

# Background

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## Transparency and Accountability at the Federal Reserve

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**Abstract:** *Increasing transparency at the Federal Reserve is critical given the breadth of the Fed's recent activities, but many of these activities involve private parties. Congress should consider that private firms will be disinclined to deal with the Fed if they lack adequate assurances that confidential information will remain confidential. As Heritage analyst J. D. Foster, Ph.D., explains, tasking the GAO to perform a comprehensive audit of the Fed would create new dangers as the GAO, being a creature of Congress, could not provide the necessary assurances. It could also ultimately diminish the independence of the Fed and therefore degrade the Fed's ability to fight inflation. A better approach is to rely on the Fed's Office of Inspector General to carry out the audit and to create a new entity in Congress to receive any confidential information associated with the audit.*

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The Federal Reserve has taken extraordinary actions during the recent financial crisis, beginning most notably with the managed collapse of Bear Stearns in March 2008. These actions have vastly expanded the Fed's scope of dealings with credit markets and the sheer size of the central bank as a financial institution in its own right. Always imbued with enormous powers, the Fed now has a previously unimagined sway over financial markets generally and over individual institutions across the domestic financial system.

The Fed's actions have led to deep, legitimate, and bipartisan concerns in many respects, including the nature of the Fed's novel transactions and the lack of

### Talking Points

- The Fed has provided an extensive array of regularly updated information on its recent activities, but it is not enough. Much more transparency is required, including a comprehensive audit, especially given the enormous sums involved.
- The GAO, as a creature of Congress, is not the right instrument for an audit of the Fed and risks subjecting the Fed and monetary policy to undue political pressures.
- Congress should task the Fed OIG with completing a confidential, comprehensive audit of the transactions and related issues in all new programs created during the recent crisis.
- No private entity should be at risk that its private proprietary or confidential information would be publicly aired as a result of transacting with the central bank.
- Congress should create a Joint Select Committee on the Federal Reserve to act as the taxpayers' watchdog—yet with a structure that guarantees the protection of the highly confidential information it would receive from the Fed OIG.

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transparency in which they were consummated. Though the Fed has provided an extensive array of regularly updated information sources on its Web site and elsewhere, it is not enough. Much more transparency is required, especially given the enormous sums involved.

In response, policymakers have proposed subjecting these transactions to audit by the Government Accountability Office (GAO).<sup>1</sup> While the policy concerns behind this legislation are valid and a comprehensive audit the appropriate response, the GAO, as a creature of Congress, is not the right instrument for the task. A GAO audit risks ultimately subjecting the Fed and monetary policy to undue political pressures, leading to a loss of the independence necessary to maintain low inflation. Moreover, information obtained through a GAO audit could be obtained by any Member of Congress who in turn could make critical, appropriately confidential information public. The threat of having confidential information released publicly could diminish the willingness of firms to engage with the Fed even under normal circumstances and could materially degrade the Fed's ability to act as lender of last resort in times of crisis.

In addressing their concerns, policymakers should keep three principles at the forefront:

1. Transparency is essential to congressional oversight and public confidence but also to the credibility and reputation of the Fed as a public institution.
2. Examinations of Fed activities involving private parties must respect confidentiality, but they must in some manner also be available to select Members of Congress and their staff on a carefully guarded, confidential basis.
3. Proposed remedies should neither politicize nor create the potential to influence the Fed for political purposes, nor should they weaken the Fed's ability to respond appropriately to future financial crises.

A far better approach, consistent with these three principles, is to follow current forms. To

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start, like all agencies, the Federal Reserve has a fully empowered Office of Inspector General (Fed OIG). Congress should task the Fed OIG with completing a confidential, comprehensive audit of the transactions and related issues in all new programs created during the recent crisis. Having determined the appropriate auditor, the question remains as to who in Congress is to receive and evaluate the audit.

The House and Senate have each established select committees on intelligence to review the activities of the nation's intelligence community and to receive regular, top-secret analysis and reports. Congress has also established bicameral "joint" committees, such as the Joint Economic Committee and Joint Tax Committee. Analogously, Congress should establish a Joint Select Committee on the Federal Reserve to receive and review the Inspector General's comprehensive audit. The committee would then summarily report back to Congress and the American people, exclusive of private confidential information, on the Fed's performance regarding these extraordinary transactions.

### **Extraordinary Actions, Extraordinary Consequences**

The Fed literally rewrote the book on crisis central banking during the recent global financial contagion. These actions included taking the federal funds rate to near zero and shifting to an aggressive policy of quantitative easing. The Fed expanded the types of institutions for which it serves as lender of last resort, going beyond commercial banks to investment banks and eventually to whatever troubled major financial institution appeared to pose a systemic risk.

