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Statement by

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Governor, Board of Governors  
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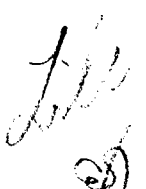
before the

Committee on Banking, Finance  
and Urban Affairs

U.S. House of Representatives

October 27, 1993

  
William V. Roth  
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I am pleased to have this opportunity to speak on the General Accounting Office's authority to audit Federal Reserve operations and the changes to that authority that would be made by H.R. 28 "The Federal Reserve System Accountability Act of 1993." President McDonough is addressing the scope of GAO audit authority from the perspective of the Federal Reserve Bank of New York.

At the outset, I would like to dispel the notion I have frequently heard that the Federal Reserve is not subject to GAO audit. In 1978 the Federal Banking Agency Audit Act gave the GAO broad authority to audit most of the operations of both the Federal Reserve Board and the Federal Reserve Banks. Since then, the GAO has completed more than 100 reports on various aspects of System operations, as well as numerous other reports that involved us less directly. At present, the GAO has roughly 25 audits of the Federal Reserve under way and maintains several of its staff in residence at the Board and at selected Reserve Banks.

The GAO has free rein to audit the System, subject to explicit exemptions for: deliberations, decisions, or actions on monetary policy matters including discount window credit operations, reserves of member banks, securities credit, interest on deposits, and open market operations; transactions made under the direction of the FOMC; transactions with, or for, foreign central banks and governmental entities; and discussions or communications among or between members of the Board and officers

and employees of the Federal Reserve System related to these matters and transactions. By excluding these areas, the Act attempts to balance the need for public accountability of the Federal Reserve through GAO audits against the need to insulate the central bank's monetary policy functions from short-term political pressures and the need to ensure that foreign central banks and governmental entities can transact business in U.S. financial markets through the Federal Reserve on a confidential basis.

The precise line differentiating those Federal Reserve specific operations and activities that are subject to GAO audit under the Banking Agency Audit Act and those that are exempt from audit is difficult to draw in the abstract. Over the years since the passage of the Act, the Federal Reserve has worked with the GAO to define those limited areas that are not subject to audit on a case by case basis in the context of individual audits. In those cases, the Federal Reserve has worked with the GAO to further the GAO's audit objectives while honoring the statutory exemptions designed to ensure the independent conduct of monetary policy and the confidentiality of foreign transactions. In the future, we will continue to work with the GAO to address its concerns consistent with the mandate of the Act.

Expanding the GAO's audit authority over the Federal Reserve into the exempt areas would be contrary to the public interest. Such an expansion could adversely affect Federal Reserve effectiveness in the conduct of monetary policy. As the

Banking Agency Audit Act recognized, such a change could reduce the central bank's insulation from day-to-day political pressures. Even what appears to be a very limited audit of the efficiency of monetary policy operations could in fact turn into pressure for a change in monetary policy itself. For example, the questions posed to Comptroller Bowsher in connection with these hearings as to whether the magnitude of our open market operations reflects unnecessary buying and selling of government securities are monetary policy questions, not efficiency questions. The number of transactions that the Open Market Desk completes in carrying out the FOMC's directive correlates directly with the substance of the policy in place. Indeed, a comprehensive audit of these operations would likely require a comparison of the actual results of the operations with intended results.

GAO scrutiny of policy deliberations, discussions, and actions also could impede the process of formulating policy. A free discussion of alternative policies and possible outcomes is essential to minimize the chance of policy errors. The prospect of GAO review of formative discussions, background documents, and preliminary conclusions could have an adverse effect on the free interchange and consensus-building that leads to good policy.

Transactions made under the direction of the FOMC include foreign exchange operations. The efficacy of these operations is crucially dependent on confidentiality. Important daily contacts and exchanges of information with foreign monetary

authorities are an integral part of these operations. They now take place in a candid and constructive atmosphere. The possibility of a GAO audit of our foreign exchange operations would reduce the willingness of foreign authorities to share information with us and would thereby reduce the effectiveness and efficiency of our operations which are frequently coordinated with foreign authorities. This caution also applies to the exemption for transactions that the Federal Reserve carries out as agent for foreign entities; however, there the principal issue is one of sensitive proprietary information about foreign governments, foreign central banks, and international financial organizations.

The benefits, if any, of broadening the GAO's authority into the areas of monetary policy and transactions with foreign official entities would be small. With regard to purely financial audits, the Federal Reserve Act already requires that the Board conduct an annual financial examination of each Reserve Bank. The Federal Reserve places great importance on both the Reserve Banks' internal audit responsibilities and the Board's responsibilities for examination of Federal Reserve Banks, in part because it recognizes that its ability to police Federal Reserve Bank operations is critical to public and congressional confidence in the Federal Reserve System.

The process of conducting annual financial audits is reviewed by a public accounting firm to confirm that the methods and techniques being employed are effective and that the program

follows generally accepted auditing standards applicable to the audit of Federal Reserve Banks. These examinations are complemented by extensive Board oversight and supervision of Federal Reserve Bank activities, including Board operations reviews of Reserve Bank effectiveness and efficiency, as well as by comprehensive audits conducted by each Reserve Bank's independent internal audit function. Oversight and supervision of Federal Reserve Bank activities include review of Federal Reserve Bank budgets and expenditures as well as personnel and operating policies.

