



OFFICE OF INSPECTOR GENERAL

Audit Report

2014-FMIC-B-014

# Opportunities Exist to Enhance the Onsite Reviews of the Reserve Banks' Wholesale Financial Services

September 30, 2014

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
CONSUMER FINANCIAL PROTECTION BUREAU

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## Abbreviations

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Board	Board of Governors of the Federal Reserve System
COSO	Committee of Sponsoring Organizations of the Treadway Commission
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Federal Reserve System	Board of Governors of the Federal Reserve System and Federal Reserve Banks
FMI	financial market infrastructure
FMU	financial market utility
NSS	National Settlement Service
PSR policy	<i>Federal Reserve Policy on Payment System Risk</i>
RBOPS	Division of Reserve Bank Operations and Payment Systems
Reserve Bank	Federal Reserve Bank
WPO	Wholesale Product Office

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# Executive Summary:

## Opportunities Exist to Enhance the Onsite Reviews of the Reserve Banks' Wholesale Financial Services

2014-FMIC-B-014

September 30, 2014

### Purpose

The Federal Reserve System comprises the Board of Governors of the Federal Reserve System (Board) and the 12 Federal Reserve Banks (Reserve Banks). The Reserve Banks provide wholesale financial services to depository institutions, the U.S. government, and foreign institutions. The Board's Division of Reserve Bank Operations and Payment Systems (RBOPS) oversees the policies and operations of the Reserve Banks. As such, our objective for this audit was to assess the extent and effectiveness of RBOPS's oversight of the Reserve Banks' wholesale financial services.

### Background

The Federal Reserve System plays a vital role in the nation's payment and settlement systems, providing a variety of wholesale financial services, including the Fedwire Funds Service, the Fedwire Securities Service, and the National Settlement Service. Reserve Banks' wholesale financial services include payment and settlement systems that facilitate the exchange of payments and the settlement of transfers of funds or financial instruments totaling approximately \$4 trillion daily. The Dodd-Frank Wall Street Reform and Consumer Protection Act broadened the Board's supervisory authority over private payment, clearing, and settlement systems designated as systemically important financial market utilities. Since the enactment of the act, RBOPS's Financial Market Infrastructure Oversight (FMI Oversight) group has worked to closely align its Reserve Banks' wholesale financial services oversight processes with those applied in the supervision of designated financial market utilities.

### Finding

We did not note any deficiencies regarding the efficiency and effectiveness of the FMI Oversight group's onsite review activities for wholesale financial services. We found that RBOPS uses offsite monitoring, ongoing communication, onsite reviews, and assistance from the General Auditors at the Reserve Banks to provide oversight of the Reserve Banks' wholesale financial services. The FMI Oversight group also recently changed its onsite review from a triennial geographical approach to an annual functional approach across the entire wholesale financial services system.

The FMI Oversight group uses a risk-based planning process and the *Federal Reserve Policy on Payment System Risk* for guidance when assessing wholesale financial services. We found, however, that the group does not have comprehensive formal policies and procedures that guide the execution and documentation of its onsite review of wholesale financial services. In addition, we noted that a small percentage of onsite review documentation was incomplete, and we noted a few instances in which the reviewer indicated a lack of understanding of a review step. We generally did not see indications of a second-level review of this documentation. FMI Oversight group management, however, explained that the team meets during and after the onsite review to ensure that needed work was performed during the review and to examine and verify any observations in bullet point summaries and final reports.

### Recommendation

We are making one recommendation to enhance RBOPS's oversight of the Reserve Banks' wholesale financial services. We recommend that RBOPS develop and document comprehensive formal policies and procedures to guide the execution and documentation of the onsite review of wholesale financial services, which should include a second-level review of onsite review documentation when necessary. In its response to a draft of our report, RBOPS generally concurred with our recommendation and noted it has initiated efforts to augment existing procedures and, if necessary, develop new procedures that guide its onsite reviews of wholesale financial services.

Access the full report: <http://oig.federalreserve.gov/reports/board-wholesale-financial-services-onsite-reviews-sep2014.htm>

For more information, contact the OIG at 202-973-5000 or visit <http://oig.federalreserve.gov>.

