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Testimony Before the Subcommittee on Economic Policy; Committee on Banking, Housing, and Urban Affairs; United States Senate

Statement of Mark Bialek, Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

Introduction

Chair Warren, Ranking Member Kennedy, and members of the subcommittee:

I am pleased to be here today to discuss oversight and accountability at the Federal Reserve.

Independent, objective oversight is critical for ensuring that government agencies work efficiently; effectively; and in accordance with the laws, rules, and regulations that govern them. Such work is also vital for maintaining public trust in government institutions.

As the Office of Inspector General for the Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau, we conduct audits, evaluations, and other reviews to assess the economy, efficiency, and effectiveness of the agencies' programs and operations. We also investigate wrongdoing—including actions that hinder the agencies' ability to supervise financial institutions within their jurisdictions—committed by agency employees, contractors, or any other person or entity.

From 2018 to 2022, we issued 108 audit and evaluation reports. Of these reports, 61 focused on the Board and included 175 recommendations, and 47 focused on the CFPB and included 122 recommendations. During the same period, we closed 170 investigations, resulting in 116 convictions and $4.4 billion in financial actions (for example, fines, restitution, forfeiture, and civil judgments). Our COVID-19 pandemic response–related investigations have so far resulted in 141 investigations, 62 convictions, and nearly $66 million in financial actions.

Consistent with the subcommittee's interest in Federal Reserve oversight and accountability, my testimony has five parts: First, I will explain our overall approach to oversight; second, I will summarize significant, enduring challenges in Board programs and operations; third, I will detail our work on the Board's supervision of financial institutions; fourth; I will describe our approach to the Board's ethics matters; and fifth, I will address proposed legislation that would reform Federal Reserve oversight.

Approach to Oversight

Statutory Mandates

Our statutory mandates are our highest priority. These mandates play a large part in our information technology (IT) audit and evaluation planning in particular: Approximately 75 percent of our IT audit and evaluation work is legislatively mandated. We also have statutory mandates related to our non-IT audit work that require reviews when a state member bank failure occurs, reviews of the Board's supervision of covered financial companies placed into receivership, and independent audits of the Board's and the Federal Financial Institutions Examination Council's financial statements. In addition, we are mandated to conduct risk assessments and audits of the Board's and the CFPB's purchase card and travel card programs as well as reviews to determine the CFPB's compliance with the Payment Integrity Information Act.

With our remaining resources, we independently exercise our discretion by focusing on those programs and operations in which potential deficiencies pose the highest risk to the Board and the CFPB in achieving their strategic goals, objectives, and priorities; meeting budgetary and financial commitments; and complying with applicable laws, regulations, and guidance.

Biennial and Dynamic Planning

In addition to these mandates, our discretionary project selections are based on two types of risk-based planning activities: our biennial planning process and dynamic planning.

We begin our biennial planning process by defining the agencies' major management challenges. Unlike other OIGs, we are not required by statute to identify these major management challenges but choose to do so as a best practice and to help focus the Board's and the CFPB's attention on the areas that will affect their ability to achieve their strategic goals and objectives. We have conducted this activity on a discretionary basis to help inform our planning and project selection decisions. This process helps to ensure that we (1) have defined the topics that can hamper the agencies' ability to achieve their strategic goals and objectives, (2) are performing work that has a clear connection to those strategic goals and objectives, and (3) are engaged in risk-based oversight. We also assess inputs such as stakeholder outreach, hotline complaints, risks, and ideas identified during prior projects.

Then, we prioritize projects that we plan to initiate over the remainder of the planning period's time horizon. The project selections we make are based on considerations such as (1) the connection to agency mission or strategic objectives, (2) the dollar amount associated with the relevant program activity, (3) the operational risk associated with the activity, (4) the reputational risk associated with the program or activity, and (5) stakeholder request or interest in the audit or evaluation.

There is also a dynamic aspect to our planning, as we strive to conduct timely and relevant work. We engage in dynamic planning activities in response to developments at or affecting the agencies, input from congressional and other stakeholders, and hotline complaints. Such issues may cause us to reconsider our planned activities and pivot to initiate a project that we had not initially contemplated in the plan. Recent examples include our pandemic response oversight work, which required us to realign our audit, evaluation, and investigative resources to oversee the Board's lending facility efforts, and our ethics program evaluation for the Board, which is explained in greater detail in my statement. Our IT audits and evaluations can be informed by reviews of newly issued federal policies and guidance, engagement with other OIGs and the U.S. Government Accountability Office, and audit and fraud risk assessments.

