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Testimony

Before the Subcommittee on Government  
Management, Organization, and  
Procurement, House Committee on  
Oversight and Government Reform

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**INSPECTORS GENERAL**

**Independent Oversight of  
Financial Regulatory  
Agencies**

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General Counsel



**GAO**

Accountability \* Integrity \* Reliability

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss H.R. 885, *Improved Financial and Commodity Markets Oversight and Accountability Act*. As you know, this proposed legislation recently referred to your subcommittee is intended to enhance the independence of inspectors general (IG) in key financial regulatory agencies including the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the National Credit Union Administration, the Pension Benefit Guaranty Corporation, and the Securities and Exchange Commission. In numerous reports and testimonies over the last several years, we have discussed the key role that IGs play in federal agency oversight.<sup>1</sup>

The Inspector General Act of 1978,<sup>2</sup> created offices of inspector general at major departments and agencies with IGs who are appointed by the President, confirmed by the Senate, and may be removed only by the President with notice to the Congress stating the reasons. (See app. I.) The IGs are to prevent and detect fraud and abuse in their agencies' programs and operations; conduct audits and investigations; and recommend policies to promote economy, efficiency, and effectiveness. In 1988, the 1978 IG Act was amended to establish additional IG offices in designated federal entities (DFE) defined by the act.<sup>3</sup> Generally, the DFE IGs have the same authorities and responsibilities as those originally established by the IG Act but there is a clear distinction—they are appointed and may be removed by their agency heads rather than by the President and are not subject to Senate confirmation. (See App. II.) In the now more than three decades since passage of the IG Act, the IGs have been instrumental in enhancing government accountability.

Our nation is currently in the midst of one of the worst financial crises ever. As we recently reported, the current U.S. financial regulatory system

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<sup>1</sup>GAO, *Inspectors General: Opportunities to Enhance Independence and Accountability*, [GAO-07-1089T](#) (Washington, D.C.: July 11, 2007); GAO, *Inspectors General: Proposals to Strengthen Independence and Accountability*, [GAO-07-1021T](#) (Washington, D.C.: June 20, 2007); GAO, *Highlights of the Comptroller General's Panel on Federal Oversight and the Inspectors General*, [GAO-06-931SP](#) (Washington, D.C.: September 11, 2006); GAO, *Inspectors General: Enhancing Federal Accountability*, [GAO-04-117T](#) (Washington, D.C.: October 8, 2003); GAO, *Inspectors General: Office Consolidation and Related Issues*, [GAO-02-575](#) (Washington, D.C.: August 15, 2002).

<sup>2</sup>Pub. L. No. 95-452, 92 Stat. 1101 (Oct. 12, 1978) (codified, as amended, at 5 U.S.C. App.).

<sup>3</sup>Pub. L. No. 100-504, 102 Stat. 2515 (Oct. 18, 1988) (5 U.S.C. App.).

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has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the last 150 years—that has not kept pace with major developments in financial markets, products, and associated risks in recent decades.<sup>4</sup> It has become apparent that the U.S. financial regulatory system is ill suited to meet the nation’s needs in the 21st century, and significant reforms to the U.S. financial regulatory system are critically and urgently needed. We have included modernization of the outdated U.S. financial regulatory system as a high-risk area in our recent report of high-risk designations across the federal government.<sup>5</sup>

Currently, both the administration and the Congress are considering many options aimed at strengthening the financial regulatory system. H.R. 885 would provide for the inspectors general for selected financial regulatory agencies to be appointed by the President with Senate confirmation. Those IGs currently are appointed by their agency heads and may be removed by their agency heads.

Today, I will discuss (1) the legislative proposals in H.R. 885, (2) the key principles and importance of auditor and IG independence, and (3) current coordination mechanisms in place for IG offices. My testimony today draws primarily on prior GAO reports and testimonies conducted in accordance with generally accepted 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Provisions of H.R. 885

Currently, the IGs at the Federal Reserve Board, Commodity Futures Trading Commission, Securities and Exchange Commission, National Credit Union Administration, and the Pension Benefit Guaranty Corporation are appointed to their offices by their agency heads and may be removed from office by their respective agency heads. H.R. 885, *Improved Financial and Commodity Markets Oversight and Accountability Act*, would provide for the conversion of these IGs from

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<sup>4</sup>GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan 8, 2009).