## Summary of Recommendation, OIG Report No. 2014-FMIC-B-014

Rec. no.	Report page no.	Recommendation	Responsible office
1	10	Develop and document comprehensive formal policies and procedures to guide the execution and documentation of the onsite review of wholesale financial services, which should include a second-level review of onsite review documentation when necessary.	Division of Reserve Bank Operations and Payment Systems

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OFFICE OF INSPECTOR GENERAL  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
CONSUMER FINANCIAL PROTECTION BUREAU

September 30, 2014

**MEMORANDUM**

**TO:** Louise Roseman  
Director, Division of Reserve Bank Operations and Payment Systems  
Board of Governors of the Federal Reserve System

**FROM:** Melissa Heist *Melissa Heist*  
Associate Inspector General for Audits and Evaluations

**SUBJECT:** OIG Report No. 2014-FMIC-B-014: *Opportunities Exist to Enhance the Onsite Reviews of the Reserve Banks' Wholesale Financial Services*

The Office of Inspector General has completed its final report on the subject audit. We conducted this audit to assess the extent and effectiveness of the Board of Governors of the Federal Reserve System's Division of Reserve Bank Operations and Payment Systems' (RBOPS) oversight of Federal Reserve Banks' wholesale financial services. Specifically, our review focused on the Financial Market Infrastructure Oversight group's onsite review activities for wholesale financial services.

Our report contains one recommendation designed to enhance RBOPS's oversight of the Reserve Banks' wholesale financial services. In your response to our draft report, you generally concurred with our recommendation and indicated that you have initiated efforts to augment existing procedures and, if necessary, develop new procedures that guide your onsite reviews of wholesale financial services. We have included your response as appendix C in our report.

We appreciate the cooperation that we received from staff of the Financial Market Infrastructure Oversight, Oversight Program Management, and Information Technology groups in RBOPS, as well as the responsible Federal Reserve Banks. Please contact me if you would like to discuss this report or any related issues.

cc: Jeffrey Marquardt  
Stuart Sperry  
William Mitchell  
J. Anthony Ogden

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# Introduction

## Objectives

The Federal Reserve System comprises the Board of Governors of the Federal Reserve System (Board) and the 12 Federal Reserve Banks (Reserve Banks). As the central bank of the United States, part of the Federal Reserve System's mission is to maintain the stability of the nation's financial system and contain systemic risk that may arise in financial markets.

The Reserve Banks provide retail<sup>1</sup> and wholesale<sup>2</sup> financial services to participants that include depository institutions, the U.S. government, and foreign institutions. These services include key wholesale payment and settlement systems identified as financial market infrastructures (FMIs).<sup>3</sup> FMIs are the backbone of the global financial system and, if not properly managed, can be sources of shock to domestic and international financial markets. As such, our audit focused on the Reserve Banks' wholesale financial services.

The Board's Division of Reserve Bank Operations and Payment Systems (RBOPS) is responsible for overseeing the policies and operations of the Reserve Banks. Our objective for this audit was to assess the extent and effectiveness of RBOPS's oversight of the Reserve Banks' wholesale financial services. Our scope and methodology are detailed in appendix A.

## Background

### *Wholesale Financial Services*

Wholesale financial services include payment and settlement systems that facilitate the exchange of payments and the settlement of transfers of funds or financial instruments. The Reserve Banks operate three wholesale payment and settlement systems: the Fedwire Funds Service, the Fedwire Securities Service, and the National Settlement Service (NSS). These services enable their participants to transfer funds, record book-entry securities,<sup>4</sup> and settle obligations. As depicted in table 1 below, the Reserve Banks' wholesale financial services involve trillions of dollars and thousands of financial institutions each day.

1. Retail payments generally are for relatively small dollar amounts and often involve a depository institution's retail clients—individuals and smaller businesses. The Reserve Banks' retail services include collecting checks and electronically transferring funds through the automated clearinghouse system. A clearinghouse is an establishment maintained by banks for settling mutual claims and accounts.
2. Wholesale payments generally are for large dollar amounts and often involve a depository institution's large corporate customers or counterparties, including other financial institutions.
3. An FMI is a multilateral system for clearing, settling, or recording payments, securities, derivatives, or other financial transactions. Multiple financial institutions participate in a single FMI.
4. Ownership of book-entry securities is not physically transferred but is recorded electronically on the books of the depository institutions where owners maintain accounts.

