GAO Highlights

Highlights of GAO-18-118, a report to congressional requesters

November 2017

LARGE BANK SUPERVISION

Improved Implementation of Federal Reserve Policies Could Help Mitigate Threats to Independence

Why GAO Did This Study

The Board of Governors created LISCC in 2010, in the wake of the financial crisis of 2007–2009, to strengthen supervision of the largest U.S. financial institutions that pose the greatest risk to the economy. However, questions have been raised about the independence of the supervisory process and the risk of regulatory capture.

GAO was asked to review regulatory capture and threats to independence in large bank supervision. This report discusses the Federal Reserve's policies for (1) managing risks of regulatory capture in the LISCC program using an ERM approach; (2) mitigating threats to supervisory independence for the LISCC program; and (3) mitigating conflicts of interest for LISCC supervisory personnel. GAO reviewed studies and Federal Reserve policies and procedures. GAO also interviewed officials and supervisory staff at the Board and the LISCC Reserve Banks.

What GAO Recommends

GAO is making six recommendations to help improve the Federal Reserve's implementation of ERM and to strengthen internal controls to more effectively mitigate risks of regulatory capture and threats to supervisory independence across the LISCC program. Although the Federal Reserve neither agreed nor disagreed with the recommendations, it identified ongoing and planned efforts to address them.

View GAO-18-118. For more information, contact Lawrance Evans, Jr. at (202) 512-8678 or EvansL@gao.gov.

What GAO Found

The Board of Governors of the Federal Reserve System (Board) has not finalized and implemented its enterprise risk management (ERM) framework, and as a result, it may have limited ability to manage risks across the Large Institution Supervisory Coordinating Committee (LISCC) program. One such risk is regulatory capture, a condition that exists when a regulator acts in service of private interests, such as the interests of the regulated industry, at the expense of the public interest. GAO has previously found that regulators should be independent of inappropriate influence, including undue influence from the industry they are regulating. LISCC is a supervisory program developed by the Board to enhance the oversight of large, complex financial institutions. LISCC takes a cross-cutting approach to supervision, drawing staff from across the Federal Reserve System including the Board and four Federal Reserve Banks, and risks of regulatory capture span various aspects of the LISCC program. To help the Board manage its diverse risks, the Board has recognized the advantages of implementing an ERM, which the Office of Management and Budget (OMB) encourages all federal agencies to do. The Board began to develop an ERM framework in 2017, but it has not yet developed some of OMB's recommended key elements, such as risk identification and assessment. Completing and implementing the ERM framework should position the Board to better manage regulatory capture risks across the LISCC program.

The LISCC program has other policies to mitigate threats to independence for supervisory staff. For example, under the LISCC program, four Reserve Banks supervise the largest financial institutions with oversight from the Board, which increases the transparency and accountability of supervisory decisions and helps to ensure those decisions are free of inappropriate influence. In addition, the Federal Reserve has mechanisms for Reserve Bank staff to communicate their views directly to Board officials. However, GAO found weaknesses in some internal controls related to guidance and monitoring mechanisms. These limit the Board's assurance that policies are being implemented consistently across the LISCC program. Because of these weaknesses, the four Reserve Banks may not be mitigating regulatory capture risks and threats to supervisory independence as effectively or consistently as possible.

The Board and the four Reserve Banks have also implemented various conflict-of-interest and other ethics policies for LISCC examiners and other types of supervisory employees. While these policies are not explicitly designed to address regulatory capture, Federal Reserve officials said they use them in part for this purpose. However, GAO found weaknesses in the Federal Reserve's implementation of these policies. For example, the Federal Reserve officials said that they have policies to help mitigate threats to independence posed by the revolving door—that is, the movement of employees between the financial industry and the Federal Reserve—but they do not systematically collect employment data needed to implement these policies effectively. Without addressing this and other weaknesses, the Federal Reserve may be limited in its ability to use its ethics policies to mitigate regulatory capture.