United States Government Accountability Office

GAO

Report to Congressional Addressees

January 2009

FINANCIAL REGULATION

A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

GAO-09-216

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Highlights

Highlights of GAO-09-216, a report to congressional addressees

Why GAO Did This Study

The United States and other countries are in the midst of the worst financial crisis in more than 75 years. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.

To help policymakers better understand existing problems with the financial regulatory system and craft and evaluate reform proposals, this report (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have created challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, GAO synthesized existing GAO work and other studies and met with dozens of representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. Twenty-nine regulators, industry associations, and consumer groups also reviewed a draft of this report and provided valuable input that was incorporated as appropriate. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

To view the full product, including the scope and methodology, click on GAO-09-216. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. As the nation finds itself in the midst of one of the worst financial crises ever, the regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s.

Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system.

- First, regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks. The portion of firms operating as conglomerates that cross financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.
- Second, regulators have had to address problems in financial markets resulting from the activities of large and sometimes less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.
- Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. As early as 1994, GAO identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products. Since then, GAO has described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs. This report offers a framework for crafting and evaluating regulatory reform proposals; it consists of the following nine characteristics that should be reflected in any new regulatory system. By applying the elements of this framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

Characteristic		Description
✓	**Clearly defined regulatory goals**	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
✓	**Appropriately comprehensive**	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
✓	**Systemwide focus**	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
✓	**Flexible and adaptable**	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
✓	**Efficient and effective**	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
✓	**Consistent consumer and investor protection**	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
✓	**Regulators provided with independence, prominence, authority, and accountability**	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.
✓	**Consistent financial oversight**	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
✓	**Minimal taxpayer exposure**	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO.

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Figures

Abbreviations

BFCU	Bureau of Federal Credit Unions
CDO	collateralized debt obligation
CEC	Commodity Exchange Commission
CFTC	Commodity Futures Trading Commission
CSE	Consolidated Supervised Entity
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FHFB	Federal Housing Finance Board
FHLBB	Federal Home Loan Bank Board
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
FTC	Federal Trade Commission
GFA	Grain Futures Administration
GLBA	Gramm-Leach-Bliley Act of 1999
GSE	government-sponsored enterprise
IMF	International Monetary Fund
LTCM	Long Term Capital Management
NAIC	National Association of Insurance Commissioners
NCUA	National Credit Union Administration
NRSRO	nationally recognized statistical rating organization
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OTC	over-the-counter
OTS	Office of Thrift Supervision
PCAOB	Public Company Accounting Oversight Board
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

United States Government Accountability Office
Washington, DC 20548

January 8, 2009

Congressional Addressees

The United States is in the midst of the worst financial crisis in more than 75 years. In recent months, federal officials have taken unprecedented steps to stem the unraveling of the financial services sector by committing trillions of dollars of taxpayer funds to rescue financial institutions and restore order to credit markets, including the creation of a $700 billion program that has been used so far to inject money into struggling institutions in an attempt to stabilize markets.[1] This current crisis largely stems from defaults on U.S. subprime mortgage loans, many of which were packaged and sold as securities to buyers in the United States and around the world. With financial institutions from many countries participating in these activities, the resulting turmoil has afflicted financial markets globally and has spurred coordinated action by world leaders in an attempt to protect savings and restore the health of the markets. While much of policymakers' attention understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.[2]

The current U.S. regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with the major developments that have occurred in financial markets and products in recent decades. In particular, the current system was not designed to adequately oversee today's large and interconnected financial institutions, whose activities pose new risks to the institutions themselves as well as risk to the broader financial system—called systemic risk, which is the risk that an event could broadly effect the financial system rather than just one or a few institutions. In addition, not all financial activities and institutions fall

[1]For more information about these activities, see GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, GAO-09-161 (Washington, D.C.: Dec. 2, 2008).

[2]Throughout this report, we use the term "financial regulatory system" to refer broadly to both the financial regulatory structure—that is, the number and organization of financial regulatory agencies—as well as other aspects of financial regulation, including agency responsibilities, and mechanisms and authorities available to agencies for fulfilling such responsibilities.

under the direct purview of financial regulators, and market innovations have led to the creation of new and sometimes very complex products that were never envisioned as the current regulatory system developed. In light of the recent turmoil in financial markets, the current financial regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century.

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the likelihood that the U.S. will experience another financial crisis similar to the current one. 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. For example, in March 2008, the Department of the Treasury (Treasury) proposed significant financial regulatory reforms in its "Blueprint for a Modernized Financial Regulatory Structure," and other federal regulatory officials and industry groups have also put forth reform proposals.[3] Under the Emergency Economic Stabilization Act, Treasury is required to submit to Congress by April 30, 2009, a report with recommendations on "the current state of the financial markets and the regulatory system."[4] As these and other proposals are developed or evaluated, it will be important to carefully consider their advantages and disadvantages and long-term implications.

To help policymakers weigh the various proposals and consider ways in which the current regulatory system could be made more effective and efficient, we prepared this report under the authority of the Comptroller General. Specifically, our report (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have raised challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and

[3]See Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Washington, D.C., March 2008); Financial Services Roundtable, *The Blueprint for U.S. Financial Services Competitiveness* (Washington, D.C., Nov. 7, 2007); Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, "Reducing Systemic Risk in a Dynamic Financial System" (speech, New York, June 9, 2008); and Ben S. Bernanke, Chairman, Federal Reserve, "Reducing Systemic Risk" (speech, Jackson Hole, Wyo., Aug. 22, 2008).

[4]Pub. L. No. 110-343, § 105(c).

others to craft or evaluate potential regulatory reform efforts going forward. This report's primary focus is on discussing how various market developments have revealed gaps and limitations in the existing regulatory system. Although drawing on examples of events from the current crisis, we do not attempt to identify all of the potential weaknesses in the actions of regulators that had authority over the institutions and products involved.

To address these objectives, we synthesized existing GAO work on challenges to the U.S. financial regulatory structure and on criteria for developing and strengthening effective regulatory structures.[5] We also reviewed existing studies, government documents, and other research for illustrations of how current and past financial market events have exposed inadequacies in our existing financial regulatory system and for suggestions for regulatory reform. In a series of forums, we discussed these developments and the elements of a potential framework for an effective regulatory system with groups of financial regulators of banking, securities, futures, insurance, and housing markets; representatives of financial services industry associations and individual financial institutions; and with selected consumer advocacy organizations, academics, and other experts in financial markets issues. The work upon which this report is based was conducted 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008. A more extensive discussion of our scope and methodology appears in appendix I.

Background

While providing many benefits to our economy and citizens' lives, financial services activities can also cause harm if left unsupervised. As a result, the United States and many other countries have found that regulating financial markets, institutions, and products is more efficient and effective

[5]For example, see GAO, *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007); and *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004). See Related GAO Products appendix for additional reports.

than leaving the fairness and integrity of these activities to be ensured solely by market participants themselves.

The federal laws related to financial regulation set forth specific authorities and responsibilities for regulators, although these authorities typically do not contain provisions explicitly linking such responsibilities to overall goals of financial regulation. Nevertheless, financial regulation generally has sought to achieve four broad goals:

- *Ensure adequate consumer protections.* Because financial institutions' incentives to maximize profits can in some cases lead to sales of unsuitable or fraudulent financial products, or unfair or deceptive acts or practices, U.S. regulators take steps to address informational disadvantages that consumers and investors may face, ensure consumers and investors have sufficient information to make appropriate decisions, and oversee business conduct and sales practices to prevent fraud and abuse.
- *Ensure the integrity and fairness of markets.* Because some market participants could seek to manipulate markets to obtain unfair gains in a way that is not easily detectable by other participants, U.S. regulators set rules for and monitor markets and their participants to prevent fraud and manipulation, limit problems in asset pricing, and ensure efficient market activity.
- *Monitor the safety and soundness of institutions.* Because markets sometimes lead financial institutions to take on excessive risks that can have significant negative impacts on consumers, investors, and taxpayers, regulators oversee risk-taking activities to promote the safety and soundness of financial institutions.
- *Act to ensure the stability of the overall financial system.* Because shocks to the system or the actions of financial institutions can lead to instability in the broader financial system, regulators act to reduce systemic risk in various ways, such as by providing emergency funding to troubled financial institutions.

Although these goals have traditionally been their primary focus, financial regulators are also often tasked with achieving other goals as they carry out their activities. These can include promoting economic growth, capital formation, and competition in our financial markets. Regulators have also taken actions with an eye toward ensuring the competitiveness of regulated U.S. financial institutions with those in other sectors or with others around the world. In other cases, financial institutions may be required by law or regulation to foster social policy objectives such as fair access to credit and increased home ownership.

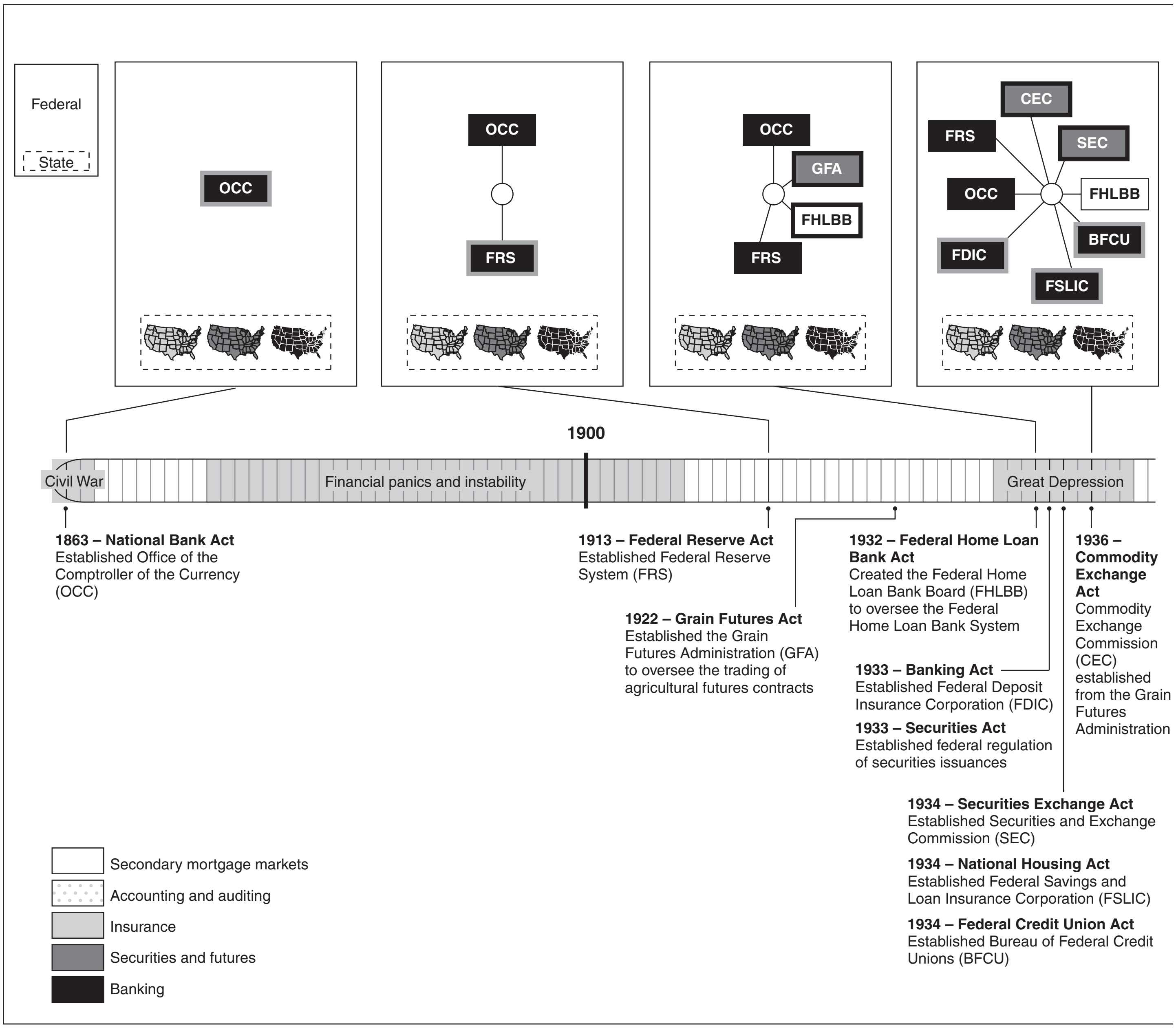
In general, these goals are reflected in statutes, regulations, and administrative actions, such as rulemakings or guidance, by financial institution supervisors. Laws and regulatory agency policies can set a greater priority on some roles and missions than others. Regulators are usually responsible for multiple regulatory goals and often prioritize them differently. For example, state and federal bank regulators generally focus on the safety and soundness of depository institutions; federal securities and futures regulators focus on the integrity of markets, and the adequacy of information provided to investors; and state securities regulators primarily address consumer protection. State insurance regulators focus on the ability of insurance firms to meet their commitments to the insured.

The degrees to which regulators oversee institutions, markets, or products also vary depending upon, among other things, the regulatory approach Congress has fashioned for different sectors of the financial industry. For example, some institutions, such as banks, are subject to comprehensive regulation to ensure their safety and soundness. Among other things, they are subject to examinations and limitations on the types of activities they may conduct. Other institutions conducting financial activities are less regulated, such as by only having to register with regulators or by having less extensive disclosure requirements. Moreover, some markets, such as those for many over-the-counter derivatives markets, as well as activities within those markets, are not subject to oversight regulation at all.

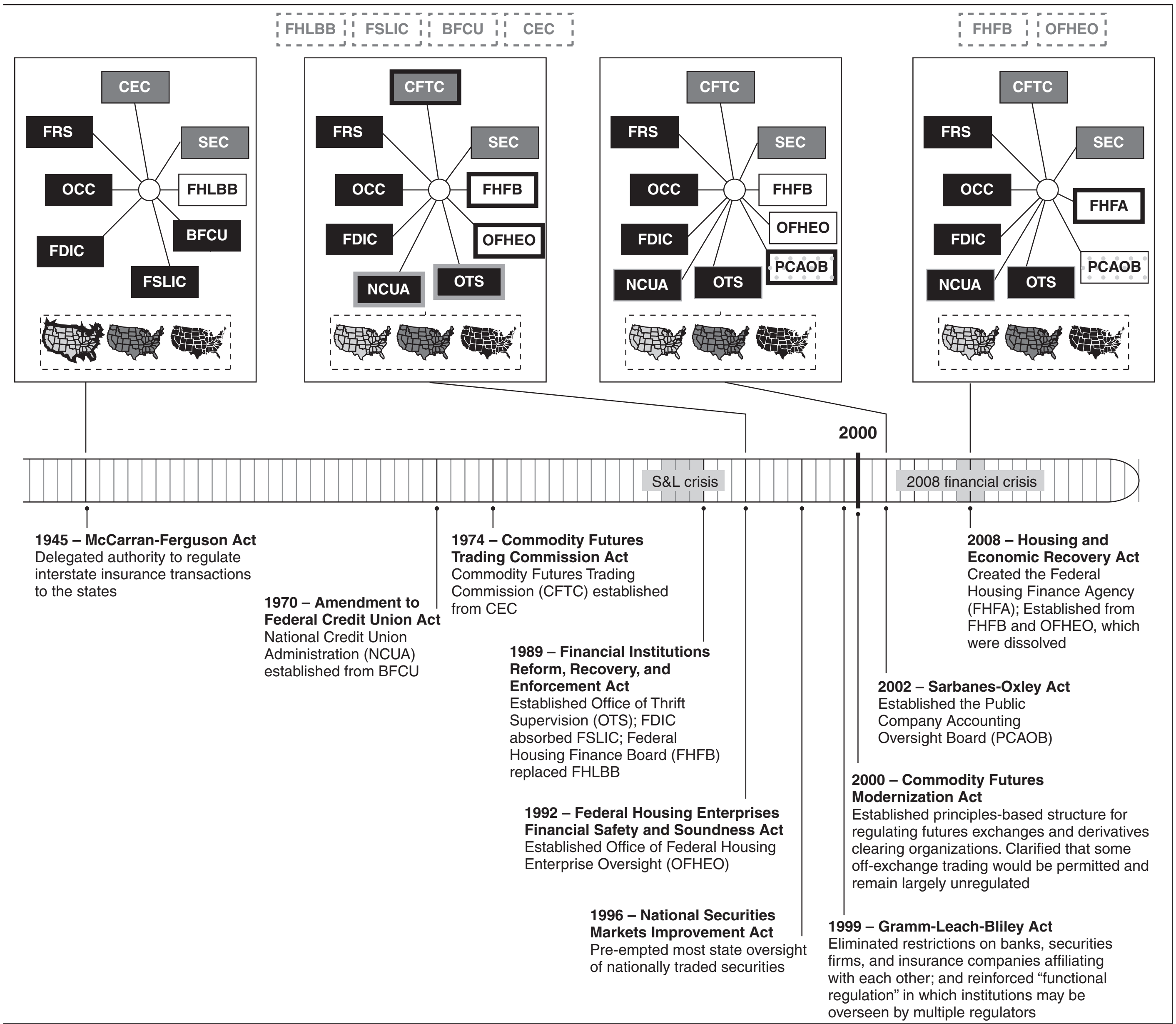
Today's Financial Regulatory System Was Built over More Than a Century, Largely in Response to Crises or Market Developments

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. (See fig. 1.) Our regulatory system has multiple financial regulatory bodies, including five federal and multiple state agencies that oversee depository institutions. Securities activities are overseen by federal and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by a federal regulator and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little federal involvement.