**Table 1: Federal Reserve System Wholesale Financial Services Statistics**

Service	Participants	Average number of transfers/day	Average value/day
Fedwire Funds	6,500 customers	535,000	\$2.8 trillion
Fedwire Securities	5,500 active customers	76,000	\$1.2 trillion
NSS	17 settlement arrangements	40 settlement files	\$69 billion

Source: OIG compilation based on information on the Board's public and internal websites.

Note: Figures represent the annual average in 2013.

### **Fedwire Funds Service**

The Fedwire Funds Service settles payments that typically are large in value and time critical. The Fedwire Funds Service processes funds transfers immediately upon receipt. Once processed, payments are final and irrevocable. Participants in the Fedwire Funds Service send and receive payments through a master account held with a Reserve Bank. These funds transfers are highly concentrated, with the top 10 participants accounting for approximately 70 percent of the total value.

Fedwire Funds Service participants submit transfer instructions either online or offline. The Fedwire Funds Service processes online transfer instructions without manual intervention; offline participants submit instructions by calling the Reserve Banks' Wholesale Operations Site. Offline participants pay more because their transactions are processed manually.

### **Fedwire Securities Service**

The Fedwire Securities Service transfers, settles, and maintains securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and some international organizations. The Fedwire Securities Service manages electronic transfer of book-entry securities between participants and processes settlements in accounts held on the books of the Reserve Banks. The Fedwire Securities Service also maintains electronic storage of securities records and processes principal and interest payments.

Fedwire Securities Service transactions are also highly concentrated; the top 25 participants generate more than 90 percent of the volume and value. In particular, transactions by the top 2 participants account for over 60 percent of the volume and value transferred across the Fedwire Securities Service. Fedwire Securities participants submit transfer instructions in the same manner as Fedwire Funds participants.

### **National Settlement Service**

The NSS facilitates settlement for private-sector groups, such as check clearinghouse associations and automated clearinghouse networks. Multiple parties participate in settlement arrangements processed by the NSS. A single settlement agent from a group submits a settlement file on behalf of the group participants to the NSS. The NSS settles participant accounts at the Reserve Banks per instructions in the settlement file. The NSS offers an offline service only when a settlement agent's online transmission is unavailable.

## ***Wholesale Financial Services Management***

The Wholesale Product Office (WPO) at the Federal Reserve Bank of New York has management responsibilities for the Reserve Banks' wholesale financial services and, in this role, sets strategic direction and centrally manages wholesale operations. The WPO also ensures Reserve Bank compliance with its standard operating procedures, and it receives application development, audit, legal, and research support from the Federal Reserve Bank of New York.

Wholesale Operations Sites, located within certain Federal Reserve Banks, support wholesale financial services through a split operations program in which each responsible location routinely supports the others' offline transactions and also provides backup for system resilience. These split operations are designed to appear seamless to customers.

The Central Electronic Payment Systems Central Business Administration Function monitors day-to-day operations of wholesale financial services to ensure their safety and soundness. The Central Electronic Payment Systems Central Business Administration Function schedules, tests, and authorizes changes to the production and test systems. It also ensures the availability of the Fedwire Funds Service, the Fedwire Securities Service, and the NSS according to business requirements and service agreements.

Wholesale Testing Units support the depository institution testing environments in which developers test applications such as future releases and emergency fixes. The Wholesale Testing Units also train new Fedwire customers, troubleshoot, and perform contingency tests.

## ***Wholesale Financial Services Guidance***

Multiple rules and regulations govern the Reserve Banks' wholesale financial services. The WPO sets forth its standard operating procedures, which are guidelines for the management, administration, and operations of wholesale financial services. The Reserve Banks' operating circulars<sup>5</sup> also provide the legal terms for, and govern the use of, Reserve Bank financial services. Wholesale financial services are subject to additional standards and supervision as discussed below.

