STATEMENT

BY

PHILIP E. COLDWELL

MEMBER, BOARD OF GOVERNORS

OF THE FEDERAL RESERVE SYSTEM

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

November 29, 1977

I am pleased to present the views of the Board of Governors of the Federal Reserve System on H. R. 2176, a bill that would provide for an audit by the Comptroller General of the United States, of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. For a number of reasons, the Federal Reserve opposes enactment of this legislation, as it has numerous similar proposals relating to GAO audit of the Federal Reserve over the last 25 years.

First, we are concerned that audit authority would constitute an initial significant step toward compromising the ability of the Federal Reserve System to render objective independent judgments on monetary policy determinations. The present exclusion of the Federal Reserve from customary appropriations and auditing procedures recognizes the special political vulnerability of a central bank because of the opposition that may be generated when it imposes monetary restraint. We appreciate the fact that H. R. 2176 provides that the audit shall not include "deliberations, decisions, and actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations". However, we are aware that the scope of this monetary policy exemption was granted by the House of Representatives with some reluctance and with an indication that it would be reconsidered in the near future. In any event, we are concerned that GAO involvement in the System's other functions could influence the operational policy environment within which monetary policy must be developed.

Second, the Federal Reserve System is already subject to extensive audit. The Federal Reserve banks, which account for almost 95 percent of the expenditures of the System are audited by the Board of Governors, pursuant to an express requirement in Section 21 of the Federal Reserve Act which states "The Board of Governors of the Federal Reserve System shall, at least once each year, order an examination of each Federal reserve bank. . .". The Board itself is audited annually by a leading firm of certified public accountants.

Third, the System's cautious stewardship of its funds and its record of sharp increases in productivity suggest no need for an efficiency audit.

Fourth, we are convinced that a regular audit by the GAO would be likely to have an adverse impact on the effectiveness of bank regulation and would impede the essential freedom of communication between bankers and bank examiners in the examination process. Moreover, it would raise the dangerous possibility of unauthorized disclosure of highly sensitive information about individual banks and their customers, and could therefore have serious adverse effects upon individual persons and institutions. We cannot emphasize too strongly the damage that GAO access to bank examination reports could have on the bank examination process.

We are aware that the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are in general support of H. R. 2176. However, these other agencies are structurally and functionally different from the Federal Reserve. The Comptroller, of course, charters banks, and the FDIC insures banks. But beyond these responsibilities, their functions are generally limited to the supervision and regulation of banks. Their financial transactions are audited by the GAO, but the scope of their internal audit functions is considerably narrower. Their operations are primarily centered in and directed from Washington. The

The Federal Reserve's organization is less centralized, and has internal audit staffs in each of the twelve Districts.

While the bank regulatory functions of the Federal Reserve are similar to those performed by other agencies, the Federal Reserve performs many unique functions that support and are closely linked to broad monetary policy implementation.

> First, there are several operations which are direct instruments for the implementation of monetary policy such as open market operations and administration of the discount window, for which the scope of GAO audit authority has been limited.
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> Second, a large number of operations are performed by the Federal Reserve as fiscal agent of the United States. These include issuing, redeeming and servicing savings bonds, Treasury, government agency, and international agency securities; collecting, maintaining accounts for, and maintaining collateral for Federal taxes; clearing government checks; and maintaining accounts for the Treasury.
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> A third group of operations provides services to the public and financial institutions. These include operations in and regulation of the commercial check clearing system, a distribution system for all currency and coin supplies, a nationwide network for electronic transfers of funds and Treasury securities, and a system of member bank reserve accounts.

Fourth, the Federal Reserve is charged with the responsibility of writing and enforcing a variety of other regulations, including margin requirements, consumer credit regulations, and the definitions of demand and time deposits.

Finally, the Federal Reserve conducts a group of support operations such as collecting economic statistics needed for monetary policy deliberations, data processing, communications, protection and other housekeeping matters.

Although it is possible to categorize Federal Reserve operations into a number of service areas, there is a considerable overlap between areas, and the lines of demarcation are frequently indistinct. While H. R. 2176 attempts to screen out direct monetary policy surveillance, it does not remove the indirect impacts. The indirect ties of the other functions of the Federal Reserve to monetary policy are reflected in both the actual changes in operations and the operational policies of the System.