Figure 1: Formation of U.S. Financial Regulatory System (1863-2008)



Source: GAO.



Overall, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations (SRO), and hundreds of state financial regulatory agencies. The following sections describe how regulation evolved in various sectors, including banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets, and other financial institutions. The accounting and auditing environment for financial institutions, and the role of the Gramm-Leach-Bliley Act in financial regulation, are also discussed.

Banking

Since the early days of our nation, banks have allowed citizens to store their savings and used these funds to make loans to spur business development. Until the middle of the 1800s, banks were chartered by states and state regulators supervised their activities, which primarily consisted of taking deposits and issuing currency. However, the existence of multiple currencies issued by different banks, some of which were more highly valued than others, created difficulties for the smooth functioning of economic activity. In an effort to finance the nation's Civil War debt and reduce financial uncertainty, Congress passed the National Bank Act of 1863, which provided for issuance of a single national currency. This act also created the Office of the Comptroller of the Currency (OCC), which was to oversee the national currency and improve banking system efficiency by granting banks national charters to operate and conducting oversight to ensure the sound operations of these banks. As of 2007, of the more than 16,000 depository institutions subject to federal regulation in the United States, OCC was responsible for chartering, regulating, and supervising nearly 1,700 commercial banks with national charters.

In the years surrounding 1900, the United States experienced troubled economic conditions and several financial panics, including various instances of bank runs as depositors attempted to withdraw their funds from banks whose financial conditions had deteriorated. To improve the liquidity of the U.S. banking sector and reduce the potential for such panics and runs, Congress passed the Federal Reserve Act of 1913. This act created the Federal Reserve System, which consists of the Board of Governors of the Federal Reserve System (Federal Reserve), and 12 Federal Reserve Banks, which are congressionally chartered semiprivate entities that undertake a range of actions on behalf of the Federal Reserve, including supervision of banks and bank holding companies, and lending to troubled banks. The Federal Reserve was given responsibility to act as the federal supervisory agency for state-chartered banks—banks authorized to do business under charters issued by states—that are members of the Federal Reserve System.[6] In addition to supervising and

[6]Staff at the Federal Reserve Banks act as supervisors in conjunction with the Board.

regulating bank and financial holding companies and nearly 900 state-chartered banks, the Federal Reserve also develops and implements national monetary policy, and provides financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.

Several significant changes to the U.S. financial regulatory system again were made as a result of the turbulent economic conditions in the late 1920s and 1930s. In response to numerous bank failures resulting in the severe contraction of economic activity of the Great Depression, the Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC), which administers a federal program to insure the deposits of participating banks. Subsequently, FDIC's deposit insurance authority expanded to include thrifts.[7] Additionally, FDIC provides primary federal oversight of any insured state-chartered banks that are not members of the Federal Reserve System, and it serves as the primary federal regulator for over 5,200 state-chartered institutions. Finally, FDIC has backup examination and enforcement authority over all of the institutions it insures in order to mitigate losses to the deposit insurance funds.

Securities

Prior to the 1930s, securities markets were overseen by various state securities regulatory bodies and the securities exchanges themselves. In the aftermath of the stock market crash of 1929, the Securities Exchange Act of 1934 created a new federal agency, the Securities and Exchange Commission (SEC) and gave it authority to register and oversee securities broker-dealers, as well as securities exchanges, to strengthen securities oversight and address inconsistent state securities rules.[8] In addition to regulation by SEC and state agencies, securities markets and the broker-dealers that accept and execute customer orders in these markets

[7]Thrifts, also known as savings and loans, are financial institutions that accept deposits and make loans, particularly for home mortgages. Until 1989, thrift deposits were federally insured by the Federal Savings and Loan Insurance Corporation (FSLIC), which was created by the National Housing Act of 1934. After experiencing solvency problems in connection with the savings and loan crisis of the 1980s, FSLIC was abolished and its insurance function was transferred to FDIC.

[8]The Securities Act of 1933 (1933 Act), 48 Stat. 74. et. seq., assigned federal supervision of securities to the Federal Trade Commission (FTC) by, among other things, requiring that securities offerings subject to the act's registration requirements be registered with the FTC. See 1933 Act, §§ 2, 5, 6 (May 27, 1933). In the 1934 act, Congress replaced the FTC's role by transferring its powers, duties, and functions under the 1933 act to SEC. See Securities Exchange Act of 1934, 48 Stat. 881, §§ 3(a), 210 (June 6, 1934).

continue to be regulated by SROs, including those of the exchanges and the Financial Industry Regulatory Authority, that are funded by the participants in the industry. Among other things, these SROs establish rules and conduct examinations related to market integrity and investor protection. SEC also registers and oversees investment companies and advisers, approves rules for the industry, and conducts examinations of broker-dealers and mutual funds. State securities regulators—represented by the North American Securities Administrators Association—are generally responsible for registering certain securities products and, along with SEC, investigating securities fraud.[9] SEC is also responsible for overseeing the financial reporting and disclosures that companies issuing securities must make under U.S. securities laws. SEC was also authorized to issue and oversee U.S. accounting standards for entities subject to its jurisdiction, but has delegated the creation of accounting standards to a private-sector organization, the Financial Accounting Standards Board, which establishes generally accepted accounting principles.

Thrifts and Credit Unions

The economic turmoil of the 1930s also prompted the creation of federal regulators for other types of depository institutions, including thrifts and credit unions.[10] These institutions previously had been subject to oversight only by state authorities. However, the Home Owners' Loan Act of 1933 empowered the newly created Federal Home Loan Bank Board to charter and regulate federal thrifts, and the Federal Credit Union Act of 1934 created the Bureau of Federal Credit Unions to charter and supervise credit unions.[11] Congress amended the Federal Credit Union Act in 1970 to

[9]The National Securities Markets Improvement Act, Pub. L. No. 104-290 (Oct. 11, 1996), pre-empted state securities registration requirements for all but a subset of small securities products and limited state supervision of broker-dealers, but left intact the right of states to investigate securities fraud.

[10]Credit unions are member-owned financial institutions that generally offer their members services similar to those provided by banks.

[11]Home Owners' Loan Act of 1933, 48 Stat. 128 (June 13, 1933). The administration of the Federal Credit Union Act was originally vested in the Farm Credit Administration (Act of June 26, 1934, 48 Stat. 1216.) Executive Order No. 9148, dated April 27, 1942 (7 F.R. 3145), transferred the functions, powers and duties of the Farm Credit Administration to FDIC. Effective July 29, 1948, the powers, duties and functions transferred to FDIC were transferred to the Federal Security Agency. (Act of June 29, 1948, 62 Stat. 1091.) Reorganization Plan No. 1 of 1953, effective April 11, 1953, abolished the Federal Security Agency and transferred the Bureau of Federal Credit Unions, together with other agencies of the Federal Security Agency, to the Department of Health, Education, and Welfare. (67 Stat. 631, 18 F.R. 2053.).

establish the National Credit Union Administration (NCUA), which is responsible for chartering and supervising over 5,000 federally chartered credit unions, as well as insuring deposits in these and more than 3,000 state-chartered credit unions.[12] Oversight of these state-chartered credit unions is managed by 47 state regulatory agencies, represented by the National Association of State Credit Union Supervisors.[13]

From 1980 to 1990, over 1,000 thrifts failed at a cost of about $100 billion to the federal deposit insurance funds. In response, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Home Loan Bank Board and, among other things, established the Office of Thrift Supervision (OTS) to improve thrift oversight.[14] OTS charters about 750 federal thrifts and oversees these and about 70 state-chartered thrifts, as well as savings and loan holding companies.[15]

Futures

Oversight of the trading of futures contracts, which allow their purchasers to buy or sell a specific quantity of a commodity for delivery in the future, has also changed over the years in response to changes in the marketplace. Under the Grain Futures Act of 1922, the trading of futures contracts was overseen by the Grain Futures Administration, an office within the Department of Agriculture, reflecting the nature of the products for which futures contracts were traded.[16] However, futures contracts were later created for nonagricultural commodities, such as energy products like oil and natural gas, metals such as gold and silver, and financial products such as Treasury bonds and foreign currencies. In 1974,

[12]Public Law 91–206 (Mar. 10, 1970, 84 Stat. 49) created the National Credit Union Administration as an independent agency and transferred all of the functions of the Bureau of Federal Credit Unions to the new administration.

[13]Federally insured state credit unions also are subject to supervision by NCUA.

[14]Pub. L. No. 101-73 § 301 (Aug. 9, 1989).

[15]The five federal depository institution regulators discussed earlier coordinate formally through the Federal Financial Institutions Examination Council, an interagency body that was established in 1979 and is empowered to (1) prescribe uniform principles, standards, and report forms for the federal examination of financial institutions; and (2) make recommendations to promote uniformity in the supervision of financial institutions.

[16]The Grain Futures Act (ch. 369, 42 Stat. 998, Sept. 21, 1922). In 1936 the act was renamed the “Commodity Exchange Act (CEA),” which, among other things, created the Commodity Exchange Commission (CEC), a predecessor agency to the Commodity Futures Trading Commission. 49 Stat. 1491 (June 15, 1936).

a new independent federal agency, the Commodity Futures Trading Commission (CFTC), was created to oversee the trading of futures contracts.[17] Like SEC, CFTC relies on SROs, including the futures exchanges and the National Futures Association, to establish and enforce rules governing member behavior. In 2000, the Commodity Futures Modernization Act of 2000 established a principles-based structure for the regulation of futures exchanges and derivatives clearing organizations, and clarified that some off-exchange derivatives trading—and in particular trading on facilities only accessible to large, sophisticated traders—was permitted and would be largely unregulated or exempt from regulation.[18]

Insurance

Unlike most other financial services, insurance activities traditionally have been regulated at the state level. In 1944, a U.S. Supreme Court decision determined that the insurance industry was subject to interstate commerce laws, which could then have allowed for federal regulation, but Congress passed the McCarran-Ferguson Act in 1945 to explicitly return insurance regulation to the states.[19] As a result, as many as 55 state, territorial, or other local jurisdiction authorities oversee insurance activities in the United States, although state regulations and other activities are often coordinated nationally by the National Association of Insurance Commissioners (NAIC).[20]

[17]Commodity Futures Trading Commission Act, Pub. L. No. 93-463 (Oct. 23, 1974).

[18]A derivative is a financial instrument representing a right or obligation based on the value at a particular time of an underlying asset, reference rate, or index, such as a stock, bond, agricultural or other physical commodity, interest rate, currency exchange rate, or stock index. Derivatives contracts are used by firms around the world to manage market risk—the exposure to the possibility of financial loss caused by adverse changes in the values of assets or liabilities—by transferring it from entities less willing or able to manage it to those more willing and able to do so. Common types of derivatives include futures, options, forwards, and swaps and can be traded through an exchange, known as exchange-traded, or privately, known as over-the counter.

[19]Up until 1944, insurance was not considered interstate commerce and, therefore, was not subject to federal regulation. In *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944) the Supreme Court held that Congress could regulate insurance transactions that truly are interstate. Congress subsequently enacted the McCarran-Ferguson Act (Mar. 9, 1945), ch. 20, 59 Stat. 33, which provides that state laws apply to insurance unless they are specifically pre-empted by Congress. See 15 U.S.C. § 1011.

[20]NAIC is made up of the heads of the insurance departments of 50 states, the District of Columbia, and U.S. territories to provide a forum for the development of uniform policy when uniformity is appropriate.

Secondary Mortgage Markets

The recent financial crisis in the credit and housing markets has prompted the creation of a new, unified federal financial regulatory oversight agency, the Federal Housing Finance Agency (FHFA), to oversee the government-sponsored enterprises (GSE) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.[21] Fannie Mae and Freddie Mac are private, federally chartered companies created by Congress to, among other things, provide liquidity to home mortgage markets by purchasing mortgage loans, thus enabling lenders to make additional loans. The system of 12 Federal Home Loan Banks provides funding to support housing finance and economic development.[22] Until enactment of the Housing and Economic Recovery Act of 2008, Fannie Mae and Freddie Mac had been overseen since 1992 by the Office of Federal Housing Enterprise Oversight (OFHEO), an agency within the Department of Housing and Urban Development, and the Federal Home Loan Banks were subject to supervision by the Federal Housing Finance Board (FHFB), an independent regulatory agency.[23] OFHEO regulated Fannie Mae and Freddie Mac on matters of safety and soundness, while HUD regulated their mission-related activities. FHFB served as the safety and soundness and mission regulator of the Federal Home Loan Banks. In July 2008, the Housing and Economic Recovery Act of 2008 created FHFA to establish more effective and more consistent oversight of the three housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. With respect to Fannie Mae and Freddie Mac, the law gives FHFA such new regulatory authorities as the power to regulate the retained mortgage portfolios, to set more stringent capital standards, and to place a failing entity in receivership. In addition, the law provides FHFA with funding outside the annual appropriations process. The law also combined the regulatory authorities for all the housing GSEs that were previously distributed

[21]Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, title I, subtitle A (July 30, 2008).

[22]The 12 Federal Home Loan Banks form a system of regional cooperatives, each with its own president and board of directors, located in different regions of the country. Their statutory mission is to provide cost-effective funding to members for use in housing, community, and economic development; to provide regional affordable housing programs, which create housing opportunities for low- and moderate-income families; to support housing finance through advances and mortgage programs; and to serve as a reliable source of liquidity for its membership.

[23]OFHEO was created in title XIII of the Housing and Community Development Act (1992), Pub. L. No. 102-550 (Oct. 28, 1992). In 1932, the Federal Home Loan Bank Act created the Federal Home Loan Bank System to provide liquidity to thrifts to make home mortgages. Oversight of these responsibilities was later transferred to the Federal Housing Finance Board.

among OFHEO, FHFB, and the Department of Housing and Urban Development. In September 2008, Fannie Mae and Freddie Mac were placed in conservatorship, with FHFA serving as the conservator under powers provided in the 2008 act. Treasury also created a backstop lending facility for the Federal Home Loan Banks, should they decide to use it. In November 2008, the Federal Reserve announced plans to purchase mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac on the open market.

Gramm-Leach-Bliley

Changes in the types of financial activities permitted for depository institutions and their affiliates have also shaped the financial regulatory system over time. Under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services. However, in the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities and, in addition, provided a regulatory process allowing for the approval of new types of financial activity.[24] Under GLBA, qualifying financial institutions are permitted to engage in banking, securities, insurance, and other financial activities. When these activities are conducted within the same bank holding company structure, they remain subject to regulation by "functional regulators," which are the federal authorities having jurisdiction over specific financial products or services, such as SEC or CFTC. As a result, multiple regulators now oversee different business lines within a single institution. For example, broker-dealer activities are generally regulated by SEC even if they are conducted within a large financial conglomerate that is subject to the Bank Holding Company Act, which is administered by the Federal Reserve. The functional regulator approach was intended to provide consistency in regulation, focus regulatory restrictions on the relevant functional area, and avoid the potential need for regulatory agencies to develop expertise in all aspects of financial regulation.

[24]Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (Nov. 12, 1999). Although originally precluded from conducting significant securities underwriting activities, bank holding companies were permitted to conduct more of such activities over the years. For example, in 1987, the Federal Reserve allowed the subsidiaries of bank holding companies to engage in securities underwriting activities up to 5 percent of their revenue. Over time, the Federal Reserve also expanded the types of securities that banks could conduct business in and raised the revenue limit to 10 percent in 1989 and to 25 percent in 1996.

Accounting and Auditing

In addition to the creation of various regulators over time, the accounting and auditing environment for financial institutions and market participants—a key component of financial oversight—has also seen substantial change. In the early 2000s, various companies with publicly traded securities were found to have issued materially misleading financial statements. These companies included Enron and WorldCom, both of which filed for bankruptcy. When the actual financial conditions of these companies became known, their auditors were called into question, and one of the largest, Arthur Andersen, was dissolved after the Department of Justice filed criminal charges related to its audits of Enron. As a result of these and other corporate financial reporting and auditing scandals, the Sarbanes-Oxley Act of 2002 was enacted.[25] Among other things, Sarbanes-Oxley expanded public company reporting and disclosure requirements and established new ethical and corporate responsibility requirements for public company executives, boards of directors, and independent auditors. The act also created a new independent public company audit regulator, the Public Company Accounting Oversight Board, to oversee the activities of public accounting firms. The activities of this board are, in turn, overseen by SEC.