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1. The leading legislation is the Federal Reserve Transparency Act of 2009, H.R. 1207, introduced by Congressman Ron Paul (R-TX), and its Senate companion bill, S. 604, introduced by Senator Jim DeMint (R-SC).

The Fed greatly expanded the types of financial instruments it would trade, such as agency mortgage-backed securities. The Fed expanded its traditional Discount Window lending facility, which hitherto had largely made overnight loans, to permit loans of up to 90 days. It established the Term Asset-Backed Securities Loan Facility, through which it supported the securitization markets for consumer and small business credit, and the Commercial Paper Funding Facility to support the commercial paper market.

The Fed's actions, along with those of other major central banks, succeeded in preventing the global financial system from collapsing. Yet whatever the proprieties and necessities of the Fed's actions, its newly demonstrated powers leave policymakers deeply disquieted that so much power should rest in the (unelected) hands of so few. This disquiet is exacerbated by the fact that no one outside the Fed knows all of what the Fed has done with billions of taxpayer funds given the complexities and implications of the Fed's new programs. And the nagging suspicion persists that along the way many individuals and firms at the center of the storm have profited unduly—including many who may have contributed significantly to its onset. The public must be able to rely on its elected representatives to provide appropriate oversight of the Fed in these matters, yet market participants must remain assured that the Fed and Congress will hold crucial information confidential.

### **The Many Hues of Information and Transparency**

These appropriate concerns naturally lead to an impetus to improve the Fed's transparency as it exercises these new powers and to ensure against improprieties by the Fed or by private parties. Improved transparency is certainly needed, but policymakers also need to be clear and careful about the sorts of information at issue and their treatment. For example, there is broad agreement that as a public institution there is little if anything regarding the Fed's own operations that ought to be shielded from public and congressional scrutiny.

At the same time, however no private entity should be at risk that its private proprietary or con-

fidential information would be publicly aired as a result of transacting with the central bank. For example, suppose a bank participates in a Fed program. The Fed's activities should be open to public scrutiny, but transacting with the Fed should not open the bank to the risk that the transaction's details would be made public. Nor should the bank be at risk of indirectly disclosing confidential information that might reveal its business strategy, the makeup of its assets, proposed new financial products, or relationships to its clients or investors. Much of this business-critical information can be gleaned from transactional details by discerning competitors.

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Information specific to the Fed should be subject to public oversight as a general rule, and private information on transactions with the Fed must be reviewed on behalf of the taxpayer. But the information itself, including details such as the name of the institution, the nature of any collateral, the price or interest rate paid, and the duration, need not be made public to achieve the desired transparency and indeed must not be made public or both commerce and the Fed's effectiveness would be severely damaged. So great care must be exercised in choosing which entity will review these activities, who in Congress will receive the information, and on what basis it will all occur.

### **Current Efforts at Transparency**

For decades since its inception, the Fed zealously guarded the secrets of its internal workings against prying public eyes. This naturally led to great distrust in the Fed generally, but it also diminished its effectiveness. Consequently, in recent years the Fed has significantly improved its transparency before Congress and the American people. In addition to traditional congressional testimony, public reports, and speeches, the Federal Open Market Committee now releases a statement immediately after each

regularly scheduled meeting, and detailed minutes are released subsequently.

The Fed now publishes its economic forecasts on a regular basis. Beginning in June of this year, the Fed also began to publish a monthly report on its Web site as required by the Emergency Economic Stabilization Act of 2008 (the legislation that created the Troubled Asset Relief Program, or TARP) providing additional information on the Fed's liquidity programs, including details of its lending, collateral, etc.<sup>2</sup> When actions are publicly announced—such as occurred with Bear Stearns, AIG, Citigroup, and Bank of America—the Fed posts the terms and conditions of the transaction.<sup>3</sup>

The Board, the Reserve Banks, and the Federal Reserve System are all subject to several levels of audit and review. The Fed's financial statements and its compliance with laws and regulations affecting those statements are audited annually by an outside auditor retained by the Fed OIG. The financial statements of the 12 individual Reserve Banks are also audited annually by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board. The Board's financial statements and the combined financial statements for the Reserve Banks are published in the Board's annual report.

The Fed publishes the terms and conditions along with extensive data on its Discount Window facility, a long-standing program designed to relieve liquidity needs at specific depository institutions. It also publishes such information relating to its open market operations through which the Fed interacts with market participants to sustain its target Federal funds rate.<sup>4</sup> Apropos the current debate, the Fed has never published the details of the individual trans-

actions relating to the Discount Window facility or open market operations, nor has this heretofore been a notable issue.

