have accounts with Federal Reserve Banks. These correspondents held \$60 billion of U. S. Treasury and Federal agency securities in their accounts at the end of 1974. During 1974, transactions in these securities through their accounts totaled \$85 billion. These transfers and investments are often the counterpart of official foreign exchange intervention or official reserve investment operations that reflect sovereign actions and policies these authorities insist on keeping confidential. It is their explicit understanding that use of an account with Federal Reserve Banks maintains this confidentiality. Only those employees with a need to know have access to the information concerning foreign transactions. Extreme care is taken in assigning either internal auditors or examiners from the Board of Governors, although no compromises in the sufficiency of the audits are tolerated.

Just what action the foreign central banks, foreign governments, and international financial institutions might take if the confidential status were not maintained cannot be predicted with certainty. It is probable, however, that their use of accounts at the Federal Reserve Banks would be considerably curtailed. They might even change the composition of their reserve holdings so that the dollar assets would be a smaller part.

Action which resulted in transferring the investments of foreign official institutions to non-government financial institutions would make it more difficult for the Federal Reserve System to conduct its open market operations, since the Federal Reserve would no longer be able to coordinate its own very large transactions with the comparably large transactions that it conducts on behalf of foreign monetary authorities. There would also be a reduced flow of financial information, and the relationships maintained with foreign financial institutions and governments could be harmed.

A similar issue was discussed when legislation (Public Law 91-599) was being considered regarding audits of the Exchange Stabilization Fund by the General Accounting Office. The following is quoted from the hearings pertaining to that legislation:

"The Exchange Stabilization Fund deals in extremely confidential and highly sensitive monetary transactions with foreign governments. It is important not only that such transactions and the arrangements underlying them remain confidential but also that nothing be done which would in any way impair the confidentiality of

such transactions. The prospect of decisions of the Secretary of the Treasury with respect to transactions through this Fund being subjected to possible public question and debate would undoubtedly be disturbing to markets and to foreign governments, and would therefore hamper the use of the Fund by the Secretary of the Treasury for its intended purpose."

The Congress wisely recognized that foreign exchange operations and other aspects of international financial policy must not be subject to premature disclosure under any circumstances. The legislation exempted "information determined by the Secretary to be of an internationally significant nature" from audit by the General Accounting Office.

We believe providing the GAO access to "reports of examination of member banks, from whatever source," as H.R. 4316 would do, could reduce the flow and change the character of communications essential to effective bank supervision. It should be emphasized that although the Federal Deposit Insurance Corporation is audited by the GAO, reports of examination of insured banks are properly exempt from the scope of the audit authority. Neither does the GAO have access to reports of examinations conducted by the Comptroller of the Currency. Enactment of H.R. 4316, as it is presently worded, could give the GAO access to reports of examination prepared not only by the Federal Reserve, but also by the other supervisory agencies.

We strongly oppose providing such access to the General Accounting Office. In this connection, I might note that H.R. 10265, as reported by the full Committee in 1973, provided an explicit and complete exemption for both transactions conducted on behalf of foreign central banks and examination reports of member banks.

We also believe it would be unwise to allow access to specific files and memoranda containing information relating to Federal Reserve Bank lending cases. It has long been an established practice in the field of banking that private information relating to a borrower and made available to the lending institution is held in strictest confidence. This practice is founded on the very sound principle that the lender should have access to all the information it needs to make a prudent lending decision without exposing the borrowers' private, internal plans and operations to scrutiny by its competitors or the public. As with other forms of banking, lending to a member bank requires the borrower to provide confidential information on its financial condition and internal operations as well as certain plans. Administration of such credit requires very candid communications between the borrowing bank and the Reserve Bank with respect to problems a bank may be encountering in its day-to-day operations and specific strategies which it plans to follow to remedy its difficulties. Because the information required from borrowing banks is sensitive,

we strongly oppose providing anyone access to these files except those charged with the responsibility for the lending function.

At a time when financial markets are already nervous, when citizens of this country are fearful of the inflationary impact of the growing Federal deficit, and when foreign central banks are looking to the Federal Reserve for leadership in international financial matters, enactment of this legislation would be particularly unfortunate. We see no need to risk damaging effects upon our efforts toward international financial negotiations or reinforcing the financial uncertainties at home.

Staff Memorandum

Board of Governors of the Federal Reserve System

Securities Transactions - Federal Reserve Banks

In 1974, the Federal Reserve Banks issued, redeemed, and exchanged U. S. Government securities valued at \$3.08 trillion.

The bulk of System open market operations are for the purpose of offsetting the potentially destabilizing market impact of short-run variations in member bank reserves arising from such technical factors as movements in bank float and changes in the Treasury deposit balance at Federal Reserve Banks. To achieve this purpose, the Federal Reserve makes extensive use of repurchase agreements and matched sale-purchase transactions. The volume of such transactions in 1974 amounted to somewhat more than \$172 billion (or twice that if both the sale and purchase are included), or about 88 per cent of the total of system open market transactions of approximately \$195 billion. When the System uses repurchase agreements and matched sale-purchase transactions, market participants immediately understand that the System is only temporarily supplying (absorbing) reserves, and that this process will be reversed in a short period. The knowledge that the process is self-reversing enables the market to avoid possible misinterpretation of System activities.

Volume of System Open Market Operations Transactions
in Government Securities in 1974
(In millions)

| | |
|------------------------------------|---------------|
| Repurchase agreements | \$108,147 |
| Matched sale-purchase transactions | 64,228 |
| Outrights: | |
| Treasury bills | |
| Purchases | 11,659 |
| Sales | 5,829 |
| Treasury notes & bonds | |
| Purchases | 1,746 |
| Sales | -- |
| Redemptions | -- |
| Federal Agencies | |
| Purchases | 3,087 |
| Sales | 3 |
| Total | \$194,699 |

NOTE: Data for repurchase agreements and matched sale-purchase transactions reflect the initial side of these transactions only. Thus, for example, the total for repurchase agreements is the sum of purchases made by the System under such contracts, and does not include the subsequent resale of securities back to their original owners.