Other Financial Institutions

Some entities that provide financial services are not regulated by any of the existing federal financial regulatory bodies. For example, entities such as mortgage brokers, automobile finance companies, and payday lenders that are not bank subsidiaries or affiliates primarily are subject to state oversight, with the Federal Trade Commission acting as the primary federal agency responsible for enforcing their compliance with federal consumer protection laws.

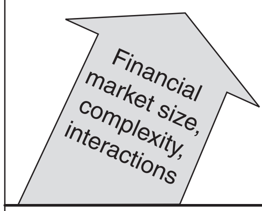
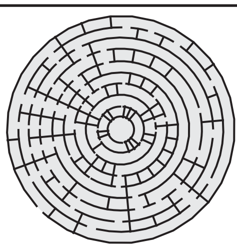
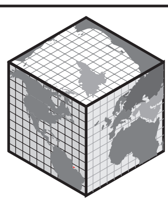
[25]Pub. L. No. 107-204 (July 30, 2002).

Changes in Financial Institutions and Their Products Have Significantly Challenged the U.S. Financial Regulatory System

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 2.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulating these large conglomerates has proven challenging, particularly in overseeing their risk management activities on a consolidated basis and in identifying and mitigating the systemic risks they pose. A second development has been the emergence of large and sometimes less-regulated market participants, such as hedge funds and credit rating agencies, which now play key roles in our financial markets. Third, the development of new and complex products and services has challenged regulators' abilities to ensure that institutions are adequately identifying and acting to mitigate risks arising from these new activities and that investors and consumers are adequately informed of the risks. In light of these developments, ensuring that U.S. accounting standards have kept pace has also proved difficult, and the impending transition to conform to international accounting standards is likely to create additional challenges.[26] Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

[26]We include discussion of audit and accounting standards in this report because any new effort to examine the structure of financial regulation in the United States could include consideration of the process for creating and adopting these standards. However, determining whether the oversight of this process should be changed was not part of the scope of this report.

Figure 2: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System

Developments in financial markets and products		Examples of how developments have challenged the regulatory system
	**Emergence of large, complex, globally active, interconnected financial conglomerates**	Regulators sometimes lack sufficient authority, tools, or capabilities to oversee and mitigate risks.
		Identifying, preventing, mitigating, and resolving systemic crises has become more difficult.
	**Less-regulated entities have come to play increasingly critical roles in financial system**	Nonbank lenders and a new private-label securitization market played significant roles in the subprime mortgage crisis that led to broader market turmoil.
		Activities of hedge funds have posed systemic risks.
		Overreliance on credit ratings of mortgage-backed products contributed to the recent turmoil in financial markets.
		Financial institutions' use of off-balance sheet entities led to ineffective risk disclosure and exacerbated recent market instability.
	**New and complex products that pose challenges to financial stability and investor and consumer understanding of risks.**	Complex structured finance products have made it difficult for institutions and their regulators to manage associated risks.
		Growth in complex and less-regulated over-the-counter derivatives markets have created systemic risks and revealed market infrastructure weaknesses.
		Investors have faced difficulty understanding complex investment products, either because they failed to seek out necessary information or were misled by improper sales practices.
		Consumers have faced difficulty understanding mortgages and credit cards with new and increasingly complicated features, due in part to limitations in consumer disclosures and financial literacy efforts.
		Accounting and auditing entities have faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.
	**Financial markets have become increasingly global in nature, and regulators have had to coordinate their efforts internationally.**	Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards.
		Fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators, such as negotiations on Basel II and certain insurance matters.

Sources: GAO (analysis); Art Explosion (images).

Conglomeration and Increased Interconnectedness in Financial Markets Have Created Difficulties for a Regulatory System That Lacks a Systemwide Focus

Overseeing large financial conglomerates that have emerged in recent decades has proven challenging, particularly in regulating their consolidated risk management practices and in identifying and mitigating the systemic risks they pose. These systemically important institutions in many cases have tens of thousands or more customers and extensive financial linkages with each other through loans, derivatives contracts, or trading positions with other financial institutions or businesses. The activities of these large financial institutions, as we have seen by recent events, can pose significant systemic risks to other market participants and the economy as a whole, but the regulatory system was not prepared to adequately anticipate and prevent such risks.

Largely as the result of waves of mergers and consolidations, the number of financial institutions today has declined. However, the remaining institutions are generally larger and more complex, provide more and varied services, offer similar products, and operate in increasingly global markets. Among the most significant of these changes has been the emergence and growth of large financial conglomerates or universal banks that offer a wide range of products that cut across the traditional financial sectors of banking, securities, and insurance. A 2003 IMF study highlighted this emerging trend. Based on a worldwide sample of the top 500 financial services firms in assets, the study found that the percentage of the largest financial institutions in the United States that are conglomerates—financial institutions having substantial operations in more than one of the sectors (banking, securities, and insurance)—increased from 42 percent of the U.S. financial institutions in the sample in 1995 to 62 percent in 2000.[27] This new environment contrasts with that of the past in which banks primarily conducted traditional banking activities such as deposit taking and lending; securities broker-dealers were largely focused on brokerage and underwriting activities; and insurance firms offered a more limited set of insurance products. In a report that analyzed the regulatory structures of various countries, The Group of Thirty noted that the last 25 years have been a period of enormous transformation in the financial services sector, with a marked shift from firms engaging in distinct banking, securities, and insurance businesses to one in which more integrated financial services conglomerates offer a broad range of financial products across the globe. These fundamental changes in the nature of the financial service markets

[27]Gianni De Nicoló, Philip Bartholomew, Jahanara Zaman, and Mary Zephirin, "Bank Consolidation, Internationalization, and Conglomeration: Trends and Implications for Financial Risk" (IMF Working Paper 03/158, Washington, D.C., July 2003).

around the world have exposed the shortcomings of financial regulatory models, some of which have not been adapted to the changes in business structures.[28]

While posing challenges to regulators, these changes have resulted in some benefits in the United States financial services industry. For example, the ability of financial institutions to offer products of varying types increased the options available to consumers for investing their savings and preparing for their retirement. Conglomeration has also made it more convenient for consumers to conduct their financial activities by providing opportunities for one-stop shopping for most or all of their needs, and by promoting the cross-selling of new innovative products of which consumers may otherwise not have been aware.

However, the rise of large financial conglomerates has also posed risks that our current financial regulatory system does not directly address. First, although the activities of these large interconnected financial institutions often cross traditional sector boundaries, financial regulators under the current U.S. regulatory system did not always have full authority or sufficient tools and capabilities to adequately oversee the risks that these financial institutions posed to themselves and other institutions. As we noted in a 2007 report, the activities of the Federal Reserve, SEC, and OTS to conduct consolidated supervision of many of the largest U.S. financial institutions were not as efficient and effective as needed because these agencies were not collaborating more systematically.[29] In addition, the recent market crisis has revealed significant problems with certain aspects of these regulators' oversight of financial conglomerates. For example, some of the top investment banks were subject to voluntary and limited oversight at the holding-company level—the level of the institution that generally managed its overall risks—as part of SEC's Consolidated Supervised Entity (CSE) Program. SEC's program was created in 2004 as a way for global investment bank conglomerates that lack a supervisor

[28]Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (Washington, D.C., 2008). The Group of Thirty, established in 1978, is a private, nonprofit, international body—composed of very senior representatives of the private and public sectors and academia—that consults and publishes papers on international economic and monetary affairs.

[29]GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007).

under law to voluntarily submit to regulation.[30] This supervision, which could include SEC examinations of the parent companies' and affiliates' operations and monitoring of their capital levels, enabled the CSEs to qualify for alternative capital rules in exchange for consenting to supervision at the holding company level. Being subject to consolidated supervision was perceived as necessary for these financial institutions to continue operating in Europe under changes implemented by the European Union in 2005.[31]

However, according to a September 2008 report by SEC's Inspector General, this supervisory program failed to effectively oversee these institutions for several reasons, including the lack of an effective mechanism for ensuring that these entities maintained sufficient capital. In comparison to commercial bank conglomerates, these investment banks were holding much less capital in relation to the activities exposing them to financial risk. For example, at the end of 2007, the five largest investment banks had assets to equity capital leverage ratios of between 26 and 34 to 1—meaning that for every dollar of capital capable of absorbing losses, these institutions held between $26 and $34 of assets subject to loss. In contrast, the largest commercial bank conglomerates, which were subject to different regulatory capital requirements, tended to be significantly less leveraged, with the average leverage ratio of the top five largest U.S. bank conglomerates at the end of 2007 only about 13 to 1. Moreover, because the program SEC used to oversee these investment bank conglomerates was voluntary, it had no authority to compel these institutions to address any problems that may have been identified. Instead, SEC's only means for coercing an institution to take corrective actions was to disqualify an institution from CSE status. SEC also lacked the ability to provide emergency funding for these investment bank conglomerates in a similar way that the Federal Reserve could for commercial banks. As a result, these CSE firms, whose activities resulted in their being significant and systemically important participants with vast interconnections with other financial institutions, were more vulnerable to market disruptions that could create risks to the overall financial system,

[30]Under the CSE program, which SEC initiated pursuant to its capitalization requirements for broker-dealers, SEC instituted a system for supervising large broker-dealers at the holding company level. See 69 *Fed. Reg.* 34428 (June 21, 2004). Previously, SEC had focused its broker-dealer net capital regulations only upon the firms themselves, not their holding companies or other subsidiaries.

[31]69 *Fed. Reg.* 34428 at n. 9.

Collapse of the Investment Bank Model

Until 2008, the largest U.S. investment banks all generally had similar structures that were characterized by a publicly traded holding company with a U.S. broker-dealer subsidiary. Each of these firms typically had a large number of affiliates, including certain special-purpose U.S.-regulated banks, banking and securities subsidiaries regulated in foreign jurisdictions, and unregulated subsidiaries in the United States and abroad, including those used for over-the-counter derivatives transactions. Each of these firms was also involved with mortgage activities to varying degrees, including originating loans, purchasing loans from others, and creating mortgage-backed securities sold to investors. However, unlike their commercial bank counterparts that had access to large, relatively stable deposit bases to fund part of their operations, investment banks were more dependent on short-term wholesale funding markets, such as the repurchase or "repo" market that involves placing securities (i.e., U.S. Treasury bonds) with another party in exchange for cash for a short time and agreeing to buy back the securities at the end of that period. As their mortgage-related losses increased in the recent turmoil, these institutions encountered increasing difficulties in obtaining sufficient funding in these wholesale credit markets. Although in March 2008, the Federal Reserve extended to the remaining institutions funding that had previously only been available to banks, investors' doubts about the viability of these investment banks resulted in each of the top five firms either filing for bankruptcy, being sold to other institutions, or converting themselves into bank or financial holding companies.

but not all were subject to full and consistent oversight by a supervisor with adequate authority and resources. For example, one of the ways that the bankruptcy filing of Lehman Brothers affected other institutions was that 25 money market fund advisers had to act to protect their investors against losses arising from their investments in that company's debt, with at least one of these funds having to be liquidated and distributed to its investors.

Following the sale of Bear Stearns to JPMorgan Chase, the Lehman bankruptcy filing, and the sale of Merrill Lynch to Bank of America, the remaining CSEs opted to become bank holding companies subject to Federal Reserve oversight. SEC suspended its CSE program and the Chairman stated that "the last six months have made it abundantly clear that voluntary regulation does not work."[32]

Recent events have also highlighted difficulties faced by the Federal Reserve and OTS in their roles in overseeing risk management at large financial and thrift holding companies, respectively. In June 2008 testimony, a Federal Reserve official acknowledged such supervisory lessons, noting that under the current U.S. regulatory structure consisting of multiple supervisory agencies, challenges can arise in assessing risk profiles of large, complex financial institutions operating across financial sectors, particularly given the growth in the use of sophisticated financial products that can generate risks across various legal entities. He also noted that recent events have highlighted the importance of enterprisewide risk management, noting that supervisors need to understand risks across a consolidated entity and assess the risk management tools being applied across the financial institution.[33] Our own work had raised concerns over the adequacy of supervision of these large financial conglomerates. For example, one of the large entities that OTS oversaw was the insurance conglomerate AIG, which was subject to a government takeover necessitated by financial difficulties the firm experienced as the result of OTC derivatives activities related to mortgages. In a 2007 report, we expressed concerns over the appropriateness of having OTS oversee diverse global financial institutions

[32]SEC Press Release (2008-230), *Chairman Cox Announces End of Consolidated Supervised Entities Program* (Sept. 26, 2008).

[33]Senate Committee on Banking, Housing, and Urban Affairs, *Condition of the Banking System*, 110th Cong., 2nd sess., June 5, 2008 (testimony of Federal Reserve Vice Chairman Donald L. Kohn).

given the size of the agency relative to the institutions for which it was responsible.[34] We had also noted that although OTS oversaw a number of holding companies that are primarily in the insurance business, including AIG, it had only one specialist in this area as of March 2007.[35] An OTS official noted, however, that functional regulation established by Gramm-Leach-Bliley avoided the need for regulatory agencies to develop expertise in all aspects of financial regulation.

Second, the emergence of these large institutions with financial obligations with thousands of other entities has revealed that the existing U.S. regulatory system is not well-equipped for identifying and addressing risks across the financial system as a whole. In the current environment, with multiple regulators primarily responsible for just individual institutions or markets, no one regulator is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. For example, multiple factors contributed to the subprime mortgage crisis, and many market participants played a role in these events, including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others. The collective activities of these entities, rather than one particular institution, likely all contributed to the overall market collapse. In particular, the securitization process created incentives throughout the chain of participants to emphasize loan volume over loan quality, which likely contributed to the problem as lenders sold loans on the secondary market, passing risks on to investors. Similarly, once financial institutions began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events. Ad hoc actions by the Department of the Treasury, the Federal Reserve, other members of the President's Working Group on Financial Markets, and FDIC were aimed at helping to mitigate the fallout once events began to unfold.[36] However, even given this ad hoc coordination, our past work has repeatedly identified limitations of the current U.S. federal regulatory structure to adequately coordinate and share information to monitor risks across markets or "functional" areas to

[34]GAO-07-154.

[35]AIG is subject to OTS supervision as a savings and loan holding company because of its control of a thrift. See, e.g., 12 U.S.C. § 1467a(a)(1)(D), (H).

[36]The President's Working Group on Financial Markets consists of the Secretary of the Treasury, and the Chairmen of the Federal Reserve, SEC, and CFTC.

identify potential systemic crises.[37] Whether a greater focus on systemwide risks would have fully prevented the recent financial crises is unclear, but it is reasonable to conclude that such a mechanism would have had better prospects of identifying the breadth of the problem earlier and been better positioned to stem or soften the extent of the market fallout.

Existing Regulatory System Failed to Adequately Address Problems Associated with Less-Regulated Entities That Played Significant Roles in the U.S. Financial System

A second dramatic development in U.S. financial markets in recent decades has been the increasingly critical roles played by less-regulated entities. In the past, consumers of financial products generally dealt with entities such as banks, broker-dealers, and insurance companies that were regulated by a federal or state regulator. However, in the last few decades, various entities—nonbank lenders, hedge funds, credit rating agencies, and special-purpose investment entities—that are not always subject to full regulation by such authorities have become important participants in our financial services markets. These unregulated or less-regulated entities can provide substantial benefits by supplying information or allowing financial institutions to better meet demands of consumers, investors or shareholders but pose challenges to regulators that do not fully or cannot oversee their activities.