<sup>5</sup>GAO, *High –Risk Series: An Update*, GAO-09-271 (Washington, D.C.: January 2009).

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appointment by their respective agency heads to appointment by the President with confirmation by the Senate. Likewise, after this conversion, these IGs may be removed only by the President with advance notification to the Congress of the reasons. We believe that the differences in the appointment and removal processes between presidentially appointed IGs and those appointed by their agency heads result in a clear difference in the level of independence of the IGs. A general tenet to keep in mind is that the further removed the appointment source is from the entity to be audited, the greater the level of independence.

In the past, the Congress has taken actions to convert IGs from appointment by their agency heads to appointment by the President with Senate confirmation as a way to enhance IG independence. For example, on the heels of the savings and loan and banking crisis, over two decades ago, the role of the Federal Deposit Insurance Corporation's (FDIC) IG became increasingly important in providing oversight. Due to the perceived limitation of the FDIC IG's independence resulting from agency appointment, the Congress converted the IG from agency appointment to appointment by the President with Senate confirmation.<sup>6</sup> In another example, the Congress took action to convert the Tennessee Valley Authority (TVA) IG to appointment by the President with Senate confirmation because of concerns about interference by TVA management.<sup>7</sup> In both cases, Congress recognized that the IG's independence would be enhanced by the presidential appointment. The change from agency appointment to appointment by the President has been recognized by Congress since the advent of the IG concept as strengthening the critical element of IG independence. As we have noted in prior reports and testimony, we believe independence is one of the most important elements of an effective IG function.

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## Auditor and IG Independence

We believe that the differences in the appointment and removal processes between presidentially appointed IGs and those appointed by agency heads result in a clear difference in the organizational independence of the IGs. The IG Act, as amended (IG Act),<sup>8</sup> requires IGs to perform audits in

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<sup>6</sup>Resolution Trust Corporation Completion Act, Public Law 103-204, Dec. 17, 1993.

<sup>7</sup>Pub. L. No. 106-422, 114 Stat. 1872 (Nov. 1, 2000).

<sup>8</sup>Codified at 5 U.S.C. App.

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compliance with *Government Auditing Standards*<sup>9</sup> and authorizes IGs to conduct inspections and investigations.<sup>10</sup> These standards recognize the methods for external appointment and removal of the IG as key independence considerations to enable internal IG offices to report their work externally. Those offices with IGs appointed by the President are more closely aligned with the independence standards for external audit organizations,<sup>11</sup> while those offices with IGs appointed by the agency head are more closely aligned with the independence standards for internal audit organizations.<sup>12</sup>

In 1988, IG Act amendments created the DFE IGs, including those covered by H.R. 885, with a clear distinction in their appointment—they are appointed and removed by their entity heads rather than by the President and are not subject to Senate confirmation. Organizational independence differs between the offices of presidentially appointed IGs and other IGs who are agency appointed. The DFE IGs, while generally covered by many of the same provisions of the IG Act as the IGs appointed by the President with Senate confirmation, are more closely aligned to independence standards for internal auditors than to those for external auditors. At the

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<sup>9</sup>GAO, *Government Auditing Standards, July 2007 Revision*, [GAO-07-731G](#) (Washington, D.C.: July 2007), issued by the Comptroller General of the United States.

<sup>10</sup>Professional standards for the IGs have been issued by the President’s Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency.

<sup>11</sup>External auditors report externally, meaning that their audit reports are disseminated to and used by third parties. Under professional standards, external audit organizations are organizationally independent when they are organizationally placed outside of the entity under audit. In government, this is achieved when the audit organization is in a different level of government (for example, federal auditors auditing a state government program) or different branch of government within the same level of government (for example, legislative auditors such as GAO auditing an executive branch program).