The management and operations of the Reserve Banks' wholesale financial services are guided by the risk-management policies in the *Federal Reserve Policy on Payment System Risk* (PSR policy). The Board developed the PSR policy to ensure the safety and efficiency of payment and settlement systems. The PSR policy applies to payment and settlement systems, such as the Reserve Banks' wholesale financial services, that are expected to settle a daily aggregate value of U.S. dollar-denominated transactions exceeding \$5 billion on any day during the following 12-month period. The PSR policy incorporates international principles that emphasize an effective risk-management framework, including (1) clear identification of risks, (2) sound governance, (3) clear and appropriate rules and procedures, and (4) employment of the necessary resources. The WPO follows the PSR policy in its management of wholesale financial services.

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5. Federal Reserve Bank financial services are governed by the terms and conditions set forth in applicable operating circulars. In particular, Operating Circular 6 applies to funds transfers made through the Fedwire Funds Service, Operating Circular 7 contains the terms of book-entry securities account maintenance and transfer services, and Operating Circular 12 discusses the terms of settlement services through the NSS.

The Board has published for comment revisions to its PSR policy. These revisions closely align with the proposed enhanced standards for Board-supervised private-sector financial market utilities (FMUs)<sup>6</sup> designated as systemically important by the Financial Stability Oversight Council<sup>7</sup> under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), entitled the Payment, Clearing, and Settlement Supervision Act of 2010. The purposes of Title VIII are to mitigate systemic risk in the financial system and to promote financial stability through enhanced supervision of designated FMUs. Although only designated FMUs are subject to provisions of Title VIII, the Board, in a July 2012 press release, recognized the vital role that Fedwire services play in the U.S. financial system. In that statement, the Board reaffirmed that it holds Fedwire services to supervision standards that are comparable to or that exceed those for designated FMUs.

## ***Oversight of the Federal Reserve Banks' Wholesale Financial Services***

The Federal Reserve System plays an important role in the nation's payment systems by providing wholesale financial services to depository institutions. Participants use the Federal Reserve's wholesale financial services to exchange an average daily value of approximately \$4 trillion. Multiple parties within the Federal Reserve System, as described below, are involved in the oversight of wholesale financial services. Those parties routinely scrutinize the operations and risk-management practices of wholesale financial services to ensure their safety and effectiveness.

RBOPS is responsible for the oversight of Reserve Bank operations, including overseeing and monitoring various aspects of wholesale financial services. Within RBOPS, the Oversight Program Management group is responsible for the overall onsite review process for the Reserve Banks. As such, the Oversight Program Management group coordinates onsite reviews with respective Reserve Bank operations as well as with sections within RBOPS.<sup>8</sup> The FMI Oversight group within RBOPS supports the Board in meeting its statutory responsibilities under the Federal Reserve Act<sup>9</sup> for oversight of the Reserve Banks' wholesale financial services, as well as under Title VIII of the Dodd-Frank Act for supervision of the private-sector FMUs designated as systemically important.

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6. FMUs are multilateral systems that provide the infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions. The terms *FMU* and *FMI* are often used interchangeably.
  7. In 2012, the Financial Stability Oversight Council designated eight private-sector FMUs as systemically important under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, titled the Payment, Clearing, and Settlement Supervision Act of 2010. The Board is the supervisory agency for two of these private-sector FMUs.
  8. A Reserve Bank review typically includes, among other things, reviews of business areas such as business continuity, cash, human resources, discretionary expenditures, facilities management, financial accounting, and information technology.
  9. The Federal Reserve Act authorized and empowered the Board to exercise general supervision over the Federal Reserve Banks. The Board has delegated oversight responsibility to the Director of RBOPS (or the Director's designee) in certain circumstances.

Within the FMI Oversight group, the wholesale oversight team<sup>10</sup> oversees the Reserve Banks' wholesale financial services and works closely with officials and staff at the WPO to continuously monitor activities and conduct onsite reviews.<sup>11</sup> The wholesale oversight team communicates frequently with the WPO, performing ongoing monitoring through monthly calls to discuss current issues, receiving status updates on operations and weekly status reports for certain projects, and holding ad hoc teleconferences. These communications are intended to enable the oversight team to gain critical knowledge of the WPO's management and operations of wholesale financial services. In addition, the team has an annual supervisory plan for its reviews of wholesale financial services. These oversight activities are conducted in close coordination with other responsible parties. As an example, the Information Technology section within RBOPS participates in the oversight of wholesale financial services. The Reserve Banks' General Auditors also conduct audits on wholesale financial services at their respective Reserve Banks.