Activities of Nonbank Mortgage Lenders Played a Significant Role in Mortgage Crisis but Were Not Adequately Addressed by Existing Regulatory System

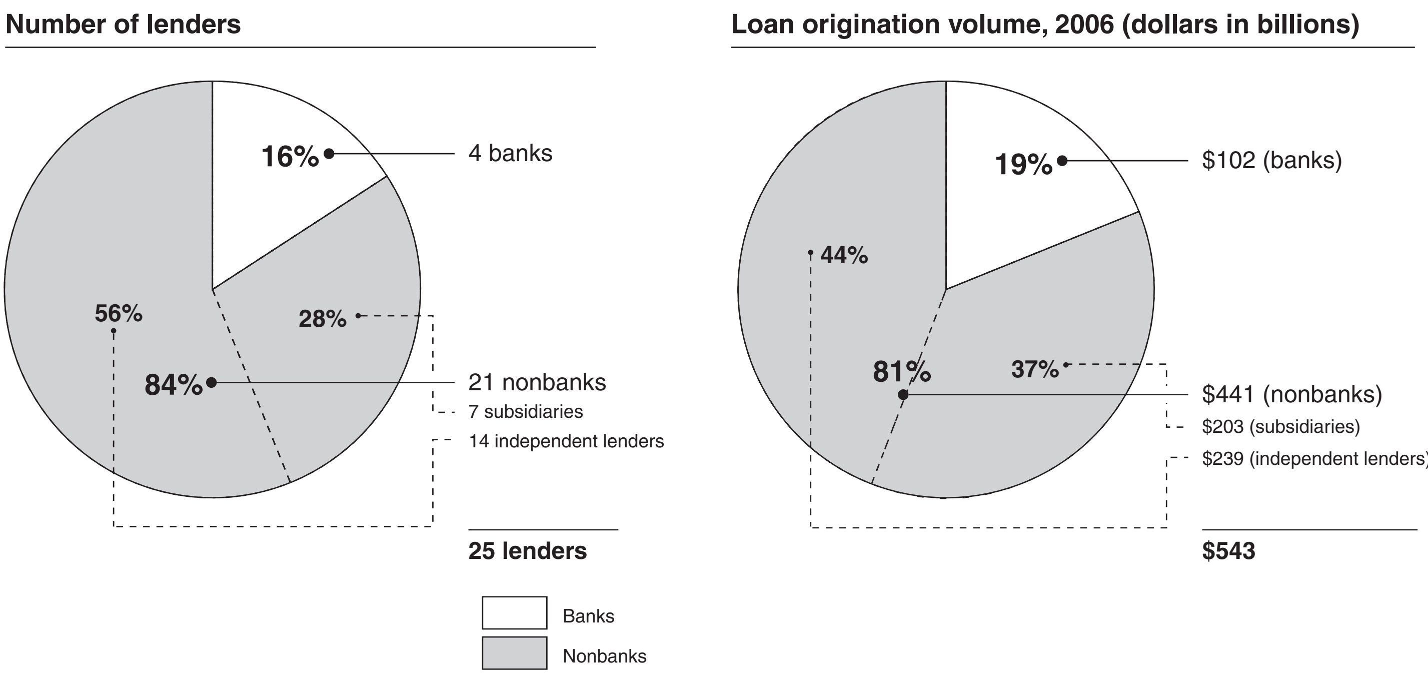
The role of nonbank mortgage lenders in the recent financial collapse provides an example of a gap in our financial regulatory system resulting from activities of institutions that were generally subject to little or no direct oversight by federal regulators.[38] The significant participation by these nonbank lenders in the subprime mortgage market—which targeted products with riskier features to borrowers with limited or poor credit history—contributed to a dramatic loosening in underwriting standards leading up to the crisis. In recent years, nonbank lenders came to represent a large share of the consumer lending market, including for subprime mortgages. Specifically, as shown in figure 3, of the top 25 originators of subprime and other nonprime loans in 2006 (which accounted for more than 90 percent of the dollar volume of all such

[37] We have noted limitations on effectively planning strategies that cut across regulatory agencies. See GAO-05-61.

[38] For the purposes of this report, nonbank lenders are those that are not banks, thrifts, or credit unions. Such entities include independent mortgage lenders, subsidiaries of national banks, subsidiaries of thrifts, and nonbank mortgage lending subsidiaries of holding companies. Although we include operating subsidiaries of national banks in the category of nonbanks, they are subject to the same federal requirements and OCC supervision and examination as their parent bank, according to an OCC official.

originations), all but 4 were nonbank lenders, accounting for 81 percent of origination by dollar volume.[39]

Figure 3: Status of Top 25 Subprime and Nonprime Mortgage Lenders (2006)



Source: GAO.

Although these lenders were subject to certain federal consumer protection and fair lending laws, they were generally not subject to the same routine monitoring and oversight by federal agencies that their bank counterparts were. From 2003 to 2006, subprime lending grew from about 9 percent to 24 percent of mortgage originations (excluding home equity loans), and Alt-A lending (nonprime loans considered less risky than subprime) grew from about 2 percent to almost 16 percent, according to data from the trade publication *Inside Mortgage Finance*. The resulting sharp rise in defaults and foreclosures that occurred as subprime and other homeowners were unable to make mortgage payments led to the collapse of the subprime mortgage market and set off a series of events that led to today's financial turmoil.

[39]Of the 21 nonbank lenders, 7 were subsidiaries of national banks, thrifts, or holding companies.

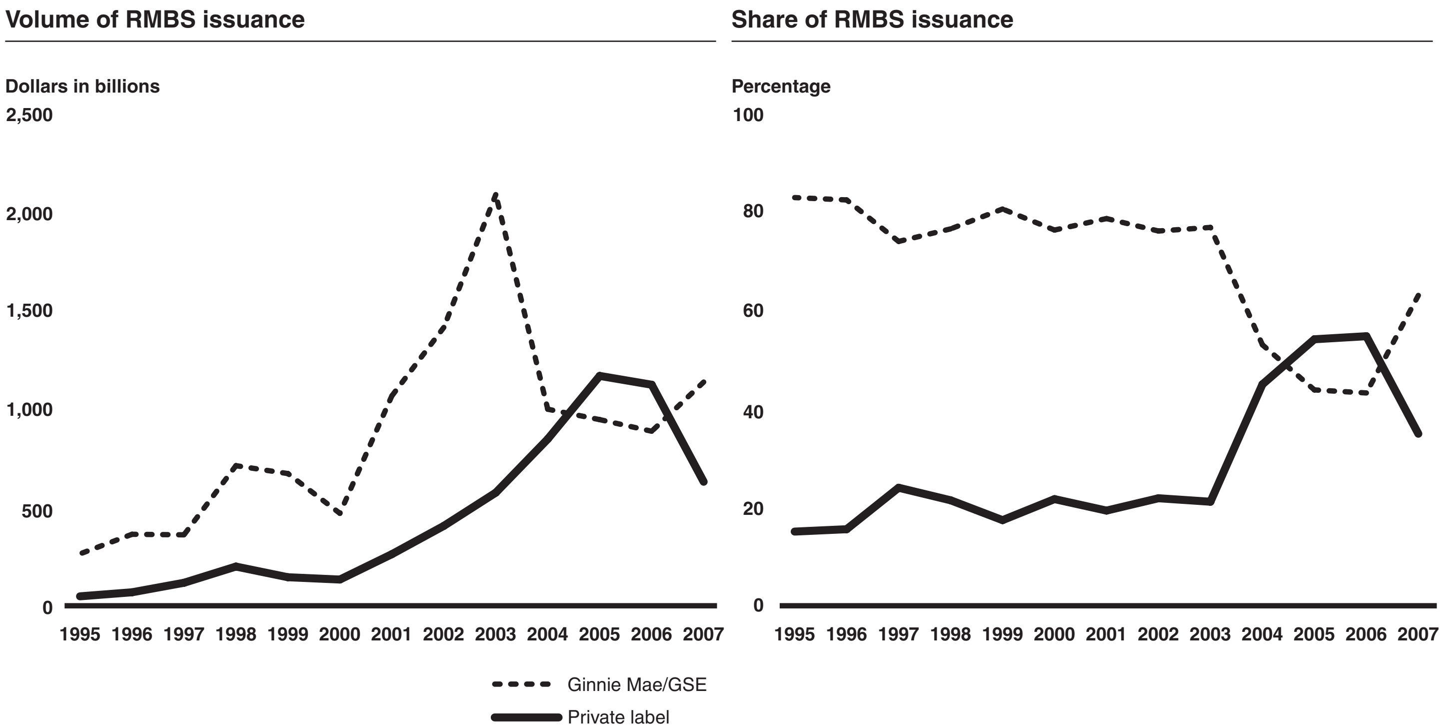
In previous reports, we noted concerns that existed about some of these less-regulated nonbank lenders and recommended that federal regulators actively monitor their activities.[40] For example, in a 2004 report, we reported that some of these nonbank lenders had been the targets of notable federal and state enforcement actions involving abusive lending. As a result, we recommended to Congress that the Federal Reserve should be given a greater role in monitoring the activities of some nonbank mortgage lenders that are subsidiaries of bank holding companies that the Federal Reserve regulates. Only recently, in the wake of the subprime mortgage crisis, the Federal Reserve began a pilot program in conjunction with OTS and the Conference of State Bank Supervisors to monitor the activities of nonbank subsidiaries of holding companies, with the states conducting examinations of independent state-licensed lenders. Nevertheless, other nonbank lenders continue to operate under less rigorous federal oversight and remain an example of the risks posed by less-regulated institutions in our financial regulatory system.

The increased role in recent years of investment banks securitizing and selling mortgage loans to investors further illustrates gaps in the regulatory system resulting from less-regulated institutions. Until recently, GSEs Fannie Mae and Freddie Mac were responsible for the vast majority of mortgage loan securitization. The securitization of loans that did not meet the GSEs' congressionally imposed loan limits or regulator-approved quality standards—such as jumbo loans that exceeded maximum loan limits and subprime loans—was undertaken by investment firms that were subject to little or no standards to ensure safe and sound practices in connection with the purchase or securitization of loans. As the volume of subprime lending grew dramatically from around 2003 through 2006, investment firms took over the substantial share of the mortgage securitization market. As shown in figure 4, this channel of mortgage funding—known as the private label mortgage-backed securities market—grew rapidly and in 2005 surpassed the combined market share of the GSEs and Ginnie Mae—a government corporation that guarantees mortgage-backed securities. As the volume of subprime loans increased, a rapidly growing share was packaged into private label securities, reaching

[40]GAO, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, GAO-04-280 (Washington, D.C.: Jan. 30, 2004); *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, GAO-06-1021 (Washington, D.C.: Sept. 19, 2006); and *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, GAO-08-78R (Washington, D.C.: Oct. 16, 2007).

75 percent in 2006, according to the Federal Reserve Bank of San Francisco.

Figure 4: Growth in Proportion of Private Label Securitization in the Mortgage-Backed Securities Market, in Dollars and Percentage of Dollar Volume (1995-2007)



Source: GAO analysis of data from Inside Mortgage Finance.

As shown in figure 4, this growth allowed private label securities to become approximately 55 percent of all mortgage-backed security issuance by 2005. This development serves as yet another example of how a less-regulated part of the market, private label securitization, played a significant role in fostering risky subprime mortgage lending, exposing a gap in the financial regulatory structure.

The role of mortgage brokers in the sale of mortgage products in recent years has also been a key focus of attention of policymakers. In past work, we noted that the role of mortgage brokers grew in the years leading up to the current crisis. By one estimate, the number of brokerages rose from about 30,000 firms in 2000 to 53,000 firms in 2004. In 2005, brokers accounted for about 60 percent of originations in the subprime market (compared with about 25 percent in the prime market).[41] In 2008, in the wake of the subprime mortgage crisis, Congress enacted the Secure and Fair Enforcement for Mortgage Licensing Act, as part of the Housing and Economic Recovery Act, to require enhanced licensing and registration of mortgage brokers.[42]

Activities of Hedge Funds Can Pose Systemic Risks Not Recognized by Regulatory System

Hedge funds, which are professionally managed investment funds for institutional and wealthy investors, have become significant participants in many important financial markets. For example, hedge funds often assume risks that other more regulated institutions are unwilling or unable to assume, and therefore generally are recognized as benefiting markets by enhancing liquidity, promoting market efficiency, spurring financial innovation, and helping to reallocate financial risk. But hedge funds receive less-direct oversight than other major market participants such as mutual funds, another type of investment fund that manages pools of assets on behalf of investors.[43] Hedge funds generally are structured and operated in a manner that enables them to qualify for exemptions from certain federal securities laws and regulations.[44] Because their participants are presumed to be sophisticated and therefore not require the full protection offered by the securities laws, hedge funds have not generally been subject to direct regulation. Therefore, hedge funds are not subject to regulatory capital requirements, are not restricted by regulation in their choice of investment strategies, and are not limited by regulation in their use of leverage. By soliciting participation in their funds from only certain large institutions and wealthy individuals and refraining from advertising to the general public, hedge funds are not required to meet the registration and disclosure requirements of the Securities Act of 1933 or the Securities Exchange Act of 1934, such as providing their investors with detailed prospectuses on the activities that their fund will undertake using

[41] GAO-08-78R.

[42] "Secure and Fair Enforcement for Mortgage Licensing Act of 2008" or "S.A.F.E. Mortgage Licensing Act of 2008", Pub. L. No. 110-289, title V.

[43] Although there is no statutory definition of hedge funds, the term is commonly used to describe pooled investment vehicles directed by professional managers that often engage in active trading of various types of assets such as securities and derivatives.

[44] See GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*, GAO-08-200 (Washington, D.C.: Jan. 24, 2008), 9.

investors' proceeds.[45] Hedge fund managers that trade on futures exchanges and that have U.S. investors are required to register with CFTC and are subject to periodic reporting, recordkeeping, and disclosure requirements of their futures activities, unless they notify the Commission that they qualify for an exemption from registration.[46]

The activities of many, but not all, hedge funds have recently become subject to greater oversight from SEC, although the rule requiring certain hedge fund advisers to register as investment advisers was recently vacated by a federal appeals court. In December 2004, SEC amended its rules to require certain hedge fund advisers that had been exempt from registering with SEC as investment advisers under its "private adviser" exemption to register as investment advisers.[47] In August 2006, SEC estimated that over 2,500 hedge fund advisers were registered with the agency, although what percentage of all hedge fund advisers active in the United States that this represents is not known. Registered hedge fund advisers are subject to the same requirements as all other registered investment advisers, including providing current information to both SEC and investors about their business practices and disciplinary history, maintaining required books and records, and being subject to periodic SEC examinations. Some questions exist over the extent of SEC's authority over these funds. In June 2006, the U.S. Court of Appeals for the

[45]Under the Securities Act of 1933, a public offering or sale of securities must be registered with SEC, unless otherwise exempted. In order to exempt an offering or sale of hedge fund shares (ownership interests) to investors from registration under the Securities Act of 1933, most hedge funds restrict their sales to accredited investors in compliance with the safe harbor requirements of Rule 506 of Regulation D. See 15 U.S.C. § 77d and § 77e; 17 C.F.R. § 230.506 (2007). Such investors must meet certain wealth and income thresholds. In addition, hedge funds typically limit the number of investors to fewer than 500, so as not to fall within the purview of Section 12(g) of the Securities Exchange Act of 1934, which requires the registration of any class of equity securities (other than exempted securities) held of record by 500 or more persons. 15 U.S.C. § 78l(g).

[46]The registration and regulatory requirements applicable to Commodity Pool Operators and Commodity Trading Advisors are subject to various exceptions and exemptions contained in CFTC regulations. See, e.g., 17 C.F.R. Secs. 4.5 (exclusion from definition of CPO for pools subject to other types of regulation such as supervision as an insured depository institution, registration under the Investment Company Act of 1940, or state regulation as an insurance company), 4.7 (exemptions from disclosure requirements for CPOs and CTAs offering or selling interests to qualified eligible persons or directing or guiding their accounts), 4.12(b) (disclosure exemption for CPOs operating pools offered and sold pursuant to the 1933 Securities Act or an exemption from the Act), 4.13 (exemption from CPO registration), 4.14 (exemption from CTA registration).

[47]69 *Fed. Reg.* 72054 (Dec. 10, 2004).

District of Columbia overturned SEC's amended rule, concluding that the rule was arbitrary because it departed, without reasonable justification, from SEC's long-standing interpretation of the term "client" in the private adviser exemption as referring to the hedge fund itself, and not to the individual investors in the fund.[48] However, according to SEC, most hedge fund advisers that previously registered have chosen to retain their registered status as of April 2007.

Although many hedge fund advisers are now subject to some SEC oversight, some financial regulators and market participants remain concerned that hedge funds' activities can create systemic risk by threatening the soundness of other regulated entities and asset markets. Hedge funds have important connections to the financial markets, including significant business relationships with the largest regulated commercial banks and broker-dealers. They act as trading counterparties with many of these institutions and constitute in many markets a significant portion of trading activity, from stocks to distressed debt and credit derivatives.[49]

The far-reaching consequences of potential hedge fund failures first became apparent in 1998. The hedge fund Long Term Capital Management (LTCM) experienced large losses related to the considerable positions—estimated to be as large as $100 billion—it had taken in various sovereign debt and other markets, and regulators coordinated with market participants to prevent a disorderly collapse that could have led to financial problems among LTCM's lenders and counterparties and potentially to the rest of the financial system.[50] No taxpayer funds were

[48]See *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). In Goldstein, the petitioner challenged an SEC regulation under the Investment Adviser's Act that defined "client" to include hedge fund investors and, therefore, prevented hedge fund advisers from qualifying for an exemption from registration for investment advisers with fewer than 15 clients. See *Goldstein*, 451 F.3d at 874-76. The Court of Appeals vacated the SEC's regulation. While hedge fund advisers may be exempt from registration, the anti-fraud provisions of the Advisers Act apply to all investment advisers, whether or not they are required to register under the Advisers Act. See Goldstein, 451 F.3d at 876. In August 2007, SEC adopted a final rule under the Investment Advisers Act (rule 206(4)–8 which prohibits advisers from (1) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (2) otherwise defrauding these investors. 72 *Fed. Reg.* 44756 (Aug. 9, 2007)).

[49]A counterparty is the opposite party in a bilateral agreement, contract, or transaction.