<sup>12</sup>Under internal auditing standards, internal auditors are generally limited to reporting internally to the organization that they audit, except when certain conditions are met, such as when mandated by statutory or regulatory requirements. (See the Institute of Internal Auditors, *International Professional Practices Framework* (Almonte Springs, Fla: Jan. 2009). Internal audit organizations are organizationally placed within the organization they audit and are defined as being organizationally independent under professional auditing standards if the head of the audit organization (1) is accountable to the head or deputy head of the government entity or to those charged with governance; (2) reports audit results both to the head or deputy head of the government entity and to those charged with governance; (3) is located organizationally outside the staff or line-management function of the unit under audit; (4) has access to those charged with governance; and (5) is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.

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same time, *Government Auditing Standards* recognizes that additional statutory safeguards exist for DFE IG independence for reporting externally. These safeguards include establishment of the IG by statute, communication of the reasons for removal of the head of an audit organization to the cognizant legislative oversight body, statutory protections that prevent the audited entity from interfering with an audit, statutory requirements for the audit organization to report to a legislative body on a recurring basis, and statutory access to records and documents related to agency programs.

Independence is one of the most important elements of an effective IG function. In fact, much of the IG Act provides specific protections to IG independence that are unprecedented for an audit and investigative function located within the organization being reviewed. These protections are necessary in large part because of the unusual reporting requirements of the IGs, who are both subject to the general supervision and budget processes of the agencies they audit, and also expected to provide independent reports of their work externally to the Congress and the public.

Independence is also the cornerstone of professional auditing. Without independence, an audit organization cannot fully provide independent audits, perspectives, and assessments. Likewise, an IG who lacks independence cannot effectively fulfill the full range of requirements for the office. Lacking this critical attribute, an audit organization's work might be classified as studies, research, consulting, or reviews, rather than independent audits.

*Government Auditing Standards* states, "In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from *personal, external, and organizational* impairments to independence, and must avoid the appearance of such impairments to independence. Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and be viewed as impartial by objective third parties with knowledge of the relevant information." (Emphasis added.)

- **Personal independence** applies to individual auditors at all levels of the audit organization, including the head of the organization. Personal independence refers to the auditor's ability to remain objective and maintain an independent attitude in all matters relating to the audit, as well as the auditor's ability to be recognized by others as independent. The

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auditor needs an independent and objective state of mind that does not allow personal bias or the undue influence of others to override his or her professional judgments. This attitude is also referred to as intellectual honesty. The auditor must also be free from direct financial or managerial involvement with the audited entity or other potential conflicts of interest that might create the perception that the auditor is not independent.

- **External independence** refers to both the auditor's and the audit organization's freedom to make independent and objective judgments free from external influences or pressures. Examples of impairments to external independence include restrictions on access to records, government officials, or other individuals needed to conduct the audit; external interference over the assignment, appointment, compensation, or promotion of audit personnel; restrictions on funds or other resources provided to the audit organization that adversely affect the audit organization's ability to carry out its responsibilities; or external authority to overrule or to inappropriately influence the auditors' judgment as to appropriate reporting content.
- **Organizational independence** refers to the audit organization's placement in relation to the activities being audited. Professional auditing standards have different criteria for organizational independence for external and internal audit organizations. The IGs, in their statutory role of providing oversight of their agencies' operations, represent a unique hybrid of external and internal reporting responsibilities.

The implementation of the IGs' reporting relationships with their respective agency heads can also significantly affect the independence of the IGs. Generally, the IGs represent a hybrid of external auditing and internal auditing in their oversight roles for federal agencies. The IG offices, having been created to perform a unique role in overseeing federal agency operations, have characteristics of both external audit organizations and internal audit organizations. For example, the IGs have external reporting requirements consistent with the reporting requirements for external auditors, while at the same time they are part of their respective agencies.

IGs also have a dual reporting responsibility to the Congress and their agency heads. The IGs' external reporting requirements in the IG Act include reporting the results of their work in semiannual reports to the Congress. Under the IG Act, the IGs are to report their findings without alteration by their respective agencies, and public reports are to be made available on each IG's website. The IG Act also directs the IGs to keep agency heads and the Congress fully and currently informed of any

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problems, deficiencies, abuses, fraud, or other serious problems relating to the administration of programs and operations of their agencies. Also, the IGs are required to report particularly serious or flagrant problems, abuses, or deficiencies immediately to their agency heads, who are required to transmit the IG's report to the Congress within 7 calendar days.