Major Management Challenges for the Board

Our oversight of the Board covers every facet of its programs and operations. From 2018 to 2022, we issued 61 reports on the Board, which included 175 recommendations to improve the economy, efficiency, and effectiveness of its programs and operations. Nearly three-quarters, or 129, of these recommendations have been closed.

From this body of work, as well as our knowledge of the Board's programs and operations and our outreach with agency management, key themes emerge that point to significant and enduring challenges that, if not addressed, are likely to hamper the Board's accomplishment of its mission. We are close to issuing our major management challenges for the Board for 2023. As noted, the issuance of management challenges reports is not mandated for us. These challenges are complex, and addressing them will require multiyear efforts. We will continue to focus on these areas, make recommendations, and ensure that the Board acts on those recommendations.

I would like to highlight four of the Board's eight challenges for you, which have carried over from our 2021 list of Board challenges:

1. strengthening organizational governance and enterprise risk management (ERM)
2. remaining adaptable while supervising financial institutions
3. enhancing oversight of cybersecurity at supervised financial institutions and service providers
4. ensuring an effective information security program

Other challenges that we have identified for the Board are evolving with financial sector innovations; managing hybrid work and workforce planning, updating the human capital system, and advancing diversity initiatives; monitoring COVID-19 pandemic emergency lending facilities and underlying loan portfolios; and ensuring that physical infrastructure effectively meets mission needs.

Organizational Governance and ERM

The Board has complex, decentralized governance structures for guiding the operations of the Federal Reserve System; challenges exist in determining the appropriate balance between centralizing or decentralizing certain functions and responsibilities. Further, because of its decentralized structure, the Board has a consensus-driven culture that makes it difficult to establish an enterprisewide approach for managing risks and administering certain business functions. The Board has made some progress toward enhancing its organizational governance and establishing an ERM program but should continue to focus on governance challenges at both the System and Board levels. The Board may have to address cultural challenges when introducing new governance structures, as these efforts require considerable coordination and effective change management. In circumstances where enhanced governance results in revised business processes, the Board will need to ensure that effective controls are in place and are actively monitored.

Adaptability in Financial Institution Supervision

Promoting the safety and soundness of individual financial institutions and financial stability more broadly is a core mission of the Board. The Board should assess the effectiveness of its supervisory tools and approaches in light of developments in the banking sector, such as the failure of Silicon Valley Bank. In addition, the Board should ensure that the System's examination workforce is sufficiently trained to address changing conditions by reinforcing existing, or creating new, supervisory rules and guidance. Maintaining strong cooperative relationships with other agencies to coordinate supervisory activities; leveraging the work of other supervisors, as appropriate; and collaborating, as necessary, on any updates to banking regulation and policy will also be important for the Board.

Oversight of Cybersecurity at Supervised Financial Institutions

Cyberthreats to financial institutions supervised by the Board continue to increase in both number and sophistication. Cyberattacks can create substantial operational risk, disrupt critical services, and ultimately affect financial stability. As a result, cybersecurity remains an area of significant focus for supervised financial institutions and federal financial regulators. The Board should continue to ensure that its supervisory approaches for financial institutions and service providers evolve with changing cybersecurity risks, ensure that it has effective and efficient approaches to assess the threat an incident poses, and ensure that banking organizations or any service providers involved take appropriate action to minimize any disruption to the organizations' or providers' operations or to the U.S. banking system.