[50]GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999).

used as part of this effort; instead, the various large financial institutions with large exposures to this hedge fund agreed to provide additional funding of $3.6 billion until the fund could be dissolved in an orderly way. Since LTCM, other hedge funds have experienced near collapses or failures, including two funds owned by Bear Stearns, but these events have not had as significant impact on the broader financial markets as LTCM.

Also, since LTCM's near collapse, investors, creditors, and counterparties have increased their efforts to impose market discipline on hedge funds. According to regulators and market participants, creditors and counterparties have been conducting more extensive due diligence and monitoring risk exposures to their hedge fund clients. In addition, hedge fund advisers have improved disclosure and become more transparent about their operations, including their risk-management practices. However, we reported in 2008 that some regulators continue to be concerned that the counterparty credit risk created when regulated financial institutions transact with hedge funds can be a primary channel for potentially creating systemic risk.[51]

Credit Rating Agency Activities Also Illustrate the Failure of the Regulatory System to Address Risks Posed by Less-Regulated Entities

Similar to hedge funds, credit rating agencies have come to play a critical role in financial markets, but until recently they received little regulatory oversight. While not acting as direct participants in financial markets, credit ratings are widely used by investors for distinguishing the creditworthiness of bonds and other securities. Additionally, credit ratings are used in local, federal, and international laws and regulations as a benchmark for permissible investments by banks, pension funds, and other institutional investors. Leading up to the recent crisis, some investors had come to rely heavily on ratings in lieu of conducting independent assessments on the quality of assets. This overreliance on credit ratings of subprime mortgage-backed securities and other structured credit products contributed to the recent turmoil in financial markets. As these securities started to incur losses, it became clear that their ratings did not adequately reflect the risk that these products ultimately posed. According to the trade publication *Inside B&C Lending*, the three major credit rating agencies have each downgraded more than half of the subprime mortgage-backed securities they originally rated between 2005 and 2007.

[51]See GAO-08-200. Counterparty credit risk is the risk that a loss will be incurred if a counterparty to a transaction does not fulfill its financial obligations in a timely manner.

However, despite the critical nature of these rating agencies in our financial system, the existing regulatory system failed to adequately foresee and manage their role in recent events. Until recently, credit rating agencies received little direct oversight and thus faced no explicit requirements to provide information to investors about how to understand and appropriately use ratings, or to provide data on the accuracy of their ratings over time that would allow investors to assess their quality. In addition, concerns have been raised over whether the way in which credit rating agencies are compensated by the issuers of the securities that they rate affects the quality of the ratings awarded. In a July 2008 report, SEC noted multiple weaknesses in the management of these conflicts of interest, including instances where analysts expressed concerns over fees and other business interests when issuing ratings and reviewing ratings criteria.[52] However, until 2006, no legislation had established statutory regulatory authority or disclosure requirements over credit rating agencies.[53] Then, to improve the quality of ratings in response to events such as the failures of Enron and Worldcom—which highlighted the limitations of credit ratings in identifying companies' financial strength—Congress passed the Credit Rating Agency Reform Act of 2006, which established limited SEC oversight, requiring their registration and certain recordkeeping and reporting requirements.[54]

[52]SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (Washington, D.C., July 8, 2008).

[53]Previously, SEC regulations referred to credit ratings by "nationally recognized statistical rating organizations," or NRSROs, but this designation was not established or defined in statute. SEC staff identified credit rating agencies as NRSROs through a no-action letter process in which they determine whether a rating agency had achieved broad market acceptance for its ratings.

[54]Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (Sept. 29, 2006). Under the act, a credit rating agency seeking to be treated as an NRSRO must apply for, and be granted, registration with SEC, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. In addition, the act provides the SEC with rulemaking authority to prescribe: the form of the application (including requiring the furnishing of additional information); the records an NRSRO must make and retain; the financial reports an NRSRO must furnish to SEC on a periodic basis; the specific procedures an NRSRO must implement to manage the handling of material nonpublic information; the conflicts of interest an NRSRO must manage or avoid altogether; and the practices that an NRSRO must not engage in if SEC determines they are unfair, coercive, or abusive. The act expressly prohibits SEC from regulating the rating agencies' methodologies or the substance of their ratings. Pub. L. No. 109-291 § 4(a). SEC adopted rules implementing the act in June 2007. 72 *Fed. Reg.* 33564 (June 18, 2007).

Since the financial crisis began, regulators have taken steps to address the important role of rating agencies in the financial system. In December 2008, in response to the subprime mortgage crisis and resulting credit market strains, SEC adopted final rule amendments and proposed new rule amendments that would impose additional requirements on nationally recognized statistical rating organizations in order to address concerns raised about the policies and procedures for, transparency of, and potential conflicts of interest relating to ratings. Determining the most appropriate government role in overseeing credit rating activities is difficult. For example, SEC has expressed concerns that too much government intervention—such as regulatory requirements of credit ratings for certain investments or examining the underlying methodology of ratings—would unintentionally provide an unofficial "seal of approval" on the ratings and therefore be counterproductive to reducing overreliance on ratings. Whatever the solution, it is clear that the current regulatory system did not properly recognize and address the risks associated with the important role these entities played.

Regulatory System Failed to Identify Risks Associated with Special-Purpose Entities

The use by financial institutions of special-purpose entities provides another example of how less-regulated aspects of financial markets came to play increasingly important roles in recent years, creating challenges for regulators in overseeing risks at their regulated institutions. Many financial institutions created and transferred assets to these entities as part of securitizations for mortgages or to hold other assets and produce fee income for the institution that created it—known as the sponsor. For example, after new capital requirements were adopted in the late 1980s, some large banks began creating these entities to hold assets for which they would have been required to hold more capital against if the assets were held within their institutions. As a result, these entities are also known as off-balance sheet entities because they generally are structured in such a way that their assets and liabilities are not required to be consolidated and reported as part of the overall balance sheet of the sponsoring financial institution that created them. The amount of assets accumulated in these entities resulted in them becoming significant market participants in the last few years. For example, one large commercial bank reported that its off-balance sheet entities totaled more than $1 trillion in assets at the end of 2007.

Some of these off-balance sheet entities were structured in a way that left them vulnerable to market disruptions. For example, some financial institutions created entities known as asset-backed commercial paper conduits that would purchase various assets, including mortgage-related securities, financial institution debt, and receivables from industrial

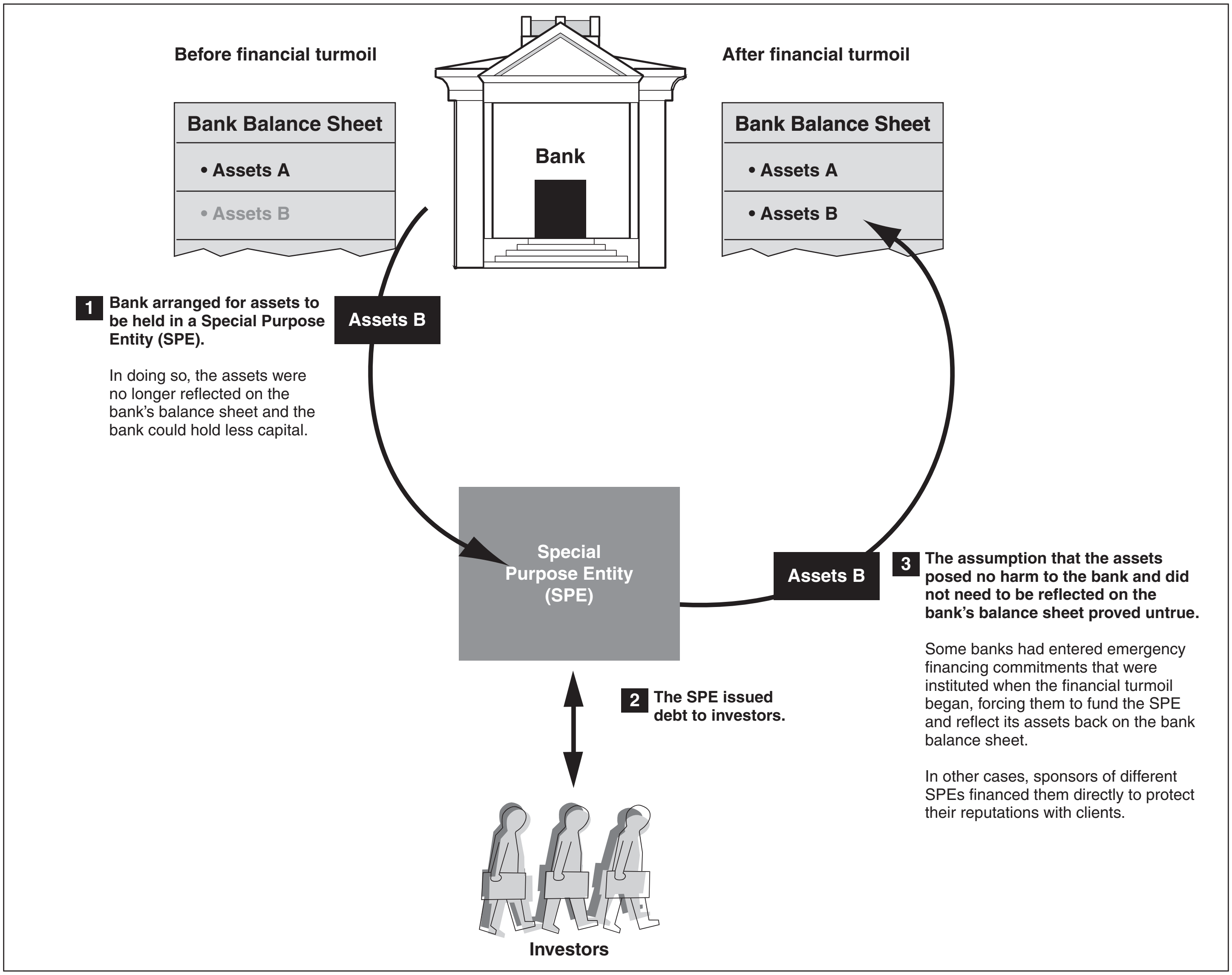
Credit Ratings and the Financial Crisis

Traditionally, products receiving the highest credit ratings, such as AAA, were a small set of corporate and sovereign bonds that were deemed to be the safest and most stable debt investments. However, credit rating agencies assigned similarly high credit ratings to many of the newer mortgage-related products even though these products did not have the same characteristics as previously highly rated securities. As a result of these ratings, institutions were able to successfully market many of these products, including to other financial firms and institutional investors in the United States and around the world. Ratings were seen to provide a common measure of credit risk across all debt products, allowing structured credit products that lacked an active secondary market to be valued against similarly rated products with available prices. Starting in mid-2007, increasing defaults on residential mortgages, particularly those for subprime borrowers, led to a widespread, rapid, and severe series of downgrades by rating agencies on subprime-related structured credit products. These downgrades undermined confidence in the quality of ratings on these and related products. Along with increasing defaults, the uncertainty over credit ratings led to a sharp repricing of assets across the financial system and contributed to large writedowns in the market value of assets by banks and other financial institutions. This contributed to the unwillingness of many market participants to transact with each other due to concerns over the actual value of assets and the financial condition of other financial institutions.

businesses. To obtain the funds to purchase these assets, these special-purpose vehicles often borrowed using shorter-term instruments, such as commercial paper and medium-term notes. The difference between the interest paid to the commercial paper or note holders and the income earned on the entity's assets produced fee and other income for the sponsoring institution. However, these structures carried the risk that the entity would find it difficult or costly to renew its debt financing under less-favorable market conditions.

Although structured as off-balance sheet entities, when the turmoil in the markets began in 2007, many financial institutions that had created these entities had to take back the loans and securities in certain types of these off-balance sheet entities. (See fig. 5.)

Figure 5: Example of an Off-Balance Sheet Entity



Source: GAO.

In general, banks stepped in to finance the assets held by these entities when they were unable to refinance their expiring debt due to market concerns over the quality of the assets. In some cases, off-balance sheet entities relied on emergency financing commitments that many sponsoring banks had extended to these entities. In other cases, financial institutions supported troubled off-balance sheet entities to protect their reputations with clients even when no explicit requirement to do so existed. This, in turn, contributed to the reluctance of banks to lend as they had to fund additional troubled assets on their balance sheets. Thus, although the use of these entities seemingly had removed the risk of these assets from these institutions, their inability to obtain financing resulted in the ownership, risks, and losses of these entities' assets coming back into many of the sponsoring financial institutions.

According to a 2008 IMF study, financial institutions' use of off-balance sheet entities made it difficult for regulators, as well as investors, to fully understand the associated risks of such activities. In response to these developments, regulators and others have begun to reassess the appropriateness of the regulatory and accounting treatment for these entities. In January 2008, SEC asked the Financial Accounting Standards Board (FASB), which establishes U.S. financial accounting and reporting standards, to consider further improvements to the accounting and disclosure for off-balance sheet transactions involving securitization. FASB and the International Accounting Standards Board both have initiated projects to improve the criteria for determining when financial assets and related liabilities that institutions transfer to special-purpose entities should be included on the institutions' own balance sheets—known as consolidation—and to enhance related disclosures. As part of this effort, FASB issued proposed standards that would eliminate a widely used accounting exception for off-balance sheet entities, introduce a new accounting model for determining whether special-purpose entities should be consolidated that is less reliant on mathematical calculations and more closely aligned with international standards, and require additional disclosures about institutions' involvement with certain special-purpose entities. On December 18, 2008, the International Accounting Standards Board also issued a proposed standard on consolidation of special-purpose entities and related risk disclosures. In addition, in April 2008, the Basel Committee on Banking Supervision announced new measures to capture off-balance sheet exposures more effectively.

Nevertheless, this serves as another example of the failure of the existing regulatory system to recognize the problems with less-regulated entities and take steps to address them before they escalate. Existing accounting and disclosure standards had not required banks to extensively disclose their holdings in off-balance sheet entities and allowed for very low capital requirements. As a March 2008 study by the President's Working Group on Financial Markets noted, before the recent market turmoil, supervisory authorities did not insist on appropriate disclosures of firms' potential exposure to off-balance sheet entities.

New and Complex Financial Products and Services Also Revealed Limitations in the Regulatory Structure

Another development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. Although posing challenges, these new products also have provided certain benefits to financial markets and consumers. For example, the creation of securitized products such as mortgage-backed securities increased the liquidity of credit markets by providing additional funds to lenders and a wider range of investment returns to investors with excess funds. Other useful product innovations included OTC derivatives, such as currency options, which provide a purchaser the right to buy a specified quantity of a currency at some future date, and interest rate swaps, which allow one party to exchange a stream of fixed interest rate payments for a stream of variable interest rate payments. These products help market participants hedge their risks or stabilize their cash flows. Alternative mortgage products, such as interest-only loans, originally were used by a limited subset of the population, mainly wealthy borrowers, to obtain more convenient financing for home purchases. Despite these advantages, the complexity and expanded use of new products has made it difficult for the current regulatory system to oversee risk management at institutions and adequately protect individual consumers and investors.

New Complex Securitized Products Have Created Difficulties for Institutions and Regulators in Valuing and Assessing Their Risks

Collateralized debt obligations (CDO) are one of the new products that proliferated and created challenges for financial institutions and regulators. In a basic CDO, a group of loans or debt securities are pooled and securities are then issued in different tranches that vary in risk and return depending on how the underlying cash flows produced by the pooled assets are allocated. If some of the underlying assets defaulted, the more junior tranches—and thus riskier ones—would absorb these losses first before the more senior, less-risky tranches. Purchasers of these CDO securities included insurance companies, mutual funds, commercial and investment banks, and pension funds. Many CDOs in recent years largely consisted of mortgage-backed securities, including subprime mortgage-backed securities.

Although CDOs have existed since the 1980s, recent changes in the underlying asset mix of these products led to increased risk that was poorly understood by the financial institutions involved in these investments. CDOs had consisted of simple securities like corporate bonds or loans, but more recently have included subprime mortgage-backed securities, and in some cases even lower-rated classes of other equally complex CDOs. Some of these CDOs included investments in 100 or more asset-backed securities, each of which had its own large pool of loans and specific payment structures.[55] A large share of the total value of the securities issued were rated AA or AAA—designating them as very safe investments and unlikely to default—by the credit rating agencies. In part because of their seemingly high returns in light of their rated risk, demand for these new CDOs grew rapidly and on a large scale. Between 2004 and 2007, nearly all adjustable-rate subprime mortgages were packaged into mortgage-backed securities, a large portion of which were structured into CDOs.

As housing prices in the United States softened in the last 2 years, default and foreclosure rates on the mortgages underlying many CDOs rose and the credit rating agencies downgraded many CDO ratings, causing investors to become unwilling to purchase these products in the same quantities or at the prices previously paid. Many financial institutions, including large commercial and investment banks, struggled to realize the size of their exposure to subprime credit risk. Many of these institutions appeared to have underestimated the amount of risk and potential losses that they could face from creating and investing in these products. Reductions in the value of subprime-backed CDOs have contributed to reported losses by financial institutions totaling more than $750 billion globally, as of September 2008, according to the International Monetary Fund, which estimates that total losses on global holdings of U.S. loans and securities could reach $1.4 trillion.