## **Reviews of Wholesale Financial Services**

The oversight of wholesale financial services has evolved to reflect the changing environment of payment, clearing, and settlement systems. The Board's decision to align its supervision of the Fedwire services with that of designated FMUs resulted in changes to the wholesale oversight team's approach in its supervision of Fedwire services. For example, historically, reviews of wholesale financial services were conducted as a part of the triennial geographical review of the relevant Reserve Bank. The FMI Oversight group now carries out annual reviews of wholesale financial services to align with the Title VIII requirement that supervisory agencies conduct annual examinations of designated private-sector FMUs. These reviews assess functions of wholesale services, regardless of where the particular functions are performed, and may involve more than one Reserve Bank.

### ***Review Planning***

The wholesale oversight team employs a risk-based planning process to identify risks in the operation and governance of wholesale financial services, which is consistent with the process examiners use to supervise private-sector FMUs. The team uses this process to (1) identify areas of supervisory focus and (2) prioritize and organize those areas into supervisory activities. The process incorporates the risk-management framework from the PSR policy and international principles. The team employed this process to plan its onsite review schedule for 2012 and 2013.

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10. The wholesale oversight team, which consisted of three staff members, had increased to four staff members as of June 2014, after we completed our fieldwork.

11. RBOPS is organized into sections that focus on distinct but related issues that generally align with financial services and support functions at the Reserve Banks, such as information technology, accounting, fiscal agency services, and retail services.

## Review Processes

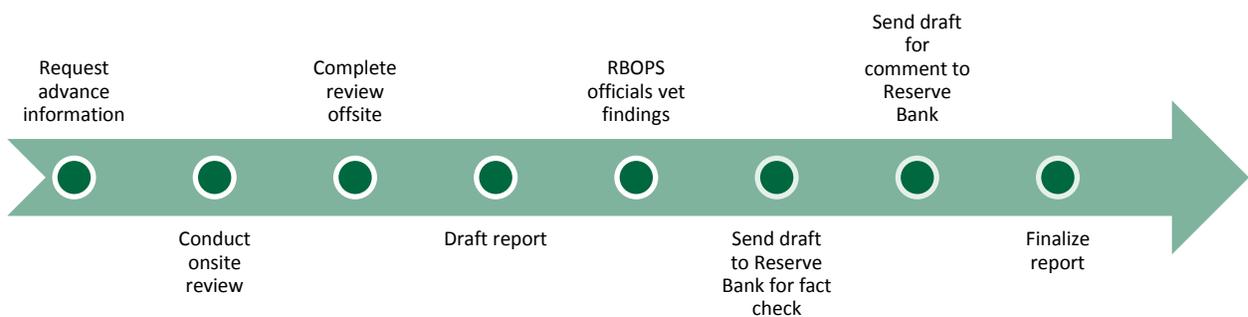
After identifying areas of supervisory focus and corresponding objectives and review plans, the wholesale oversight team works with the RBOPS Oversight Program Management group in preparing and conducting onsite reviews. The Oversight Program Management group is responsible for the overall review process and coordinates review logistics with Reserve Banks as well as other RBOPS review teams that conduct reviews of different business areas.

The wholesale oversight team obtains necessary information in advance to plan its onsite review procedures. Once onsite, the team spends about a week conducting its review. While onsite, the wholesale oversight team meets regularly with Reserve Bank staff members to discuss the status of the review. Additionally, the team holds a status meeting at the conclusion of its onsite visit and provides observation bullet points.

After the onsite visit, the wholesale oversight team completes its review and drafts a report. Each team member drafts his or her review section. The team then compiles the sections into one draft and submits the draft to FMI Oversight management. After management's review, the draft is submitted to the Oversight Program Management group. The Oversight Program Management group combines drafts from the wholesale oversight team and other RBOPS review teams that conducted their reviews concurrently.