Ensuring an Effective Information Security Program

Information security continues to be a key risk area for the Board. While the Board maintains an effective information security program and is taking multiple steps to strengthen and mature its program, the agency faces challenges in three key areas:

1. **Full implementation of a zero trust architecture (ZTA).** A *ZTA* is a set of system design principles and a coordinated cybersecurity and system management strategy based on an acknowledgement that threats exist both inside and outside traditional network boundaries. The Board's complex short- and long-term challenges in successfully implementing its ZTA are compounded by the decentralized nature of some IT services, which results in an incomplete view of the risks affecting the Board's security posture. Successful implementation of a ZTA will require close partnerships and coordination between Board business lines and divisions and the overall System.
2. **Optimal integration of ERM and cybersecurity risk management.** Board governance structures and reporting relationships between various disciplines need to be refined, and as the Board's ERM program matures, IT governance and risk management processes will need to be aligned.
3. **Enhanced IT supply chain risk management practices.** The Board will need to strengthen processes to ensure that it has effective insight into and knowledge of the cybersecurity environment of third-party and cloud computing providers. Effective IT supply chain risk

management will require close coordination and integration across Board divisions and disciplines, such as procurement, ERM, and data management.

Our Work Pertaining to Bank Supervision

A core mission of the Board is to promote the safety and soundness of individual financial institutions and to monitor their effect on the financial system as a whole. As part of our independent oversight authority, we have conducted numerous engagements to assess and identify opportunities to enhance the Board's supervisory programs and operations. Our projects assess whether these programs operate consistently with applicable laws, regulations, and other standards, including supervisory guidance, examination manuals, or management's expectations documented in policies and procedures.

During the 2008 financial crisis, our office performed numerous reviews of failed state member banks because of our statutory mandates on this topic, and we identified common factors and themes related to the cause of the failures and the Board's supervision of the institutions. We reported those common themes in a compilation report.[1] Some of the themes included (1) bank management pursuing robust growth objectives and making strategic choices that proved to be poor decisions; (2) rapid loan portfolio growth exceeding the bank's risk management capabilities or internal controls; (3) asset concentrations tied to particular types of loans,[2] which increased the bank's vulnerability to changes in the marketplace and compounded the risks inherent in individual loans; and (4) bank management failing to have sufficient capital to cushion losses. Additionally, our prior reports revealed certain practices that contributed to specific failures, such as risky funding strategies and incentive compensation programs that inappropriately encouraged risk taking. With respect to the supervision of the failed state member banks, many of our prior reports noted that examiners identified key safety and soundness risks but did not take sufficient supervisory action in a timely manner to compel the board of directors and management to mitigate those risks.

More recently, our office independently decided to initiate reviews pertaining to the supervision of certain banking organizations. On March 14, 2023, we initiated an engagement addressing the failure of Silicon Valley Bank, a state member bank located in Santa Clara, California, and supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco). We received notice from the Federal Deposit Insurance Corporation on the estimated loss to the Deposit Insurance Fund last week, thus triggering our statutory requirement to review Silicon Valley Bank's failure and supervision by November.[3] Nevertheless, we plan to issue our report in September 2023.

Also on March 14, 2023, we initiated an independent review assessing the supervision of Silvergate Bank, a state member bank located in La Jolla, California, and supervised by FRB San Francisco. Silvergate Bank is an open institution and has voluntarily begun the process of liquidation.

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[1] Office of Inspector General, *Summary Analysis of Failed Bank Reviews*, September 30, 2011.

[2] Frequently, these prior reviews cited concentrations in commercial real estate or construction, land, and land development loans.

[3] Section 38(k) of the Federal Deposit Insurance Act, as amended, requires that we complete a review of the agency's supervision of a failed institution and issue a report within 6 months of notification from the Federal Deposit Insurance Corporation OIG that the projected loss to the Deposit Insurance Fund is material. Section 38(k) defines a material loss to the Deposit Insurance Fund as an estimated loss in excess of $50 million.

For both reviews, we will seek to evaluate the Board's and FRB San Francisco's supervision of the institutions and will make recommendations, as appropriate. We anticipate having both reviews completed in September. We also continue to monitor banking conditions to assess whether other situations may trigger statutory requirements or warrant our office initiating reviews.

In addition to our reviews of the Board's and FRB San Francisco's supervision of certain banking organizations, we also use our law enforcement authorities to investigate bank fraud committed by bank officials who falsified financial records, lied to or misled examiners, or obstructed examinations in a manner that may have hindered the Board's ability to carry out its supervisory operations.