The GAO, under authority from Congress, has conducted numerous reviews of Federal Reserve program effectiveness outside the realm of monetary policy per se. In 2008, for example, the GAO completed seven reports (with an additional eight in process) dealing broadly with the management and effectiveness of Fed programs, such as information security, risk-based capital requirements, and federal enforcement of fair lending laws. In addition, the Fed OIG audits and investigates Board programs and operations as well as those Board functions delegated to the Reserve Banks. Completed and active GAO reviews and completed Fed OIG audits, reviews, and assessments are listed in the Board's annual report.<sup>5</sup>

### More, Yet Guarded, Transparency Needed

Steps taken thus far by the Fed reflect a high degree of transparency by the nation's central bank. However, the Fed has strenuously resisted providing detailed information relating to specific transactions. The Fed's determined lack of transparency in this area has raised red flags among policymakers, leading to Freedom of Information Act filings with the Fed and proposed legislation in Congress to subject the Fed to an outside audit of its activities, possibly by the GAO.

Three key considerations should guide policymakers as they address these issues:

1. **Relevant transparency is key.** Transparency is essential to congressional oversight and public confidence but also to the credibility and reputation of the Fed as a public institution. How-

2. See Federal Reserve Board of Governors, "Federal Reserve System Monthly Reports on Credit and Liquidity Programs and Balance Sheet," at [http://www.federalreserve.gov/monetarypolicy/bst\\_reports.htm](http://www.federalreserve.gov/monetarypolicy/bst_reports.htm) (November 18, 2009).

3. See Federal Reserve Board of Governors, "Support for Specific Institutions," at [http://www.federalreserve.gov/monetarypolicy/bst\\_supportspecific.htm](http://www.federalreserve.gov/monetarypolicy/bst_supportspecific.htm) (November 18, 2009).

4. See Federal Reserve Board of Governors, "The Primary and Secondary Lending Programs," at <http://www.frbdiscountwindow.org/programs.cfm?hdrID=14> (November 18, 2009), and "Open Market Operations," at [http://www.federalreserve.gov/monetarypolicy/bst\\_openmarketops.htm](http://www.federalreserve.gov/monetarypolicy/bst_openmarketops.htm) (November 18, 2009).

5. See Federal Reserve Board of Governors, "Annual Report of the Board of Governors of the Federal Reserve System," at <http://www.federalreserve.gov/boarddocs/RptCongress/> (November 18, 2009).



ever, the scope of the needed transparency is not boundless.

2. **Audits for transparency must respect confidentiality.** The Fed should be subject to a financial audit of its recent activities as a financial institution, much as would any financial institution. The audit should be performed by a qualified, independent party and should among its concerns emphasize the discovery of fraud or abuse in Fed programs. This audit should not be performed by the GAO, which has neither the expertise nor the independence necessary. A GAO audit would also jeopardize the confidentiality of private information necessary to carry out the Fed's mission.
3. **Do not politicize the Fed.** Congress should take care to devise no new reporting structures that might politicize or otherwise infringe upon the Fed's independence or degrade its effectiveness. This is paramount to maintaining the expectation and the reality of low inflation and the Fed's ability to respond in a crisis.

### **Preserving the Fed's Independence, Lender of Last Resort Effectiveness**

American political systems operate best in broad daylight, whereas mischief lies in the shadows. In contrast, economic transactions, especially financial transactions, typically require that the particulars of the transaction remain confidential. This is true whether the transaction involves two private parties or a private party and the Federal Reserve.

The Fed must preserve the confidentiality of the counterparties in its transactions; otherwise, the counterparties would be highly reluctant to participate in Fed programs even to ensure their own survival or the financial system's stability. Lacking this assurance of confidentiality, the Fed would have been far less effective in responding to the recent crisis.

These two realities—the need for transparency and the need for confidentiality—come into stark conflict in many of the Fed's recent activities. The Fed must assure that a private party's confidentiality will be respected. But this confidentiality also means that transactions with a public entity are

explicitly not transparent, creating suspicions of mischief and abuse.

### **The GAO Is Not the Way to Go**

A resolution of the conflict between confidentiality and transparency is in the best interests of the economy, the taxpayers, and the Federal Reserve. Some form of extraordinary, credible, outside examination is necessary. However, contrary to what some have suggested, the GAO is not the appropriate instrument to carry out this task for one transcendent and inescapable reason: The GAO is itself a creature of the United States Congress.