The Oversight Program Management group schedules a senior management meeting with RBOPS officers, managers, project leaders, and some team members to discuss review findings. Each review team presents its review results and findings in the meeting, and senior management assesses the team's work and the resulting findings. Based on the results of the meeting, the review team will update or revise the findings as necessary. After Reserve Bank officials conduct a fact-checking review of the initial draft report, the Oversight Program Management group sends the official draft report to Reserve Bank officials for their review and finalizes the report after receiving the Reserve Bank officials' comments. The review process is depicted in figure 1.

**Figure 1: Review Process**



Source: OIG generated based on interviews with RBOPS staff and officials.

## ***Review Findings***

Review findings are tracked and monitored by multiple parties. Within RBOPS, the Oversight Program Management group is responsible for tracking review findings. The Oversight Program Management group tracks the status of review findings with a system called Issue Tracker. Staff members from the Oversight Program Management group enter review findings into the system and update the information as necessary. Depending on the severity level of findings, either RBOPS or the General Auditor, or both, may follow up on the findings. RBOPS can clear any findings, whereas the General Auditor can only close severity level 2 or 3 findings with RBOPS's concurrence.<sup>12</sup> General Auditors also have access to Issue Tracker and are responsible for reporting the status of the findings to the Oversight Program Management group quarterly. The wholesale oversight team tracks the status of findings through its frequent communication with the WPO and closely monitors the progress of findings resolution.

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12. See appendix B for the description of the severity levels of review findings.

# Finding: The FMI Oversight Group Needs to Formalize Its Policies and Procedures That Guide the Execution of Its Oversight Responsibilities

The FMI Oversight group uses a risk-based planning process, as well as the PSR policy and Reserve Bank Financial Services operating circulars, for guidance when assessing wholesale financial services. However, the wholesale oversight team within the FMI Oversight group does not have comprehensive formal policies and procedures that guide the execution and documentation of its onsite review of wholesale financial services. We found that a small percentage of onsite review documentation was incomplete, and we noted a few instances in which the reviewer indicated that he or she did not understand what a review step meant. In addition, we generally did not see indications of a second-level review of onsite review documentation. The *Standards for Internal Control in the Federal Government*, issued by the Comptroller General of the United States, offers guidance related to documenting and supervising oversight activities and lists policies and procedures as control activities that enforce management's directives. Additionally, the *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO),<sup>13</sup> discusses policies and procedures as control activities to establish clear responsibility and accountability. While the FMI Oversight group has begun to formalize procedures, comprehensive formal policies and procedures are not yet available because the group's enhanced review process is still evolving and the group had limited resources to support a formalization effort. We did not note any deficiencies regarding the efficiency and effectiveness of the FMI Oversight group's onsite review activities; however, we believe formal written policies and procedures would help promote the quality and consistency of oversight and ensure that new staff members understand and meet their responsibilities more quickly. Further, incorporating guidance from the *Standards for Internal Control in the Federal Government* into a more formalized process, as appropriate, may yield benefits, including standardizing information capture to build institutional knowledge, refining subsequent onsite review activities, and enhancing support for findings.

## The FMI Oversight Group Uses Informal Procedures to Guide the Execution of Its Oversight Responsibilities

The FMI Oversight group has informal procedures for review processes, and it uses policies such as the PSR policy and operating circulars to guide its review work and related assessments; however, the team does not have comprehensive formal policies and procedures that describe procedural steps for conducting the onsite review of wholesale financial services. The wholesale oversight team members provided us with the templates used for onsite examinations and were able to explain to us the informal process for the use of onsite documentation and for the

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13. COSO's internal control framework is widely used and recognized as a leading framework for designing, implementing, and evaluating the effectiveness of internal control. It integrates various internal control concepts into a framework in which a common definition is established and control components are identified. COSO's internal control framework was updated in May 2013 with a transition period ending December 15, 2014.

selection of a subject-matter expert for a review, but they could not provide comprehensive formal procedures.

When conducting onsite reviews of wholesale financial services, the wholesale oversight team within the FMI Oversight group completes documentation, which includes interview guides and write-ups from interviews and meetings with WPO management, sample testing results for Wholesale Operations Site operations, and templates with various work steps. While work steps in the templates describe the onsite review activities to be completed, the team does not have written formal guidance for completing, maintaining, and approving those templates.