Recent high-profile bank fraud investigations include the following:

- **Former Bank Executives and Others Guilty in First NBC Bank Fraud.** In April 2017, the $5 billion First NBC Bank failed. Based in New Orleans, the bank was a subsidiary of First NBC Bank Holding Company, a Board-supervised bank holding company. In a long-running scheme that led to First NBC Bank's collapse, several executives conspired with borrowers to defraud the bank. The executives extended loans to borrowers who were unable to repay them, then extended new loans to the borrowers to cover their existing loans. The executives enriched themselves through fees earned on the loans while concealing their actions—and the true financial condition of the bank—from the board of directors and outside auditors and examiners. By the time the bank collapsed, these bogus loans totaled hundreds of millions of dollars. The bank's failure cost the Deposit Insurance Fund nearly $1 billion. Former First NBC President and Chief Executive Officer Ashton J. Ryan Jr. was found guilty of all 46 counts against him, including bank fraud, conspiracy to commit bank fraud, and making false entries in bank records. Former Executive Vice President Robert B. Calloway, former Chief Credit Officer William J. Burnell, and former General Counsel Gregory St. Angelo all pleaded guilty to conspiracy to commit bank fraud. In addition, several business owners and borrowers pleaded guilty to conspiracy to commit bank fraud. Each faces prison terms ranging from 5 to 30 years and fines up to $1 million or the greater of twice their gains or twice the losses to the victims. Others have been convicted for various roles in defrauding First NBC Bank, including a former assistant district attorney for St. Bernard Parish.

- **Wells Fargo Agrees to Pay a $3 Billion Civil Monetary Penalty Resolving Criminal and Civil Investigations Into False Sales Practices.** Wells Fargo and Co. and its subsidiary, Wells Fargo Bank, N.A., agreed to pay $3 billion to resolve three matters stemming from a years-long practice of pressuring employees to meet unrealistic sales goals, which led thousands of employees to provide millions of accounts or products to customers under false pretenses or without consent, often by creating false records or misusing customers' identities. As part of these agreements, Wells Fargo admitted that it collected millions of dollars in fees and interest the company was not entitled to, harmed the credit ratings of certain customers, and unlawfully misused customers' sensitive personal information.

Our Recent Work on Board Ethics Matters

In the wake of widespread reporting on personal investment and trading incidents involving Board and Federal Reserve Bank officials, we have been evaluating and investigating ethics matters at the Board and the Reserve Banks.

In October 2021, the Board requested that we "conduct an independent review of whether the 2020 trading activities of Rob Kaplan, President of the Dallas Federal Reserve Bank; Eric Rosengren, President of the Boston Federal Reserve Bank; and Rich Clarida, Vice Chair of the Board of Governors of the Federal Reserve System violated the law or Federal Reserve policies, whether the trading activities warrant further investigation by other authorities, and any other related matters that you deem appropriate."

In response, we initiated separate investigations of Board and Reserve Bank officials. Given the public reporting on Chair Jerome Powell's December 2019 financial transactions, we independently decided to expand our investigation of former Vice Chair Clarida's trading activities to also cover the chair's trading activities.

Our investigation of senior Reserve Bank officials is ongoing, so I cannot disclose any details at this time, but we concluded our investigation into the trading activities of the senior Board officials and publicly released our results.[4] Although we determined that former Vice Chair Richard Clarida's and Chair Powell's trading activities did not violate applicable laws, rules, regulations, or policies, we reported that

- former Vice Chair Clarida omitted several trades on his 2019 and 2020 financial disclosure forms but later notified the Board's ethics official of the omissions and filed an amended form, which we verified as accurate
- on behalf of a Powell family trust, a trust financial advisor executed five trades in December 2019 to facilitate charitable donations during a Federal Open Market Committee (FOMC) trading blackout period

Separately, we initiated an evaluation to assess the design and effectiveness of the FOMC's personal investment and trading rules, as well as the Board's and the Reserve Banks' approach to monitoring personal investment and trading activities for possible conflicts of interest. Following the personal investment and trading incidents subject to our above-referenced investigations and the subsequent media coverage of those incidents in 2021, the FOMC adopted the *Investment and Trading Policy* in February 2022 to support public confidence in the impartiality and integrity of the FOMC's work. The policy prohibits covered individuals from purchasing individual securities, restricts active trading, and revises certain public reporting and disclosure requirements, among other things.