In the payments mechanism function, which includes check clearing and electronic funds transfers, there are numerous operating policies which the Federal Reserve establishes to assure the efficiency and effectiveness of the nation's payment system. One such policy is a requirement that banks pay for checks drawn on them on the day of receipt, which is immediate in the case of financial center banks and a one or two-day deferment schedule for country banks. This requirement assures that commercial check float, which is a component of the money supply, is predictable and controllable within reasonable limits. In addition, we have pursued a restriction on the clearance of non-par checks, which has resulted in the gradual elimination of non-par banks. Similarly, we have promoted a regional check processing program which has resulted in additional processing centers to provide overnight clearing of checks; we have encouraged the development of automated clearing houses to reduce the paper burden and promote the long-run efficiency of the payments system; and we have cooperated with the Treasury in the development of a Government check truncation program which will eventually eliminate the shipping costs associated with the handling of large volumes of Government checks.

We must assume that the GAO would wish to devote attention to our payments mechanism operations since they comprise almost 40 percent of our costs. Thus, they might expect to review the cost-effectiveness and public purposes of our policies in this area. Short-run cost effectiveness might be improved by policy changes but such changes could be disruptive to financial markets and impair our ability to conduct monetary policy. The implementation of monetary policy relies heavily upon the certainty and speed of financial flows and the safety and soundness of the banking system. Indeed, these are the basic purposes of the System's activities and the objectives of its primary operational functions. Thus pressure to change policies without full understanding of the Federal Reserve's objectives in promoting and maintaining an efficient payments mechanism could be quite counter productive. Freedom to establish and maintain such policies is therefore of great importance in the long run to our monetary policy responsibilities. In fact, the legislative history in the House of Representatives appears to give some recognition to this point.

The same reasoning applies to the operations that we perform for the Treasury as its Fiscal Agent. We have sought ways of improving the efficiency of these operations, and the improvements have resulted in substantial savings to the Treasury and thus to every taxpayer. We have cooperated with the Treasury in developing an elaborate computer-based book-entry system for Government securities that has virtually eliminated the need for definitive securities. We are now cooperating with the Treasury in a new system of accounting for Treasury tax and loan accounts which will result in substantially increased earnings on the Treasury's cash balances. While these developments have had as their primary objective the reduction of costs, we at the Federal Reserve have also been interested in the long-run implications upon the efficiency of the Government securities market. This, of course, is of great importance to the implementation of monetary policy, and again, the flexibility to effectuate the policies which we have followed in this area has been a major contributing factor to its success.

Our policies with respect to the collection of banking and other financial statistics are designed to enhance the flow of information for monetary policy decisions. The cost effectiveness of our large data collection effort is not always obvious to outside observers, but it is our judgment that this information is essential to the decisions made by the Federal Open Market Committee and is necessary to evaluate the results of our past actions. This area provides an illustration of why we believe that a GAO operational or efficiency type audit, even though not intended to involve the monetary policy field, is not likely to avoid it.

Thus, while we recognize and appreciate that this bill has included limits on GAO audit authority over monetary policy operations, nearly all Federal

Reserve operations have some ultimate relationship to monetary policy. Therefore, the probability exists that any GAO audit may impinge on policy matters and the execution of monetary policy operations. We believe the System should have the freedom to develop and implement its own procedures without the inhibiting presence of GAO, and that any GAO audit could ultimately be used to infringe upon monetary policy implementation, however carefully such audit authority may be circumscribed.

If a GAO audit is not intended to influence monetary policy, is its purpose to verify statistical data and financial information presently available to the Congress? If so, such audits will be a very expensive and redundant procedure since an extensive and effective system of audits already exists. The effectiveness of our existing system of audits and examinations has been recognized by the Congress, GAO, and independent CPA firms.

Let me briefly describe the coverage now provided. The audit program established within the Federal Reserve System is comprehensive and incorporates a series of controls coupled with a number of checks and balances. First, the General Auditor of each Reserve Bank accomplishes an internal audit of all operations at least annually. Each General Auditor is administratively independent of Bank management and reports his findings directly to the District's Board of Directors. Second, the staff of the Board of Governors examines each Reserve Bank annually in accordance with the Federal Reserve Act, including confirmation of each asset and liability account as well as determining compliance with procedures established by the Bank itself and by the Federal Reserve System as a whole. The Board's staff also accomplishes a series of reviews to determine the effectiveness and efficiency of Bank operations, including the internal audit function.

Each year the results of the staff's examinations and reviews in each District are discussed individually in executive session with the Board of Governors. Subsequently, a Board official briefs the Board of Directors of each District on the condition of operations. In addition, an independent CPA firm is engaged to evaluate the examination and review procedures used by the Board staff. Representatives of this firm accompany the examination and review teams to various offices on a random basis and provide the Board of Governors with an annual report of the evaluations. This report is in turn transmitted to the Congress.