For our audit, the FMI Oversight group provided us 59 documents associated with the 2011 and 2012 wholesale financial service onsite reviews. Templates accounted for slightly less than one-third (18) of the 59 documents. We found that 8 of the 18 review templates were incomplete; there was no documentation to evidence that 37 of the 179 review steps included in these 8 templates were completed by an analyst. We also identified documentation for a few of the tests conducted during the 2011 review in which the analyst responded to a work step with an explanation that he or she did not understand what the work step meant. We did not find these issues with the remaining 41 documents. However, we did not see any indication of a system of formal second-level review for onsite review documentation, and we were unable to find records or evidence to support that a second-level review of the onsite review documentation took place.

The *Standards for Internal Control in the Federal Government* lists policies and procedures as control activities. Control activities are an important tool for ensuring that actions are taken to address risks that occur at all levels, and they include a wide range of diverse activities, such as approval, authorization, verification, and maintenance of records showing appropriate documentation. The *Standards for Internal Control in the Federal Government* states that policies and procedures ensure an entity's accountability for achieving effective results. It further states that management is responsible for developing the detailed policies, procedures, and practices that are built into the agency's operations. Additionally, the COSO framework discusses policies and procedures as control activities and states that policies establish what is expected and procedures put policies into action. Although the COSO framework acknowledges that unwritten policies can be effective in certain environments, it cautions that unwritten policies and procedures can be easier to circumvent and can be costly to the organization if there is turnover in personnel.

According to the FMI Oversight group, the group does not have a formal process for onsite review documentation or internal requirements for a second-level review of the documentation. The FMI Oversight group stated that its workpapers are used to inform and document the review write-up. FMI Oversight officials further explained that the incomplete steps we found were not applicable to the specific review procedures being conducted at that time. An FMI Oversight staff member stated that certain tests may not have made sense once the review team was onsite at the bank, and thus the reviewer may have left the work step blank or written that he or she did not understand the meaning of the work step. FMI Oversight group management also stated that the team has numerous meetings during and after the onsite review to ensure that needed work was performed during the review and to examine and verify any observations.

The FMI Oversight group has begun to establish procedures that include a working draft of an overview document of recurring responsibilities within the FMI Oversight function. According to an RBOPS official, the FMI Oversight group is currently defining policies and procedures. The ongoing evolution of review procedures and limited staff resources prevented the FMI

Oversight group from formalizing all its policies and procedures. An FMI Oversight official stated that the group's goal was to start formalizing policies and procedures in 2014.

While we recognize that RBOPS is not a traditional audit organization, we believe that the FMI Oversight group can improve its oversight by enhancing and formalizing its policies and procedures. Written policies and procedures specific to the oversight of wholesale financial services, including formalized review documentation procedures, can help ensure consistency within the team throughout the review process and in ongoing monitoring. Additional benefits include helping new staff to understand and meet their responsibilities more quickly. Further, we believe that a formal process that incorporates a second-level review of workpapers could ensure the completeness, quality, and consistency of work performed and concrete support or evidence for the review findings.

## **Recommendation**

We recommend that the Director of RBOPS

1. Develop and document comprehensive formal policies and procedures to guide the execution and documentation of the onsite review of wholesale financial services, which should include a second-level review of onsite review documentation when necessary.

## **Management's Response**

The Director of RBOPS generally concurs with this recommendation. In her response, the Director noted that RBOPS is not a traditional audit organization and does not derive its oversight practices from conventional audit standards. The Director stated, however, that RBOPS agrees with the benefits associated with enhancing its oversight procedures and has initiated efforts to augment existing procedures and, if necessary, develop new procedures that guide its onsite reviews of wholesale financial services.

## **OIG Comment**

We believe that the actions described by RBOPS are responsive to our recommendation. The OIG intends to follow up on RBOPS's actions to ensure that the recommendation is fully addressed.