Several factors could explain why institutions—and regulators—did not effectively monitor and limit the risk that CDOs represented. Products like CDOs have risk characteristics that differ from traditional investments. First, the variation and complexity of the CDO structures and the underlying assets they contain often make estimating potential losses and determining accurate values for these products more difficult than for traditional securities. Second, although aggregating multiple assets into these structures can diversify and thus reduce the overall risk of the securities issued from them, their exposure to the overall housing market downturn made investors reluctant to purchase even the safest tranches, which produced large valuation losses for the holders of even the highest-

[55]CDO cash flows also can be affected by other contract terms, such as detailed provisions that divert payments from the junior classes to the more senior classes when certain conditions are met, such as if the portfolio value or interest proceeds fall below a certain level.

rated CDO securities.[56] Finally, Federal Reserve staff noted that an additional reason these securities performed worse than expected was that rating agencies and investors did not believe that housing prices could have fallen as significantly as they have.

The lack of historical performance data for these new instruments also presented challenges in estimating the potential value of these securities. For example, the Senior Supervisors Group—a body comprising senior financial supervisors from France, Germany, Switzerland, the United Kingdom, and the United States—reported that some financial institutions substituted price and other data associated with traditional corporate debt in their loss estimation models for similarly rated CDO debt, which did not have sufficient historical data.[57] As a report by a group of senior representatives of financial regulators and institutions has noted, the absence of historical information on the performance of CDOs created uncertainty around the standard risk-management tools used by financial institutions.[58] Further, structured products such as CDOs may lack an active and liquid market, as in the recent period of market stress, forcing participants to look for other sources of valuation information when market prices are not readily available. For instance, market participants often turned to internal models and other methods to value these products, which raised concerns about the consistency and accuracy of the resulting valuation information.

Growth in OTC Derivatives Markets, Which Feature Complex Products That Are Not Regulated, Raised Regulator Concerns about Systemic Risk and Weak Market Infrastructure

The rapid growth in OTC derivatives—or derivatives contracts that are traded outside of regulated exchanges—is another example of how the emergence of large markets for increasingly complex products has challenged our financial regulatory system. OTC derivatives, which began trading in the 1980s, have developed into markets with an estimated notional value—which is the amount underlying a financial derivatives contract—of about $596 trillion, as of December 2007, according to the

[56]For more information, see The Joint Forum, Bank for International Settlements, *Credit Risk Transfer: Developments from 2005 to 2007* (Basel, Switzerland, April 2008).

[57]See the Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (New York, Mar. 6, 2008).

[58]See the Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (Basel, Switzerland, Apr. 7, 2008). The Financial Stability Forum promotes international financial stability through information exchange and international cooperation in financial supervision and surveillance. It is composed of senior representatives of national financial authorities and various international financial organizations and the European Central Bank.

Bank for International Settlements.[59] OTC derivatives transactions are generally not subject to regulation by SEC, CFTC, or any other U.S. financial regulator and in particular are not subject to similar disclosure and other requirements that are in place for most securities and exchange-traded futures products. Institutions that conduct derivatives transactions may be subject to oversight of their lines of business by their regulators. For example, commercial banks that deal in OTC derivatives are subject to full examinations by their respective regulators. On the other hand, investment banks generally conducted their OTC derivatives activities in affiliates or subsidiaries that traditionally—since most OTC derivatives are not securities—were not subject to direct oversight by SEC, although SEC did review how the largest investment banks that were subject to its CSE program were managing the risk of such activities.

Although OTC derivatives and their markets are not directly regulated, the risk exposures that these products created among regulated financial institutions can be sometimes large enough to raise systemic risk concerns among regulators. For example, Bear Stearns, the investment bank that experienced financial difficulties as the result of its mortgage-backed securities activities, was also one of the largest OTC derivatives dealers. According to regulators, one of the primary reasons the Federal Reserve, which otherwise had no regulatory authority over this securities firm, facilitated the sale of Bear Stearns rather than let it go bankrupt was to avoid a potentially large systemic problem because of the firm's large OTC derivatives obligations. More than a decade ago, we reported that the large financial interconnections between derivatives dealers posed risk to the financial system and recommended that Congress and financial regulators take action to ensure that the largest firms participating in the OTC derivatives markets be subject to similar regulatory oversight and requirements.[60]

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[59]The notional amount is the amount upon which payments between parties to certain types of derivatives contracts are based. When this amount is not exchanged, it is not a measure of the amount at risk in a transaction. According to the Bank for International Settlements, the amount at risk, as measured by the gross market value of OTC derivatives outstanding, was $15 trillion, as of December 2007, or about 2 percent of the notional/contract amount. (The gross market value is the cost that would be incurred if the outstanding contracts were replaced at prevailing market prices.)

[60]GAO, *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133 (Washington, D.C.: May 18, 1994).

The market for one type of OTC derivative—credit default swaps—had grown so large that regulators became concerned about its potential to create systemic risks to regulated financial institutions. Credit default swaps are contracts that act as a type of insurance, or a way to hedge risks, against default or another type of credit event associated with a security such as a corporate bond. One party in the contract—the seller of protection—agrees, in return for a periodic fee, to compensate the other party—the protection buyer—if the bond or other underlying entity defaults or another specified credit event occurs. In recent years, the size of the market for credit default swaps (in terms of the notional amount of outstanding contracts) has increased almost tenfold from just over $6 trillion in 2004 to almost $58 trillion at the end of 2007, according to the Bank for International Settlements.

As this market has grown, regulators increasingly have become concerned about the adequacy of the infrastructure in place for clearing and settling these contracts, especially the ability to quickly resolve contracts in the event of a large market participant failure. For example, in September 2008, concerns over the effects that a potential bankruptcy of AIG—which was a large seller of credit default swaps—would have on this firm's swap counterparties contributed to a decision by the Federal Reserve to lend the firm up to $85 billion.[61] The Federal Reserve expressed concern at the time that a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. As with other OTC derivatives, credit default swaps are not regulated as products, but many of the large U.S. and internationally regulated financial institutions act as dealers. Despite the credit default market's rapid growth, as recently as 2005 the processing of transactions was still paper-based and decentralized. Regulators have put forth efforts over the years to strengthen clearing and settlement mechanisms. For example, in September 2005, the Federal Reserve Bank of New York began working with dealers and market participants to strengthen arrangements for clearing and settling these swap transactions. Regulators began focusing on reducing a large backlog of unconfirmed trades, which can inhibit market participants' ability to manage their risks if errors are not found quickly or if uncertainty exists about how other institutions would

[61]Subsequently, the Federal Reserve agreed to loan AIG up to an additional $38 billion. In November 2008, the Federal Reserve and U.S. Treasury restructured these lending arrangements with a new financial support package totaling over $150 billion.

be affected by the failure of a firm with which they hold credit default swap contracts. Regulators continue to monitor dealers' progress on these efforts to reduce operational risk arising from these products, and recently have begun holding discussions with the largest credit derivatives dealers and other entities, including certain exchanges, regarding the need to establish a centralized clearing facility, which could reduce the risk of any one dealer's failure to the overall system. In November 2008, the President's Working Group on Financial Markets announced policy objectives to guide efforts to address challenges associated with OTC derivatives, including recommendations to enhance the market infrastructure for credit default swaps. However, as of December 2008, no such entity had begun operations.

New Complex Products Have Also Created Challenges for Regulators in Ensuring Adequate Investor and Consumer Protection

The regulations requiring that investors receive adequate information about the risks of financial assets being marketed to them are also being challenged by the development of some of these new and complex products. For some of the new products that have been created, market participants sometimes had difficulty obtaining clear and accurate information on the value of these assets, their risks, and other key information. In some cases, investors did not perform needed due diligence to fully understand the risks associated with their investment. In other cases, investors have claimed they were misled by broker-dealers about the advantages and disadvantages of products. For example, investors for municipal governments in Australia have accused Lehman Brothers of misleading them regarding the risks of CDOs. As another example, the treasurer of Orange County who oversaw investments leading to the county's 1994 bankruptcy claimed to have relied on the advice of a large securities firm for his decision to pursue leveraged investments in complex structured products. Finally, a number of financial institutions—including Bank of America, Wachovia, Merrill Lynch, and UBS—have recently settled SEC allegations that these institutions misled investors in selling auction-rate securities, which are bonds for which the interest rates are regularly reset through auctions. In one case, Bank of America, in October 2008, reached a settlement in principle in response to SEC charges that it made misrepresentations to thousands of businesses, charities, and institutional investors when it told them that the products were safe and highly liquid cash and money market alternative investments.

Similarly, the introduction and expansion of increasingly complicated retail products to new and broader consumer populations has also raised challenges for regulators in ensuring that consumers are adequately protected. Consumers face growing difficulty in understanding the relative advantages and disadvantages of products such as mortgages and credit cards with new and increasingly complicated features, in part because of limitations on the part of regulatory agencies to improve consumer disclosures and financial literacy. For example, in the last few years many borrowers likely did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate at which they had been in recent years. In particular, a significant majority of subprime borrowers from 2003 to 2006 took out adjustable-rate mortgages whose interest rates were fixed for the first 2 or 3 years but then adjusted to often much higher interest rates and correspondingly higher mortgage payments. In addition, many borrowers took out loans with interest-only features that resulted in significant increases in mortgage payments later in the loan. The combination of reduced underwriting standards and a slowdown in house price appreciation led many borrowers to default on their mortgages.

Alternative mortgage products such as interest-only or payment option loans, which allow borrowers to defer repayment of principal and possibly part of the interest for the first few years of the loan, grew in popularity and expanded greatly in recent years. From 2003 through 2005, originations of these types of mortgage products grew threefold, from less than 10 percent of residential mortgage originations to about 30 percent. For many years, lenders had primarily marketed these products to wealthy and financially sophisticated borrowers as financial management tools. However, lenders increasingly marketed alternative mortgage products as affordability products that enabled a wider spectrum of borrowers to purchase homes they might not have been able to afford using a conventional fixed-rate mortgage. Lenders also increased the variety of such products offered after interest rates rose and adjustable rate mortgages became less attractive to borrowers.

In past work, we found that most of the disclosures for alternative mortgage products that we reviewed did not always fully or effectively explain the risks associated with these products and lacked information on some important loan features.[62] Some evidence suggests more generally that existing mortgage disclosures were inadequate, a problem that is likely to grow with the increased complexity of products. A 2007 Federal Trade Commission report found that both prime and subprime borrowers

[62]See GAO-06-1021.

failed to understand key loan terms when viewing current disclosures.[63] In addition, some market observers have been critical of regulators' oversight of these products and whether products with such complex features were appropriate for some of the borrowers to which they were marketed. For example, some were critical of the Federal Reserve for not acting more quickly to use its authority under the 1994 Home Ownership and Equity Protection Act to prohibit unfair or deceptive acts or practices in the mortgage market. Although the Federal Reserve took steps in 2001 to ban some practices, such as engaging in a pattern or practice of refinancing certain high-cost loans when it is not in the borrower's interest, it did not act again until 2008, when it banned additional products and practices, such as certain loans with limited documentation. In a 2007 testimony, a Federal Reserve official noted that writing such rules is difficult, particularly since determinations of unfairness or deception depend heavily on the facts of an individual case.[64]

Efforts by regulators to respond to the increased risks associated with new mortgage products also have sometimes been slowed in part because of the need for five federal regulators to coordinate their response. In late 2005, regulators began crafting regulatory guidance to strengthen lending practices and improve disclosures for loans that start with relatively low payments but leave borrowers vulnerable to much higher ones later. The regulators completed their first set of such standards in September 2006, with respect to the disclosure of risks associated with nontraditional mortgage products, and a second set, applicable to subprime mortgage loans, in June 2007.[65] Some industry observers and consumer advocacy groups have criticized the length of time it took for regulators to issue these changes, noting that the second set of guidance was released well after many subprime lenders had already gone out of business.

[63] Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms: A Bureau of Economics Staff Report.* (Washington D.C.: June 2007).

[64] House of Representatives Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Subprime Mortgages*, 110th Cong. 2nd sess., Mar. 27, 2007 (testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Federal Reserve).

[65] 71 *Fed. Reg.* 58609 (Oct. 4, 2006) "Interagency Guidance on Nontraditional Mortgage Product Risks"; 72 *Fed. Reg.* 37569 (Jul. 10, 2007) "Statement on Subprime Mortgage Lending".

As variations in the types of credit card products and terms have proliferated, consumers also have faced difficulty understanding the rates and terms of their credit card accounts. Credit card rate and fee disclosures have not always been effective at clearly conveying associated charges and fees, creating challenges to informed financial decision making. Although credit card issuers are required to provide cardholders with information aimed at facilitating informed use of credit, these disclosures have serious weaknesses that likely reduce consumers' ability to understand the costs of using credit cards. Because the pricing of credit cards is not generally subject to federal regulation, these disclosures are the primary federal consumer protection mechanism against inaccurate and unfair credit card practices. However, we reported in 2006 that the disclosures in materials provided by four of the largest credit card issuers were too complicated for many consumers to understand. Following our report, Federal Reserve staff began using consumer testing to involve them to a greater extent in the preparation of potentially new and revised disclosures, and in May 2007, issued proposed changes to credit card disclosure requirements. Nonetheless, the Federal Reserve recognizes the challenge of presenting the information that consumers may need to understand the costs of their cards in a clear way, given the increasingly complicated terms of credit card products.[66] In December 2008, the Federal Reserve, OTS, and NCUA finalized rules to ban various unfair credit card practices, such as allocating payments in a way that unfairly maximizes interest charges.

The expansion of new and more complex products also raises challenges for regulators in addressing financial literacy. We have also noted in past work that even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters.[67] In response to increasing evidence that many Americans are lacking in financial literacy, the federal government has taken steps to expand financial education efforts. However, attempts by the Financial Literacy and Education Commission to coordinate federal financial literacy efforts have sometimes proven difficult due, in part, to the need to reach consensus among its 20 participating federal agencies, which have different missions and perspectives. Moreover, the commission's staff and

[66]See GAO, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO-06-929 (Washington, D.C.: Sept. 12, 2006).

[67]See GAO-04-280.

funding resources are relatively small, and it has no legal authority to require agencies to redirect their resources or take other actions.[68]

Increased Complexity and Other Factors Have Challenged Accounting Standard Setters and Regulators

As new and increasingly complex financial products have become more common, FASB and SEC have also faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.[69] The development and widespread use of increasingly complex financial products has heightened the importance of having effective accounting and financial reporting requirements that provide interested parties with information that can help them identify and assess risk. As the pace of financial innovation increased in the last 30 years, accounting and financial reporting requirements have also had to keep pace, with 72 percent of the current 163 standards having been issued since 1980—some of which were revisions and amendments to recently established standards, which evidences the challenge of establishing accounting and financial reporting requirements that respond to needs created by financial innovation.

As a result of the growth in complex financial instruments and a desire to improve the usefulness of financial information about them, U.S. standard setters and regulators currently are dealing with accounting and auditing challenges associated with recently developed standards related to valuing financial instruments and special-purpose entities. Over the last year, owners and issuers of financial instruments have expressed concerns about implementing the new fair value accounting standard, which requires that financial assets and liabilities be recorded at fair or market value. SEC and FASB have recently issued clarifications of measuring fair value when there is not an active market for the financial instrument.[70] In addition, market participants raised concerns about the availability of

[68]See GAO, *Financial Literacy and Education Commission: Further Progress Needed to Ensure an Effective National Strategy*, GAO-07-100 (Washington, D.C.: Dec. 4, 2006).

[69]FASB issues generally accepted accounting principles for financial statements prepared by nongovernmental entities in the United States. SEC issues financial reporting and disclosure requirements for U.S. publicly traded companies and recognizes the standards issued by FASB as "generally accepted" within the United States. SEC oversees FASB's standard-setting activities.

[70]FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (Oct. 10, 2008); and SEC Press Release No. 2008-234, *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting* (Sept. 30, 2008).

useful accounting and financial reporting information to assess the risks posed by special-purpose entities. Under current accounting rules, publicly traded companies that create qualifying special-purpose entities are allowed to move qualifying assets and liabilities associated with certain complex financial instruments off the issuing company's balance sheets, which results in virtually no accounting and financial reporting information being available about the entities' activities. Due to the accounting and financial reporting treatment for these special-purpose entities, as the subprime crisis worsened, banks initially refused to negotiate loans with homeowners because banks were concerned that the accounting and financial reporting requirements would have the banks put the assets and liabilities back onto their balance sheets. In response to questions regarding modification of loans in special-purpose entities, the SEC's Chief Accountant issued a letter that concluded his office would not object to loans being modified pursuant to specific screening criteria. In response to these concerns, FASB expedited its standards-setting process in order to reduce the amount of time before the issuance of a new accounting standard that would effectively eliminate qualified special-purpose entities.[71]

Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards. The rapid integration of the world's capital markets has made establishing a single set of effective accounting and financial reporting standards increasingly relevant. FASB and SEC have acknowledged the need to address the convergence of U.S. and international accounting standards, and SEC has proposed having U.S. public companies use International Financial Reporting Standards by 2014. As the globalization of accounting standards moves forward, U.S. standard setters and regulators need to anticipate and manage the challenges posed by their development and implementation, such as how to apply certain standards in unique legal and regulatory environment frameworks in the United States as well as in certain unique industry niches. Ensuring that auditing standards applicable to U.S. public companies continue to provide the financial markets with the important

[71]On September 15, 2008, FASB issued an exposure draft, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, for a 30-day comment period that closed on October 15, 2008. On December 11, 2008, FASB issued FASB Staff Position (FSP) FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. This document requires additional disclosures about transfers of financial assets and variable interests in qualifying special purpose entities. It also requires public enterprises to provide additional disclosures about their involvement with variable interest entities.

and independent assurances associated with existing U.S. auditing standards will also prove challenging to the Public Company Accounting Oversight Board.