The Board's annual financial examinations of Federal Reserve Banks, operations reviews, and its oversight and supervision of Federal Reserve Bank activities specifically include examinations, operations reviews and oversight of open market and foreign transactions. The annual financial examinations include review of all accounts for accuracy, compliance with internal controls, and confirmation that balances reflected on the books agree with the records of account holders. Operations reviews for effectiveness and efficiency of open market and foreign operations are conducted by multi-disciplinary teams, including economists familiar with FOMC operations, and specialists in data and physical security, automation, communication, accounting, and secondary market trading and settlement. These operations reviews also include the Federal Reserve Bank of New York's internal audit attentions to the open market account.

Further, a private accounting firm audits the Board's balance sheet, and the Board's Inspector General audits the effectiveness and efficiency of Board programs and operations under the Inspector General Act of 1978 as amended.

The Board has continually reviewed its procedures for examinations and oversight of Federal Reserve activities. For example, recently the Board has contracted for independent private audits of two Federal Reserve Banks (Kansas City and Cleveland) in order to provide an independent evaluation of the Reserve Banks' control environments and the Board's examination procedures and to determine the feasibility of substituting, from time to time, outside audits for financial examinations by the Board's examiners. These audits have indicated that previous financial examinations of these Reserve Banks were at least as thorough as the outside audits, that those Reserve Banks were well controlled, and that financial controls may be regarded as satisfactory from an audit perspective. Indeed these audits have indicated that many policies are uniquely applicable to Federal Reserve Banks and that in these areas the Board's examiners have a significant advantage in auditing for Reserve Bank compliance.

The Board is strongly committed to ensuring that its examinations, both internal and external, oversight and supervision of the Federal Reserve Banks, as well as its own internal audit function and external audits, are as effective as possible and will continue to review these functions with an eye to ensuring their future effectiveness.

Finally, and more broadly, Congress has, in effect, mandated its own review of monetary policy by requiring semiannual reports to Congress on monetary policy under the Full Employment and Balanced Growth Act of 1978 (also known as the Humphrey-Hawkins Act) and by holding hearings on various monetary policy issues as they arise. In addition, there is a vast and continuously updated body of literature and expert evaluation of U.S. monetary policy. In this environment, the contribution that a GAO audit would make to the active public discussion of the conduct of monetary policy is not likely to outweigh the disadvantages of expanding GAO audit authority in this area.

In sum, we believe that the Board's supervision and oversight of Federal Reserve Bank activities and the Board's own audit functions have served the public interest well, particularly in the area of confidentiality of monetary policy information. In this regard, Mr. Chairman, you have asked about the security checks on personnel involved in the monetary policy process and incidents of so-called insider trading by Federal Reserve officials. Attendees at FOMC meetings are now required to have "secret" or higher clearances and, over the years, there have been only three known incidents where monetary policy information may have been used for private gain. In the first instance, in October 1979, there were errors in the deposit data reported by a large New York commercial bank. These errors were technical or clerical and were not intentional on the part of the bank. The Federal Reserve's screening procedures flagged the



data as possible errors, but the bank stated that the numbers were correct as reported. The data therefore resulted in overstatements of the estimates of the money supply published by the Board. Subsequent data submitted by the bank indicated that the deposit data were indeed incorrect; as a result the bank revised its deposit data and the money supply figures were revised downward correspondingly. At the request of the House Committee on Banking, Finance and Urban Affairs, the Board conducted an investigation to determine if any institution or individual had improperly profited from the errors.

In order to ensure objectivity in the investigation, the Board engaged the services of a private law firm to conduct a complete inquiry and prepare a report. That firm, with the Board's concurrence, in turn engaged a private accounting firm to review trading activity. The report concluded that neither the bank that had made the reporting error nor persons connected with it, the Board, or the Federal Reserve Bank of New York had improperly and knowingly profited from the erroneous estimates or revision of the erroneous money supply estimates. Nor did the report find that any other institution or individual had improperly and knowingly profited from that error.

Nevertheless the report did identify one transaction that gave rise to an appearance of a conflict of interest in which an officer of the Federal Reserve Bank of New York who had knowledge of the impending revision of the money supply data had purchased units of a municipal bond fund immediately after the

revised data had become publicly available. That officer resigned from the Reserve Bank shortly thereafter.

In the second incident, in 1982, an ex-employee of the Board managed to gain telephonic access to confidential money supply data stored in the Board's computer system shortly after the employee had left the Board to work for a private firm. This access was identified quickly and the matter was referred to the Federal Bureau of Investigation promptly. The individual ultimately pleaded guilty to one count of wire fraud and received one year's probation. Subsequently additional security measures were implemented to prevent a recurrence of similar data security violations.

In the third incident, in 1986, in connection with the United States Attorney's investigation of allegations of securities fraud and tax evasion by former principals of a failed government securities dealer, the U.S. Attorney's office contacted the Federal Reserve Bank of New York concerning a former director of that Reserve Bank. After further investigation by both the Reserve Bank and the U.S. Attorney's Office, the U.S. Attorney's Office brought a criminal proceeding against the former director. In 1989, the former director pleaded guilty to charges of bank fraud based on the illegal disclosure of sensitive, non-public information regarding changes in the discount rate and was sentenced to a jail term, probation and community service. Again, Board and Reserve Bank procedures were revised after this event to prevent a recurrence.

We believe that the paucity and nature of the incidents that have occurred over the eighty-year history of the Federal Reserve System is strong evidence of the integrity of the Federal Reserve monetary policy process. Further it is doubtful that any of these incidents would have been prevented by a broadened GAO audit authority.

For these reasons and the reasons stated previously, we believe that enactment of the provisions of H.R. 28 that would expand the GAO's audit authority by removing the current exception for monetary policy matters; transactions made under the direction of the FOMC; and transactions with, or for, foreign official entities would be counter to the public interest.