

Banking and Finance Law Daily Wrap Up, OVERSIGHT AND INVESTIGATION—GAO reminds the Fed, OCC, FDIC of their high-priority recommendations, (Aug. 9, 2023)

Banking and Finance Law Daily Wrap Up

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All three agencies were asked for continued attention to recommendations pertaining to blockchain technology and financial technology, while the Fed was also asked to give attention to stress testing.

The Government Accountability Office (GAO) has sent letters to the [Federal Reserve Board](#), [Federal Deposit Insurance Corporation](#), and [Office of the Comptroller of the Currency](#) providing updates on the agencies' overall status on implementation of the GAO's recommendations and calling for continued attention to open recommendations that should be given high priority. For all three agencies, two of the priority recommendations involve establishing a formal coordination mechanism to identify and address blockchain-related risks and communicating the appropriate use of alternative data in the underwriting process with banks engaging in third-party relationships with financial technology (fintech) lenders. In addition, the Fed was tasked with improving its ability to manage model risk and stress testing of banking institutions. The GAO also urged the adoption of noncapital triggers into the agencies' corrective action frameworks and continuation of their efforts to modernize the U.S. financial regulatory system.

Blockchain technology. Noting the recent fraud, bankruptcies, and volatility of the crypto assets markets, the GAO recommended that the agencies and other financial regulators jointly establish a formal coordination mechanism to identify and address blockchain-related risks. The GAO believes that implementation of such a coordination mechanism would allow the agencies to collectively identify risks posed by blockchain-related products and services and develop and implement regulatory responses in a timely manner. This would also “improve protections for consumers and investors, mitigate illicit finance and threats to financial stability, and promote responsible innovation and U.S. competitiveness.”

Fintech. According to the GAO, when determining creditworthiness, fintech lenders may analyze large amounts of alternative data on borrower characteristics, such as information from bank accounts. The GAO recommended that the agencies, along with other federal banking regulators and the Consumer Financial Protection Bureau, communicate the appropriate use of alternative data in the underwriting process, including issues to consider when selecting types of alternative data to use, with banks that engage in third-party relationships with fintech lenders. The GAO believes that implementation of such communication could better position federally regulated banks to manage the risks associated with partnering with fintech lenders using the data. According to the GAO, “[c]lear communication on appropriate use of alternative data would give fintech lenders greater certainty about their compliance with consumer protection laws and help banks manage the risks associated with partnering with fintech leaders.”

Stress testing. The GAO had two priority recommendations for the Federal Reserve's Board of Governors concerning stress testing of banking institutions to ensure they have enough capital to survive economic shocks and continue lending activities. The recommendations include implementing a process to communicate information on the uncertainty surrounding post-stress capital ratio estimates during capital analysis and review deliberations. The GAO also recommended implementing a process to articulate tolerance levels for key risks identified through sensitivity testing and for the degree of uncertainty in the projected capital ratios. The GAO believes that implementing these two recommendations could help the Fed manage the risks in its models and appropriately account for uncertainty and sensitivity of model results. If the Fed does not implement these recommendations, the GAO believes the Fed “may miss important connections between elements of component

models, which in turn may limit understanding of risks inherent in their modeling choices” and that it “may be limited in its ability to effectively evaluate and manage its model risk.”

Corrective action framework. All three agencies were also urged by the GAO to revisit their prompt corrective action frameworks. According to the GAO, it recommended in 2011 that the agencies and other regulators consider adopting noncapital triggers that would require “early and forceful” regulatory actions tied to unsafe banking practices. Although the regulators considered noncapital triggers, none were added to the agencies’ frameworks. The GAO maintains that “incorporating noncapital triggers would encourage earlier action and give the regulators and banks more time to address deteriorating conditions.”

Modernization. One of the high-risk areas the GAO included on its last biennial update to its High-Risk List identifying government operations with greater vulnerabilities to fraud, waste, abuse, and mismanagement or the need for transformation to address economy, efficiency, or effectiveness challenges was modernizing the U.S. financial regulatory system. All three agencies were urged to pay attention to the “effective and efficient oversight of financial institutions and activities.” Other government-wide high-risk areas directly relating to all three agencies include: (1) improving the management of IT acquisitions and operations, (2) improving strategic human capital management, (3) managing federal real property, (4) ensuring the nation’s cybersecurity, and (5) managing the government-wide personnel security process.

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