Globalization Will Further Challenge the Existing U.S. Regulatory System

Just as global accounting and auditing standards are converging, financial markets around the world are becoming increasingly interlinked and global in nature, requiring U.S. regulators to work with each other and other countries to effectively adapt. To effectively oversee large financial services firms that have operations in many countries, regulators from various countries must coordinate regulation and supervision of financial services across national borders and must communicate regularly. Although financial regulators have effectively coordinated in a number of ways to accommodate some changes, the current fragmented regulatory structure has complicated some of these efforts.

For example, the current U.S. regulatory system complicates the ability of financial regulators to convey a single U.S. position in international discussions, such as those related to the Basel Accords process for developing international capital standards. Each federal regulator involved in these efforts oversees a different set of institutions and represents an important regulatory perspective, which has made reaching consensus on some issues more difficult than others. Although U.S. regulators generally agree on the broad underlying principles at the core of Basel II, including increased risk sensitivity of capital requirements and capital neutrality, in a 2004 report we noted that although regulators communicated and coordinated, they sometimes had difficulty agreeing on certain aspects of the process.[72] As we reported, in November 2003, members of the House Financial Services Committee warned in a letter to the bank regulatory agencies that the discord surrounding Basel II had weakened the negotiating position of the United States and resulted in an agreement that was less than favorable to U.S. financial institutions.[73] International officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making. However, regulatory officials told us that the final outcome of the Basel II negotiations was better than it would have been with a single U.S. representative because of the agencies' varying perspectives and expertise. In particular, one regulator noted that, in light of the magnitude

[72] GAO-05-61.

[73] Letter from Representative Michael Oxley et al. to Chairman Alan Greenspan et al., Nov. 3, 2003.

of recent losses at banks and the failure of banks and rating agencies to predict such losses, the additional safeguards built into how U.S. regulators adopted Basel II are an example of how more than one regulatory perspective can improve policymaking.

A Framework for Crafting and Assessing Alternatives for Reforming the U.S. Financial Regulatory System

The U.S. regulatory system is a fragmented and complex system of federal and state regulators—put into place over the past 150 years—that has not kept pace with the major developments that have occurred in financial markets and products in recent decades. In 2008, the United States finds itself in the midst of one of the worst financial crises ever, with instability threatening global financial markets and the broader economy. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, attention has also turned to the need to consider significant reforms to the financial regulatory system to keep pace with existing and anticipated challenges in financial regulation.

While the current U.S. system has many features that could be preserved, the significant limitations of the system, if not addressed, will likely fail to prevent future crises that could be as harmful as or worse than those that have occurred in the past. Making changes that better position regulators to oversee firms and products that pose risks to the financial system and consumers and to adapt to new products and participants as these arise would seem essential to ensuring that our financial services sector continues to serve our nation's needs as effectively as possible.

We have conducted extensive work in recent decades reviewing the impacts of market developments and overseeing the effectiveness of financial regulators' activities. In particular, we have helped Congress address financial crises dating back to the savings and loan and LTCM crises, and more recently over the past few years have issued several reports citing the need to modernize the U.S. financial regulatory structure. In this report, consistent with our past work, we are not proposing the form and structure of what a new financial regulatory system should look like. Instead, we are providing a framework, consisting of the following nine elements, that Congress and others can use to evaluate or craft proposals for financial regulatory reform. By applying the elements of this framework to proposals, the relative strengths and weaknesses of each one should be better revealed. Similarly, the framework we present could be used to craft a proposal or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system. The nine elements could be addressed in a variety of ways, but each is critically important in establishing the most effective and efficient financial regulatory system possible.

1. *Clearly defined regulatory goals.* A regulatory system should have goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.

A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of a dynamic financial services industry is to clearly define regulatory goals and objectives. In the background of this report, we identify four broad goals of financial regulation that regulators have generally sought to achieve. These include ensuring adequate consumer protections, ensuring the integrity and fairness of markets, monitoring the safety and soundness of institutions, and acting to ensure the stability of the overall financial system. However, these goals are not always explicitly set in the federal statutes and regulations that govern these regulators. Having specific goals clearly articulated in legislation could serve to better focus regulators on achieving their missions with greater certainty and purpose, and provide continuity over time.

Given some of the key changes in financial markets discussed earlier in this report—particularly the increased interconnectedness of institutions, the increased complexity of products, and the increasingly global nature of financial markets—Congress should consider the benefits that may result from re-examining the goals of financial regulation and making explicit a set of comprehensive and cohesive goals that reflect today's environment. For example, it may be beneficial to have a clearer focus on ensuring that products are not sold with unsuitable, unfair, deceptive, or abusive features; that systemic risks and the stability of the overall financial system are specifically addressed; or that U.S. firms are competitive in a global environment. This may be especially important given the history of financial regulation and the ad hoc approach through which the existing goals have been established, as discussed earlier.

We found varying views about the goals of regulation and how they should be prioritized. For example, representatives of some regulatory agencies and industry groups emphasized the importance of creating a competitive financial system, whereas members of one consumer advocacy group noted that reforms should focus on improving regulatory effectiveness rather than addressing concerns about market competitiveness. In addition, as the Federal Reserve notes, financial regulatory goals often will prove interdependent and at other times may conflict.

Revisiting the goals of financial regulation would also help ensure that all involved entities—legislators, regulators, institutions, and consumers—are able to work jointly to meet the intended goals of financial regulation. Such goals and objectives could help establish agency priorities and define responsibility and accountability for identifying risks, including those that cross markets and industries. Policymakers should also carefully define jurisdictional lines and weigh the advantages and disadvantages of having overlapping authorities. While ensuring that the primary goals of financial regulation—including system soundness, market integrity, and consumer protection—are better articulated for regulators, policymakers will also have to ensure that regulation is balanced with other national goals, including facilitating capital raising, innovation, and other benefits that foster long-term growth, stability, and welfare of the United States.

Once these goals are agreed upon, policymakers will need to determine the extent to which goals need to be clarified and specified through rules and requirements, or whether to avoid such specificity and provide regulators with greater flexibility in interpreting such goals. Some reform proposals suggest "principles-based regulation" in which regulators apply broad-based regulatory principles on a case-by-case basis. Such an approach offers the potential advantage of allowing regulators to better adapt to changing market developments. Proponents also note that such an approach would prevent institutions in a more rules-based system from complying with the exact letter of the law while still engaging in unsound or otherwise undesirable financial activities. However, such an approach has potential limitations. Opponents note that regulators may face challenges to implement such a subjective set of principles. A lack of clear rules about activities could lead to litigation if financial institutions and consumers alike disagree with how regulators interpreted goals. Opponents of principles-based regulation note that industry participants who support such an approach have also in many cases advocated for bright-line standards and increased clarity in regulation, which may be counter to a principles-based system. The most effective approach may involve both a set of broad underlying principles and some clear technical rules prohibiting specific activities that have been identified as problematic.

Key issues to be addressed:

- Clarify and update the goals of financial regulation and provide sufficient information on how potentially conflicting goals might be prioritized.
- Determine the appropriate balance of broad principles and specific rules that will result in the most effective and flexible implementation of regulatory goals.

2. *Appropriately comprehensive.* A regulatory system should ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met. As such, activities that pose risks to consumer protection, financial stability, or other goals should be comprehensively regulated, while recognizing that not all activities will require the same level of regulation.

A financial regulatory system should effectively meet the goals of financial regulation, as articulated as part of this process, in a way that is appropriately comprehensive. In doing so, policymakers may want to consider how to ensure that both the breadth and depth of regulation are appropriate and adequate. That is, policymakers and regulators should consider how to make determinations about which activities and products, both new and existing, require some aspect of regulatory involvement to meet regulatory goals, and then make determinations about how extensive such regulation should be. As we have noted, gaps in the current level of federal oversight of mortgage lenders, credit rating agencies, and certain complex financial products such as CDOs and credit default swaps likely have contributed to the current crisis. Congress and regulators may also want to revisit the extent of regulation for entities such as banks that have traditionally fallen within full federal oversight but for which existing regulatory efforts, such as oversight related to risk management and lending standards, have been proven in some cases inadequate by recent events. However, overly restrictive regulation can stifle the financial sectors' ability to innovate and stimulate capital formation and economic growth. Regulators have struggled to balance these competing objectives, and the current crisis appears to reveal that the proper balance was not in place in the regulatory system to date.

Key issues to be addressed:

- Identify risk-based criteria, such as a product's or institution's potential to harm consumers or create systemic problems, for determining the appropriate level of oversight for financial activities and institutions.
- Identify ways that regulation can provide protection but avoid hampering innovation, capital formation, and economic growth.

3. *Systemwide focus.* A regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it is created.

A regulatory system should focus on risks to the financial system, not just institutions. As noted earlier, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. As we noted earlier in the report, the collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly, once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

Having a single entity responsible for assessing threats to the overall financial system could prevent some of the crises that we have seen in the past. For example, in its *Blueprint for a Modernized Financial Regulatory Structure*, Treasury proposed expanding the responsibilities of the Federal Reserve to create a "market stability regulator" that would have broad authority to gather and disclose appropriate information, collaborate with other regulators on rulemaking, and take corrective action as necessary in the interest of overall financial market stability. Such a regulator could assess the systemic risks that arise at financial institutions, within specific financial sectors, across the nation, and globally. However, policymakers should consider that a potential disadvantage of providing the agency with such broad responsibility for overseeing nonbank entities could be that it may imply an official government support or endorsement, such as a government guarantee, of such activities, and thus encourage greater risk taking by these financial institutions and investors.

Regardless of whether a new regulator is created, all regulators under a new system should consider how their activities could better identify and address systemic risks posed by their institutions. As the Federal Reserve Chairman has noted, regulation and supervision of financial institutions is a critical tool for limiting systemic risk. This will require broadening the focus from individual safety and soundness of institutions to a systemwide oversight approach that includes potential systemic risks and weaknesses.

A systemwide focus should also increase attention on how the incentives and constraints created by regulations affects risk taking throughout the business cycle, and what actions regulators can take to anticipate and mitigate such risks. However, as the Federal Reserve Chairman has noted, the more comprehensive the approach, the more technically demanding and costly it would be for regulators and affected institutions.

Key issues to be addressed:

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.
- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.

4. *Flexible and adaptable.* A regulatory system should be adaptable and forward-looking such that regulators can readily adapt to market innovations and changes and include a mechanism for evaluating potential new risks to the system.

A regulatory system should be designed such that regulators can readily adapt to market innovations and changes and include a formal mechanism for evaluating the full potential range of risks of new products and services to the system, market participants, and customers. An effective system could include a mechanism for monitoring market developments—such as broad market changes that introduce systemic risk, or new products and services that may pose more confined risks to particular market segments—to determine the degree, if any, to which regulatory intervention might be required. The rise of a very large market for credit derivatives, while providing benefits to users, also created exposures that warranted actions by regulators to rescue large individual participants in this market. While efforts are under way to create risk-reducing clearing mechanisms for this market, a more adaptable and responsive regulatory system might have recognized this need earlier and addressed it sooner. Some industry representatives have suggested that principles-based regulation, as discussed above, would provide such a mechanism. Designing a system to be flexible and proactive also involves determining whether Congress, regulators, or both should make such determinations, and how such an approach should be clarified in laws or regulations.

Important questions also exist about the extent to which financial regulators should actively monitor and, where necessary, approve new financial products and services as they are developed to ensure the least harm from inappropriate products. Some individuals commenting on this framework, including industry representatives, noted that limiting government intervention in new financial activities until it has become clear that a particular activity or market poses a significant risk and therefore warrants intervention may be more appropriate. As with other key policy questions, this may be answered with a combination of both approaches, recognizing that a product approval approach may be appropriate for some innovations with greater potential risk, while other activities may warrant a more reactive approach.

<u>Key issues to be addressed:</u>

- Determine how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such a responsibility.
- Consider how to strike the right balance between overseeing new products as they come onto the market to take action as needed to protect consumers and investors, without unnecessarily hindering innovation.

5. *Efficient and effective.* A regulatory system should provide efficient oversight of financial services by eliminating overlapping federal regulatory missions, where appropriate, and minimizing regulatory burden while effectively achieving the goals of regulation.

A regulatory system should provide for the efficient and effective oversight of financial services. Accomplishing this in a regulatory system involves many considerations. First, an efficient regulatory system is designed to accomplish its regulatory goals using the least amount of public resources. In this sense, policymakers must consider the number, organization, and responsibilities of each agency, and eliminate undesirable overlap in agency activities and responsibilities. Determining what is undesirable overlap is a difficult decision in itself. Under the current U.S. system, financial institutions often have several options for how to operate their business and who will be their regulator. For example, a new or existing depository institution can choose among several charter options. Having multiple regulators performing similar functions does allow for these agencies to potentially develop alternative or innovative approaches to regulation separately, with the approach working best becoming known over time. Such proven approaches can then be adopted by the other agencies. On the other hand, this could lead to regulatory arbitrage, in which institutions take advantage of variations in how agencies implement regulatory responsibilities in order to be subject to less scrutiny. Both situations have occurred under our current structure.

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we noted earlier, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted earlier in the report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

One first step to addressing such problems is to seriously consider the need to consolidate depository institution oversight among fewer agencies. Since 1996, we have been recommending that the number of federal agencies with primary responsibilities for bank oversight be reduced. Such a move would result in a system that was more efficient and improve consistency in regulation, another important characteristic of an effective regulatory system. In addition, Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity. We have not studied the issue of an optional federal charter for insurers, but have through the years noted difficulties with efforts to harmonize insurance regulation across states through the NAIC-based structure. The establishment of a federal insurance charter and regulator could help alleviate some of these challenges, but such an approach could also have unintended consequences for state regulatory bodies and for insurance firms as well.

Also, given the challenges associated with increasingly complex investment and retail products as discussed earlier, policymakers will need to consider how best to align agency responsibilities to better ensure that consumers and investors are provided with clear, concise, and effective disclosures for all products.

Organizing agencies around regulatory goals as opposed to the existing sector-based regulation may be one way to improve the effectiveness of the system, especially given some of the market developments discussed earlier. Whatever the approach, policymakers should seek to minimize conflict in regulatory goals across regulators, or provide for efficient mechanisms to coordinate in cases where goals inevitably overlap. For example, in some cases, the safety and soundness of an individual institution may have implications for systemic risk, or addressing an unfair or deceptive act or practice at a financial institution may have implications on the institution's safety and soundness by increasing reputational risk. If a regulatory system assigns these goals to different regulators, it will be important to establish mechanisms for them to coordinate.

Proposals to consolidate regulatory agencies for the purpose of promoting efficiency should also take into account any potential trade-offs related to effectiveness. For example, to the extent that policymakers see value in the ability of financial institutions to choose their regulator, consolidating certain agencies may reduce such benefits. Similarly, some individuals have commented that the current system of multiple regulators has led to the development of expertise among agency staff in particular areas of financial market activities that might be threatened if the system were to be consolidated. Finally, policymakers may want to ensure that any transition from the current financial system to a new structure should minimize as best as possible any disruption to the operation of financial markets or risks to the government, especially given the current challenges faced in today's markets and broader economy.

A financial system should also be efficient by minimizing the burden on regulated entities to the extent possible while still achieving regulatory goals. Under our current system, many financial institutions, and especially large institutions that offer services that cross sectors, are subject to supervision by multiple regulators. While steps toward consolidated supervision and designating primary supervisors have helped alleviate some of the burden, industry representatives note that many institutions face significant costs as a result of the existing financial regulatory system that could be lessened. Such costs, imposed in an effort to meet certain regulatory goals such as safety and soundness and consumer protection, can run counter to other goals of a financial system by stifling innovation and competitiveness. In addressing this concern, it is also important to consider the potential benefits that might result in some cases from having multiple regulators overseeing an institution. For example, representatives of state banking and other institution regulators, and consumer advocacy organizations, note that concurrent jurisdiction—between two federal regulators or a federal and state regulator—can provide needed checks and balances against individual financial regulators who have not always reacted appropriately and in a timely way to address problems at institutions. They also note that states may move more quickly and more flexibly to respond to activities causing harm to consumers. Some types of concurrent jurisdiction, such as enforcement authority, may be less burdensome to institutions than others, such as ongoing supervision and examination.