[4] Office of Inspector General, *OIG Closing of 22-0028-I Board Trading Activity*, July 11, 2022.

We determined that the new FOMC personal trading and investment policy should be enhanced.[5] Specifically, the Board should determine which requirements that apply to senior FOMC officials should also be extended to additional staff based on the risk presented by their access to confidential FOMC information, ethics programs should be strengthened to make reviews of financial disclosure reports more uniform and to enforce consequences for policy violations, and the information individuals provide in their financial disclosure reports should be verified for completeness and accuracy. We made six recommendations to address these issues, which the Board concurred with. We will monitor the Board's progress in addressing our recommendations.

[5] Office of Inspector General, *The Board Can Further Enhance the Design and Effectiveness of the FOMC's Investment and Trading Rules*, OIG Report 2023-SR-B-006, April 26, 2023.

Proposals to Reform Federal Reserve Oversight

Legislation has been proposed that would require presidential appointment and Senate confirmation (PAS) of the inspector general (IG) for the Board and the CFPB.[6] The argument is that a PAS IG for the Board and the CFPB would be a more independent IG. I want to provide you with information about our authorities and operations as a designated federal entity (DFE) IG.

Our office is as independent as any OIG, whether headed by a DFE IG or PAS IG. Further, compared with PAS IGs, we have the same authorities, are subject to the same congressional oversight, and are subject to the same IG removal provisions.

- We have the same authorities to audit and investigate without interference from our agency heads. We have unfettered access to all agency records and documents; subpoena authority to require the production of records from nonfederal entities; law enforcement powers, such as executing arrest and search warrants; and the ability to hire our own staff and control our own resources. We also have the same reporting mechanisms at our disposal if attempts are made to resist or object to our oversight activities or to significantly delay our access to information.
- We are subject to the same congressional oversight to ensure we are held accountable. DFE IGs are mandated to keep Congress fully and currently informed about issues of fraud, waste, or abuse within our agencies through various reporting mechanisms. We also provide congressional testimonies, briefings, and responses to correspondence and inquiries regarding our work.
- All IGs are subject to removal, whether by the president in the case of PAS IGs or an agency head in the case of DFE IGs. Under the Inspector General Act of 1978, the president or an agency head must notify Congress in writing of the reasons why an IG will be removed at least 30 days beforehand. This safeguard is intended to prevent IGs from being removed for political reasons or simply because they are effectively identifying fraud, waste, or abuse. In our case, there is an added barrier to removal under the Inspector General Act of 1978. If a DFE agency is led by a board or a commission, removal of the DFE IG requires the written concurrence of two-thirds of the members of the board or commission. In the case of my office, removal would require the approval of four of the seven Board governors, not just the chair.

In addition, over 1,200 federal government positions require Senate confirmation. The number and length of IG vacancies over the years have raised questions about the effect such vacancies have on the ability of OIGs to carry out their statutory duties and responsibilities. A 2018 study conducted by the U.S. Government Accountability Office found that over a 10-year period, PAS IGs had more and longer IG vacancies than did DFE IGs. As of April 2023, there were 13 IG vacancies, 7 of which are PAS IG positions.

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[6] Office of Inspector General, *Inspector General Letter on S. 915, a Bill Regarding Presidential Appointment and Senate Confirmation of the Inspector General for the Board and the CFPB*, April 26, 2023.

I believe our current DFE IG structure is best suited to provide independent and objective oversight of the Board and the CFPB. I welcome the opportunity to further discuss this proposal, as well as the proposal to expand our jurisdiction to include the Reserve Banks, with members of the subcommittee.

Closing

In conclusion, we have been providing independent, objective oversight of the Board and the CFPB to ensure that they work efficiently; effectively; and in accordance with the laws, rules, and regulations that govern them. We will continue to actively engage with internal and external stakeholders to identify existing and emerging risks facing the Board and the CFPB so that we can allocate our resources to those areas that provide the highest value-added oversight.

Thank you, Chair Warren, Ranking Member Kennedy, and members of the subcommittee. This concludes my prepared statement. I would be pleased to respond to your questions.

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