The IG Act also provides specific protections to IG independence, including a prohibition on the ability of the agency head to prevent or prohibit the IG from initiating, carrying out, or completing any audit or investigation. This prohibition is directed at helping to protect the IG office from external forces that could compromise independence. The IG's personal independence and the appearance of independence to knowledgeable third parties is also critical when the IG makes decisions related to the nature and scope of audit and investigative work performed by the IG office. The IG must determine how to utilize the IG Act's protection of independence in conducting and pursuing the audit and investigative work. The IG's personal independence is necessary to make the proper decisions in such cases.

The IG Act provides the IGs with protections to external independence by providing access to all agency documents and records; prompt access to the agency head; the ability to select and appoint IG staff; the authority to obtain services of experts; and the authority to enter into contracts. The IG may choose whether or not to exercise the act's specific authority to obtain access to information that is denied by agency officials. Again, each IG must make decisions regarding the use of the IG Act's provisions for access to information, and the IG's personal independence becomes key in making these decisions.

The IG Reform Act of 2008 (Reform Act), enacted on October 14, 2008, amends the IG Act to further enhance the independence of the IGs, among other things.<sup>13</sup> To illustrate, the 1978 IG Act requires that the IGs nominated by the President be selected without regard to political affiliation and solely on the basis of integrity and defined abilities. However, these criteria were not included as a provision in the legislation that created the DFE IGs. The Reform Act extends these qualification criteria to apply also to the selection of the DFE IGs. In addition, the

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<sup>13</sup>Many of the provisions in the Reform Act were discussed by a panel hosted by the Comptroller General during May 2006. The discussion included the appointment and removal of IGs, an IG council established by statute, and areas related to IG independence and effectiveness. See [GAO-06-931SP](#).



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independence of all the IGs under the Reform Act amendments is enhanced by changes to the timing of notification to Congress of an IG removal or transfer—to at least 30 days before any planned removal of an IG under the IG Act, rather than merely an after-the-fact notice of prior removal.

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## IG Coordination

Prior to the passage of the IG Reform Act in 2008, the IGs' coordinating structure included two separate administratively established organizations: the IGs appointed by the President with Senate confirmation belonged to the President's Council on Integrity and Efficiency (PCIE), and the DFE IGs formed the Executive Council on Integrity and Efficiency (ECIE). Both councils have been chaired by the Deputy Director for Management in the Office of Management and Budget and were established by Executive Order to coordinate the IGs' activities across the government.<sup>14</sup> In our 2002 report, we had suggested that the Congress consider establishing an IG council by statute that includes stated roles and responsibilities, designated funding sources, and provisions for coordination with other federal oversight organizations.<sup>15</sup>

The IG Reform Act created an independent establishment in the executive branch, called the Council of IGs on Integrity and Efficiency, to replace the PCIE and ECIE, and to aid the IG community and foster government wide efforts to coordinate and improve oversight. This includes the establishment of a revolving fund to be used for council functions and duties with amounts in the fund coming from executive branch agencies. This new IG coordinating structure is to become effective 180 days after the date the Reform Act became law.

Other recent efforts involve the coordination of financial regulatory IGs. On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008 (EESA), which established the Office of Financial Stability within the Department of the Treasury and authorized the Troubled Asset Relief Program (TARP). The Special IG for TARP (SIG TARP), created by EESA, who is appointed by the President with Senate confirmation, has announced efforts to coordinate with other

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<sup>14</sup>The IG Act has required IGs to coordinate with the Comptroller General to avoid duplication and ensure effective coordination and cooperation. 5 U.S.C. App. § 4(c).

<sup>15</sup>GAO, *Inspectors General: Office Consolidation and Related Issues*, [GAO-02-575](#) (Washington, D.C.: Aug. 15, 2002).

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IGs who operate in areas related to TARP activities. The coordination group referred to as the TARP-IG Council was established administratively by the SIG TARP and includes the IGs at the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission, the Department of Housing and Urban Development, the Department of the Treasury, and the Treasury IG for Tax Administration, as well as representatives from GAO. The TARP-IG Council seeks to coordinate the activities of the IGs, establish protocols, and share ideas for comprehensive audits and investigations, while avoiding unnecessary or duplicative burdens on those charged with managing TARP.