# Appendix A

## Scope and Methodology

Our overall objective for this audit was to assess the extent and effectiveness of RBOPS's oversight of the Reserve Banks' wholesale financial services. Specifically, we reviewed how RBOPS assesses wholesale financial services against the standards defined in the PSR policy to determine whether the systems incorporate (1) an appropriate risk-management framework and (2) the international principles and recommendations in their policies and procedures.

We used the guidelines in the *Standards for Internal Control in the Federal Government*, issued by the Comptroller General of the United States, as well as COSO's *Internal Control—Integrated Framework*, to assess RBOPS's oversight.

To accomplish our overall objective, we reviewed the PSR policy; applicable sections of the Federal Reserve Act; Title VIII of the Dodd-Frank Act, the Payment, Clearing, and Settlement Supervision Act of 2010; WPO's standard operating procedures; the *Federal Reserve Administration Manual*; and relevant Federal Reserve Bank Financial Services operating circulars.

We evaluated RBOPS's documentation, including Reserve Bank review observation bullets, final reports, and review documentation; training program information; and risk-based planning process information. We interviewed relevant RBOPS staff members within the FMI Oversight, Oversight Program Management, and Information Technology groups and wholesale financial services' officials and General Auditors at the responsible Federal Reserve Banks.

The scope of our audit included RBOPS's onsite reviews of wholesale financial services for the calendar years 2011 and 2012. We selected these years, and reviewed all associated documentation, because RBOPS changed its oversight approach for wholesale financial services from its triennial geographical approach to an annual functional approach in 2012.

We conducted our audit fieldwork from May 2013 to November 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objective.

# Appendix B

## Federal Reserve Bank Review Findings Severity Levels

Each review finding or issue is classified using numeric rankings of 1 through 4, which are defined as follows:

- **Severity Level 1:** These issues are considered highly significant. They warrant immediate action and senior management attention and are only closed by RBOPS. Reserve Bank General Auditors report to RBOPS the status of these issues quarterly.
- **Severity Level 2:** These issues are considered significant and warrant prompt action and management attention. After consultation with RBOPS, Reserve Bank General Auditors may close these issues. General Auditors report to RBOPS the status of these issues quarterly. RBOPS follows up on severity level 2 issues as appropriate.
- **Severity Level 3:** These issues are less significant and may be closed by Reserve Bank General Auditors with RBOPS concurrence. General Auditors report to RBOPS the status of these issues quarterly. RBOPS follows up on these issues in its Reserve Bank review cycle.
- **Severity Level 4:** These issues are considered observations. Reserve Bank General Auditors follow up on a discretionary basis. RBOPS follows up on these issues in its review cycle unless General Auditors follow up on the issues and report them as closed.

# Appendix C Management's Response



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D.C. 20551

LOUISE L. ROSEMAN  
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DIVISION OF  
RESERVE BANK OPERATIONS  
AND PAYMENT SYSTEMS

September 22, 2014

Ms. Melissa Heist  
Associate Inspector General for Audits and Evaluations  
Office of the Inspector General  
Board of Governors of the Federal Reserve System  
Washington, D.C. 20551

Dear Melissa:

Thank you for the opportunity to comment on the OIG's draft report titled *Opportunities Exist to Enhance the Onsite Reviews of the Reserve Banks' Wholesale Financial Services*. We are pleased the OIG found no deficiencies in the efficiency and effectiveness of the onsite review activities conducted by the division's Financial Market Infrastructure Oversight program. As the report recognizes, we apply international risk-management standards and various supervisory approaches in the oversight of the Reserve Banks' wholesale financial services. We believe this comprehensive approach enhances the effectiveness and efficiency of our oversight of these services.

The draft report identifies one finding and a related recommendation concerning the need for our team to develop and document formal policies and procedures to guide the onsite review of wholesale financial services. As the report acknowledges, we are not a traditional audit organization. We do not derive our oversight practices from conventional audit standards (for example, the development and review of audit workpapers). We agree, however, with the benefits noted of enhancing our oversight procedures, and have initiated efforts to augment existing and develop new (if necessary) procedures that guide our onsite reviews of wholesale financial services.

Sincerely,

A handwritten signature in cursive script that reads "Louise".



## OFFICE OF INSPECTOR GENERAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
CONSUMER FINANCIAL PROTECTION BUREAU

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### Questions about what to report?

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