While the independence and quality of the GAO's work today is not in question, the same cannot necessarily be assured for the future. More importantly, because the GAO is a creature of Congress, neither the Fed nor ultimately the GAO can guarantee that the details of transactions between the Fed and private parties audited by the GAO would remain confidential before Congress. No private party would assume that a Member of Congress could not in general or even under specific circumstances demand and obtain critical, firm-specific information arising out of a GAO audit. And certainly no private party would assume that, having obtained this confidential information, it would remain confidential in congressional hands. On the contrary, if the GAO has sensitive, private informa-

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tion, then private parties must assume that Congress will have the information and that the information will be made public.

In addition, the prospect of a GAO audit in the hands of Congress can quickly become a new club with which Members of Congress can bludgeon the Fed over the conduct of monetary policy, especially as the Fed hikes interest rates to prevent inflation—

an especially important concern under present circumstances. The independence of a central bank in the setting of monetary policy is fundamental to hopes of preserving a modicum of price stability. A GAO audit of confidential information in the hands of Congress would represent an implicit threat to the Fed's independence and therefore to price stability.

## Two Smart Steps Toward Greater Transparency

An alternative, effective means of achieving the desired transparency while assuring confidentiality is to adapt existing forms, such as the Fed OIG, to the new task. According to the Fed OIG's Web site:

The Office of Inspector General (OIG) conducts independent and objective audits, inspections, evaluations, investigations, and other reviews related to programs and operations of the Board of Governors of the Federal Reserve System (Board). OIG efforts promote integrity, economy, efficiency, and effectiveness; help prevent and detect fraud, waste, and abuse; and strengthen accountability to the Congress and the public. The OIG's work assists the Board in managing risk and in achieving its overall mission to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.<sup>6</sup>

In 2008, for example, the Fed OIG completed 15 audits and similar examinations.

The Fed OIG is capable of addressing many of the concerns recently raised about the Fed's new activities, their propriety, and to an extent their effectiveness. Given the greater range and scope of the Fed's activities, Congress should ensure that the Fed OIG has sufficient resources to carry out a more thorough internal examination of Fed transactions under its extraordinary programs. These examinations should affirm that the transactions are performed according to the law and guidelines set up for the program and consistent with normal business practices. As with any audit of a financial institution, in the event the

Fed OIG discovers improprieties, existing remedies and processes are applicable.

The first step toward enhanced Fed transparency where it is most needed today is to task and empower the existing competent authority of the Fed OIG. However, reports of the Fed OIG are released to Congress and to the public at large. Because of the extraordinary nature of the Fed's recent activities, Congress is correct in inquiring after the additional information that would result from the OIG's examination process. However, much of this information is precisely what needs to remain confidential for private parties to be willing to engage in transactions with the Fed.

The solution is again to rely on existing forms. For example, Congress has created a handful of bicameral, or "joint" committees for specific purposes, most notably the Joint Tax Committee to advise on tax policy and the Joint Economic Committee to provide a specific venue to review economic policy and developments. Also, the House and Senate each have a select committee on intelligence to oversee the activities of the nation's intelligence services and to receive special, highly classified intelligence reports and testimony from federal officials.

Using these models, Congress should create a Joint Select Committee on the Federal Reserve to act as the taxpayers' watchdog—yet with a structure that guarantees the protection of the highly confidential information it would receive. Reflecting both the bicameral nature of the committee and its charter to receive highly confidential information from the Fed OIG, the new committee would:

- Have eight members drawn from the House and Senate Banking Committees, two members from each party;
- Be professionally staffed by individuals with the highest economic security clearances; and
- Receive a separate, periodic, confidential report from the Fed OIG, including whatever related information the committee deems necessary. The committee would then summarily report to the

6. Board of Governors of the Federal Reserve System, "Office of Inspector General," at <http://www.federalreserve.gov/oig/> (November 4, 2009).

full Congress and the American people on the substance of the audit, exclusive of all private, confidential information.

Federal penalties similar to those associated with confidential government data should attach to individuals who disclose confidential information provided to the committee by the Fed OIG.

### **Use Fed OIG and Special Committee, Not GAO**

Extraordinary actions by the Fed necessitate extraordinary steps toward transparency. However, these steps must be taken carefully to avoid politicizing or diminishing the independence of the Fed and to avoid diminishing the Fed's effectiveness acting as lender of last resort in a crisis.

Some have suggested this greater transparency be achieved through specifically directed GAO audits. As an agent of Congress, the GAO would run afoul of these cautions. A fully capable and resourced Fed OIG reporting in confidence to a special Joint Select Committee on the Federal Reserve would achieve the goals of greater transparency in the Fed's use of taxpayer funds while preserving the confidentiality of private transactions and the independence and effectiveness of the Federal Reserve.

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