The SIG TARP also announced the formation of a broad, multi agency task force designed to deter, detect, and investigate instances of fraud in the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) program, which is intended to make credit available to consumers and small businesses. The task force was created in coordination with the Federal Reserve Board IG and will include the Federal Bureau of Investigation, the Financial Crimes Enforcement Network, U.S. Immigration and Customs Enforcement, the Internal Revenue Service's Criminal Investigation, the Securities and Exchange Commission, and the U.S. Postal Inspection Service.

With the growing complexity of the federal government, the severity of the problems it faces, and the fiscal constraints under which it operates, it is important that independent, objective, and reliable IG structures be in place at federal agencies to ensure adequate audit and investigative coverage of federal programs and operations. The current crisis in the financial markets is illustrative of the significant challenges facing the federal government. As the administration and the Congress continue to take actions to address the immediate financial crisis, creating a regulatory system that reflects new market realities is a key step to reducing the likelihood that the United States will experience another financial crisis and enhancing oversight of the direction and implementation of current initiatives. As a result, considerable debate is under way over whether and how the current regulatory system should be changed, including calls for consolidating regulatory agencies, broadening certain regulators' authorities, or subjecting certain products or entities to more regulation. Strong independent oversight and accountability functions of the inspectors general at the regulatory agencies will be an important element of this reform.

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Coordination of the financial regulatory agencies' IGs is especially important during the current financial crisis. The fragmented and complex arrangement of federal and state regulators makes the communication and coordination of IGs at the regulatory agencies challenging but critical to providing effective oversight as significant reforms in the U.S. financial regulatory system evolve.

This completes my formal statement, Mr. Chairman. I would be pleased to answer any questions that you or the Subcommittee members may have at this time.

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# Appendix I: Federal Agencies and Departments with IGs Established by the IG Act of 1978, as Amended, and Appointed by the President

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Agency for International Development  
Corporation for National and Community Service  
Department of Agriculture  
Department of Commerce  
Department of Defense  
Department of Education  
Department of Energy  
Department of Health and Human Services  
Department of Homeland Security  
Department of Housing and Urban Development  
Department of the Interior  
Department of Justice  
Department of Labor  
Department of State  
Department of Transportation  
Department of Treasury  
Department of Veterans Affairs  
Environmental Protection Agency  
Export-Import Bank  
Federal Deposit Insurance Corporation  
Federal Emergency Management Agency  
General Services Administration  
National Aeronautics and Space Administration  
Nuclear Regulatory Commission  
Office of Personnel Management  
Railroad Retirement Board  
Small Business Administration  
Social Security Administration  
Tennessee Valley Authority  
Treasury Inspector General for Tax Administration

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# Appendix II: Designated Federal Entities Defined by the IG Act with IGs Appointed by Their Agency Heads

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Amtrak  
Appalachian Regional Commission  
Broadcasting Board of Governors<sup>a</sup>  
**Commodity Futures Trading Commission**  
Consumer Product Safety Commission  
Corporation for Public Broadcasting  
Denali Commission  
Election Assistance Commission  
Equal Employment Opportunity Commission  
Farm Credit Administration  
Federal Communications Commission  
Federal Election Commission  
Federal Housing Finance Board  
Federal Labor Relations Authority  
Federal Maritime Commission  
**Federal Reserve Board**  
Federal Trade Commission  
Legal Services Corporation  
National Archives and Records Administration  
**National Credit Union Administration**  
National Endowment for the Arts  
National Endowment for the Humanities  
National Labor Relations Board  
National Science Foundation  
Peace Corps  
**Pension Benefit Guaranty Corporation**  
Postal Regulatory Commission  
**Securities and Exchange Commission**  
Smithsonian Institution  
United States International Trade Commission  
United States Postal Service

<sup>a</sup>The Broadcasting Board of Governors is a designated federal entity with oversight provided by the Department of State IG.

Highlighted entities are included in H.R. 885.

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