A specific example will illustrate the depth of the audit coverage we now provide as compared to the GAO. The Comptroller General recently distributed a report to the Heads of all Executive Departments recommending increased audit attention to the use of computers in Government. The document set forth the GAO's standards in this field. The Federal Reserve System was able to show that it provides more than the GAO's standards require in terms of auditing of computer applications, review of the efficiency of computer usage, and controls over leasing and purchasing of new equipment. This is only one of a number of areas in which our audit standards meet or exceed the GAO's requirements of other agencies.

If the focus of the GAO audit is neither to influence monetary policy nor to verify statistical data and financial information, is it to evaluate the efficiency of Federal Reserve operations? Information provided by our expense accounting system provides far more detail than could be generated by a GAO audit. The Board uses this information on a continuing basis to measure the operational efficiency of the Federal Reserve Banks and Branches.

The performance record of the Federal Reserve System over the past few years strongly suggests the high degree of success the System has achieved through its internal efforts to improve operational efficiency. Since 1974, employment in the Federal Reserve Banks has been reduced by 10 percent even though the volume of operations performed by the System has increased by 24 percent. Our weighted unit cost of clearing checks, processing currency and coin, issuing and redeeming Treasury and other Government agency securities, and performing all other measurable output activities has increased by about 1 percent per year over the three year period from 1974 through 1977 projections. If unit costs are adjusted for higher prices paid for resources--that is for inflation--real unit costs have declined by approximately 7 percent per year. As reflected in the budgets of the Reserve Banks, a further decline is expected in 1978.

While output per man hour increased by more than 10 percent in 1976 and is projected to increase at similar rates in 1977 and 1978, some of these gains have been achieved through substitution of capital for labor. In an effort to adjust our productivity gains for this substitution, the Board's Staff has made estimates of changes in total factor productivity. Changes in total factor productivity measure the increase in output against the increase in all resource inputs, including both capital and labor.

Since 1974 the System's total factor productivity has increased considerably more than estimates for the private sector. In these past four years the Board of Governors and the Federal Reserve Banks have stressed the promotion of policies designed to improve operational efficiency. Through these efforts, we have brought about increases in our total factor productivity averaging 7.7 percent

percent per year through the budget year 1978. At the same time, we have tightened policies regarding allowable expenses of the Reserve Banks. The Board's staff reviews, as the GAO would, the legitimacy and reasonableness of all discretionary expenditures. Thus, an efficiency audit is already on-going, and further efforts along these lines seem clearly unnecessary.

We do not suggest that the Federal Reserve is or should be beyond the scope of Congressional oversight or that it should not be held accountable to Congress for its expenditures. The Federal Reserve System was created by the Congress, and the Congress has the authority to change any aspect of the Central bank's responsibilities. We are concerned, however, that by significantly altering one of the primary protections to Federal Reserve independence--the authority to establish its own budget and audit its expenditures--Congress may, without intending to do so, and notwithstanding the exemptions in the legislation, profoundly change the concept of an independent monetary authority that has served the country well for over 60 years.

We believe that oversight, including criticisms and suggestions for improvement of the Federal Reserve's operations with respect to the payments mechanism, bank examination and supervision, and other significant functions should be performed as a matter of policy review by the Congress and not as an audit review by the GAO.

In our opinion recent experience establishes that there are effective means by which Congress can perform oversight responsibilities in these areas without devoting substantial additional resources of the magnitude that would be required for a GAO audit. Over the past 2½ years, there have been quarterly hearings on the conduct of monetary policy held by the banking committees which have proved to be a workable and productive way of informing the Congress about the course of monetary policy. These hearings originally held pursuant to H. Con. Res. 133 have now been made a part of permanent law by P. L. 95-188 of November 16, 1977.

The Board has proposed that regular oversight hearings be conducted by the appropriate committees of the Congress on the condition of the Banking system. One such hearing has been held before the Senate Committee on Banking, Housing and Urban Affairs at which considerable documentation was made available. The Board has also presented testimony to the same Senate Committee this year on the 1977 budget of the Federal Reserve System. We understand that the Committee found these hearings to be a useful and productive means of oversight and, if so, we are prepared to repeat them annually.

Before the Congress takes such a drastic step as that contemplated by H. R. 2176, we urge that oversight hearings be held on the Board's performance of its other statutory duties, including its duty as auditor of the Federal Reserve Banks. If such hearings, in conjunction with those on the banking system and budgets, fail to satisfy Congress, then it could always return to legislation.