Key issues to be addressed:

- Consider the appropriate role of the states in a financial regulatory system and how federal and state roles can be better harmonized.
- Determine and evaluate the advantages and disadvantages of having multiple regulators, including nongovernmental entities such as SROs, share responsibilities for regulatory oversight.
- Identify ways that the U.S. regulatory system can be made more efficient, either through consolidating agencies with similar roles or through minimizing unnecessary regulatory burden.
- Consider carefully how any changes to the financial regulatory system may negatively impact financial market operations and the broader economy, and take steps to minimize such consequences.

6. *Consistent consumer and investor protection.* A regulatory system should include consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements.

A regulatory system should be designed to provide high-quality, effective, and consistent protection for consumers and investors in similar situations. In doing so, it is important to recognize important distinctions between retail consumers and more sophisticated consumers such as institutional investors, where appropriate considering the context of the situation. Different disclosures and regulatory protections may be necessary for these different groups. Consumer protection should be viewed from the perspective of the consumer rather than through the various and sometimes divergent perspectives of the multitude of federal regulators that currently have responsibilities in this area.

As discussed earlier, many consumers that received loans in the last few years did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate they had in recent years. In addition, increasing evidence exists that many Americans are lacking in financial literacy, and the expansion of new and more complex products will continue to create challenges in this area. Furthermore, as noted above, regulators with existing authority to better protect consumers did not always exercise that authority effectively. In considering a new regulatory system, policymakers should consider the significant lapses in our regulatory system's focus on consumer protection and ensure that such a focus is prioritized in any reform efforts. For example, policymakers should identify ways to improve upon the existing, largely fragmented, system of regulators that must coordinate to act in these areas. As noted above, this should include serious consideration of whether to consolidate regulatory responsibilities to streamline and improve the effectiveness of consumer protection efforts. Another way that some market observers have argued that consumer protections could be enhanced and harmonized across products is to extend suitability requirements—which require securities brokers making recommendations to customers to have reasonable grounds for believing that the recommendation is suitable for the customer—to mortgage and other products. Additional consideration could also be given to determining whether certain products are simply too complex to be well understood and make judgments about limiting or curtailing their use.

Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer

protections, including suitability requirements and disclosures across the financial services industry.

- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how products are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.

7. *Regulators provided with independence, prominence, authority, and accountability.* A regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals.

A regulatory system should ensure that any entity responsible for financial regulation is independent from inappropriate influence; has adequate prominence, authority, and resources to carry out and enforce its statutory mission; and is clearly accountable for meeting regulatory goals. With respect to independence, policymakers may want to consider advantages and disadvantages of different approaches to funding agencies, especially to the extent that agencies might face difficulty remaining independent if they are funded by the institutions they regulate. Under the current structure, for example, the Federal Reserve primarily is funded by income earned from U.S. government securities that it has acquired through open market operations and does not assess charges to the institutions it oversees. In contrast, OCC and OTS are funded primarily by assessments on the firms they supervise. Decision makers should consider whether some of these various funding mechanisms are more likely to ensure that a regulator will take action against its regulated institutions without regard to the potential impact on its own funding.

With respect to prominence, each regulator must receive appropriate attention and support from top government officials. Inadequate prominence in government may make it difficult for a regulator to raise safety and soundness or other concerns to Congress and the administration in a timely manner. Mere knowledge of a deteriorating situation would be insufficient if a regulator were unable to persuade Congress and the administration to take timely corrective action. This problem would be exacerbated if a regulated institution had more political clout and prominence than its regulator because the institution could potentially block action from being taken.

In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, as noted earlier, in a 2007 report we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.[74] It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct their work effectively. A regulatory system should also include adequate checks and balances to ensure the appropriate use of agency authorities. With respect to accountability, policymakers may also want to consider different governance structures at agencies—the current system includes a combination of agency heads and independent boards or commissions—and how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals.

Key issues to be addressed:

- Determine how to structure and fund agencies to ensure each has adequate independence, prominence, tools, authority and accountability.
- Consider how to provide an appropriate level of authority to an agency while ensuring that it appropriately implements its mission without abusing its authority.
- Ensure that the regulatory system includes effective mechanisms for holding regulators accountable.

8. *Consistent financial oversight.* A regulatory system should ensure that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally.

A regulatory system should ensure that similar institutions, products, and services posing similar risks are subject to consistent regulation, oversight, and transparency. Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very

[74] GAO-07-154.

different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.

Streamlining the regulation of similar products across sectors could also help prepare the United States for challenges that may result from increased globalization and potential harmonization in regulatory standards. Such efforts are under way in other jurisdictions. For example, at a November 2008 summit in the United States, the Group of 20 countries pledged to strengthen their regulatory regimes and ensure that all financial markets, products, and participants are consistently regulated or subject to oversight, as appropriate to their circumstances. Similarly, a working group in the European Union is slated by the spring of 2009 to propose ways to strengthen European supervisory arrangements, including addressing how their supervisors should cooperate with other major jurisdictions to help safeguard financial stability globally. Promoting consistency in regulation of similar products should be done in a way that does not sacrifice the quality of regulatory oversight.

As we noted in a 2004 report, different regulatory treatment of bank and financial holding companies, consolidated supervised entities, and other holding companies may not provide a basis for consistent oversight of their consolidated risk management strategies, guarantee competitive neutrality, or contribute to better oversight of systemic risk. Recent events further underscore the limitations brought about when there is a lack of consistency in oversight of large financial institutions. As such, Congress and regulators will need to seriously consider how best to consolidate responsibilities for oversight of large financial conglomerates as part of any reform effort.

<u>Key issues to be addressed:</u>

- Identify institutions and products and services that pose similar risks.
- Determine the level of consolidation necessary to streamline financial regulation activities across the financial services industry.
- Consider the extent to which activities need to be coordinated internationally.

9. *Minimal taxpayer exposure.* A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. Policymakers should consider identifying the best safeguards and assignment of responsibilities for responding to situations where taxpayers face significant exposures, and should consider providing clear guidelines when regulatory intervention is appropriate. While an ideal system would allow firms to fail without negatively affecting other firms—and therefore avoid any moral hazard that may result—policymakers and regulators must consider the realities of today's financial system. In some cases, the immediate use of public funds to prevent the failure of a critically important financial institution may be a worthwhile use of such funds if it ultimately serves to prevent a systemic crisis that would result in much greater use of public funds in the long run. However, an effective regulatory system that incorporates the characteristics noted above, especially by ensuring a systemwide focus, should be better equipped to identify and mitigate problems before it become necessary to make decisions about whether to let a financial institution fail.

An effective financial regulatory system should also strive to minimize systemic risks resulting from interrelationships between firms and limitations in market infrastructures that prevent the orderly unwinding of firms that fail. Another important consideration in minimizing taxpayer exposure is to ensure that financial institutions provided with a government guarantee that could result in taxpayer exposure are also subject to an appropriate level of regulatory oversight to fulfill the responsibilities discussed above.

Key issues to be addressed:

- Identify safeguards that are most appropriate to prevent systemic crises while minimizing moral hazard.
- Consider how a financial system can most effectively minimize taxpayer exposure to losses related to financial instability.

Finally, although significant changes may be required to modernize the U.S. financial regulatory system, policymakers should consider carefully how best to implement the changes in such a way that the transition to a new structure does not hamper the functioning of the financial markets, individual financial institutions' ability to conduct their activities, and consumers' ability to access needed services. For example, if the changes require regulators or institutions to make systems changes, file registrations, or other activities that could require extensive time to complete, the changes could be implemented in phases with specific target dates around which the affected entities could formulate plans.

In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.[75] Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

Comments from Agencies and Other Organizations, and Our Evaluation

We provided the opportunity to review and comment on a draft of this report to representatives of 29 agencies and other organizations, including federal and state financial regulatory agencies, consumer advocacy groups, and financial service industry trade associations. A complete list of organizations that reviewed the draft is included in appendix II. All reviewers provided valuable input that was used in finalizing this report. In general, reviewers commented that the report represented a high-quality and thorough review of issues related to regulatory reform. We made changes throughout the report to increase its precision and clarity and to provide additional detail. For example, the Federal Reserve provided comments indicating that our report should emphasize that the traditional goals of regulation that we described in the background section are incomplete unless their ultimate purpose is considered, which is to promote the long-term growth, stability, and welfare of the United States. As a result, we expanded the discussion of our framework element concerning the need to have clearly defined regulatory goals to emphasize

[75] See GAO, *Homeland Security: Critical Design and Implementation Issues*, GAO-02-957T. (Washington, D.C.: July 17, 2002).

that policymakers will need to ensure that such regulation is balanced with other national goals, including facilitating capital raising and fostering innovation.

In addition, we received formal written responses from the American Bankers Association, the American Council of Life Insurers, the Conference of State Bank Supervisors, Consumers Union, the Credit Union National Association, the Federal Deposit Insurance Corporation, the Mortgage Bankers Association, and the National Association of Federal Credit Unions, and a joint letter from the Center for Responsible Lending, the National Consumer Law Center, and U.S. PIRG; all formal written responses are included as appendixes to this report.

Among the letters we received, various commenters raised additional issues regarding consumer protection and risky products. For example, in a joint letter, the Center for Responsible Lending, the National Consumer Law Center, and the U.S. PIRG noted that the best way to avoid systemic risk is to address problems that exist at the level of individual consumer transactions, before they pose a threat to the system as a whole. They also noted that although most of the subprime lending was done by nonbank lenders, overly aggressive practices for other loan types and among other lenders also contributed to the current crisis. In addition, they noted that to effectively protect consumers, the regulatory system must prohibit unsustainable lending and that disclosures and financial literacy are not enough. The letter from FDIC agreed that effective reform of the U.S. financial regulatory system would help avoid a recurrence of the economic and financial problems we are now experiencing. It also noted that irresponsible lending practices were not consistent with sound banking practices. FDIC's letter also notes that the regulatory structure collectively permitted excessive levels of leverage in the nonbank financial system and that statutory mandates that address consumer protection and aggressive lending practices and leverage among firms would be equally important for improving regulation as would changing regulatory structure. In a letter from Consumers Union, that group urged that consumer protection be given equal priority as safety and soundness and that regulators act more promptly to address emerging risks rather than waiting until a problem has become national in scope. The letter indicates that Consumers Union supports an independent federal consumer protection agency for financial services and the ability of states to also develop and enforce consumer protections. We made changes in response to many of these comments. For example, we enhanced our discussion of weaknesses in regulators' efforts to oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system, and we made changes to the framework to emphasize the importance of consumer protection.

Several of the letters addressed issues regarding potential consolidation of regulatory agencies and the role of federal and state regulation. The letter from the American Bankers Association said that the current system of bank regulation and oversight has many advantages and that any reform efforts should build on those advantages. The letter also noted that there are benefits to having multiple federal regulators, as well as a dual banking system. The letter from the Conference of State Bank Supervisors agreed with our report that the U.S. regulatory system is complex and clearly has gaps, but cautioned that consolidating regulation and making decisions that could indirectly result in greater industry consolidation could exacerbate problems. The letter also indicates concern that our report does not fully acknowledge the importance of creating an environment that promotes a diverse industry to serve the nation's diverse communities and prevents concentration of economic power in a handful of institutions. Our report does discuss the benefits of state regulation of financial institutions, but we did not address the various types of state institutions because we focused mainly on the federal role over our markets. In the past, our work has acknowledged the dual banking system has benefits and that concentration in markets can have disadvantages. The Conference of State Bank Supervisors letter also notes that state efforts to respond to consumer abuses were stymied by federal pre-emption and that a regulatory structure should preserve checks and balances, avoid concentrations of power, and be more locally responsive. In response to this letter, we also added information about the enactment of the Secure and Fair Enforcement for Mortgage Licensing Act, as part of the Housing and Economic Recovery Act, which requires enhanced licensing and registration of mortgage brokers.

The letter from the National Association of Federal Credit Unions urged that an independent regulator for credit unions be retained because of the distinctive characteristics of federal credit unions. A letter from the Credit Union National Association also strongly opposes combining the credit union regulator or its insurance function with another agency. The letter from the Mortgage Bankers Association urges that a federal standard for mortgage lending be developed to provide greater uniformity than the currently diffuse set of state laws. They also supported consideration of federal regulation of independent mortgage bankers and mortgage brokers as a way of improving uniformity and effectiveness of the regulation of these entities. A letter from the American Council of Life Insurers noted that the lack of a federal insurance regulatory office provides for uneven consumer protections and policy availability nationwide and hampers the country's ability to negotiate internationally on insurance industry issues, and urged that we include a discussion of the need to consider a greater federal role in the regulation of insurance. As a result, in the section where we discuss the need for efficient and effective regulation we noted that harmonizing insurance regulation across states has been difficult, and that Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity.

We are sending copies of this report to interested congressional committees and members. In addition, we are sending copies to the federal financial regulatory agencies and associations representing state financial regulators, financial industry participants, and consumers, as well as to the President and Vice President, the President-Elect and Vice President-Elect, and other interested parties. The report also is available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix XII.

Gene L. Dodaro
Acting Comptroller General of the United States

List of Congressional Addressees

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Joseph I. Lieberman
Chairman
The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Edolphus Towns
Chairman
The Honorable Darrell E. Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

The Honorable Richard J. Durbin
The Honorable Tim Johnson
The Honorable Jack Reed
United States Senate

The Honorable Judy Biggert
The Honorable Paul E. Kanjorski
The Honorable Carolyn B. Maloney
The Honorable José E. Serrano
House of Representatives

Appendix I: Scope and Methodology

Our report objectives were to (1) describe the origins of the current financial regulatory system, (2) describe various market developments and changes that have raised challenges for the current system, and (3) present an evaluation framework that can be used by Congress and others to craft or evaluate potential regulatory reform efforts going forward.

To address all of these objectives, we synthesized existing GAO work on challenges to the U.S. financial regulatory structure and on criteria for developing and strengthening effective regulatory structures. These reports are referenced in footnotes in this report and noted in the Related GAO Products appendix. In particular, we relied extensively on our recent body of work examining the financial regulatory structure, culminating in reports issued in 2004 and 2007.[1] We also reviewed existing studies, government documents, and other research for illustrations of how current and past financial market events have revealed limitations in our existing regulatory system and suggestions for regulatory reform.

In addition, to gather input on challenges with the existing system and important considerations in evaluating reforms, we interviewed several key individuals with broad and substantial knowledge about the U.S. financial regulatory system—including a former Chairman of the Board of Governors of the Federal Reserve System (Federal Reserve), a former high-level executive at a major investment bank that had also served in various regulatory agencies, and an international financial organization official that also served in various regulatory agencies. We selected these individuals from a group of notable officials, academics, legal scholars, and others we identified as part of this and other GAO work, including a 2007 expert panel on financial regulatory structure. We selected individuals to interview in an effort to gather government, industry, and academic perspectives, including on international issues. In some cases, due largely to the market turmoil at the time of our study, we were unable to or chose not to reach out to certain individuals, but took steps to ensure that we selected other individuals that would meet our criteria.

To develop the evaluation framework, we also convened a series of three forums in which we gathered comments on a preliminary draft of our framework from a wide range of representatives of federal and state

[1] GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004); and *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007).

financial regulatory agencies, financial industry associations and institutions, and consumer advocacy organizations. In particular, at a forum held on August 19, 2008, we gathered comments from representatives of financial industry associations and institutions, including the American Bankers Association, the American Council of Life Insurers, The Clearing House, Columbia Bank, the Independent Community Bankers of America, The Financial Services Roundtable, Fulton Financial Corporation, the Futures Industry Association, the Managed Funds Association, the Mortgage Bankers Association, the National Association of Federal Credit Unions, the Securities Industry and Financial Markets Association, and the U.S. Chamber of Commerce. We worked closely with representatives at the American Bankers Association—which hosted the forum at its Washington, D.C., headquarters—to identify a comprehensive and representative group of industry associations and institutions.

At a forum held on August 27, 2008, we gathered comments from representatives of consumer advocacy organizations, including the Center for Responsible Lending, the Consumer Federation of America, the Consumers Union, the National Consumer Law Center, and the U.S. PIRG. We invited a comprehensive list of consumer advocacy organization representatives—compiled based on extensive dealings with these groups from current and past work—to participate in this forum and hosted it at GAO headquarters in Washington, D.C.

At a forum held on August 28, 2008, we gathered comments from representatives of federal and state banking, securities, futures, insurance and housing regulatory oversight agencies, including the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Department of the Treasury, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Federal Reserve, the Financial Industry Regulatory Authority, the National Association of Insurance Commissioners, the National Credit Union Administration, the North American Securities Administrators Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Public Company Accounting Oversight Board, and the Securities and Exchange Commission. We worked closely with officials at the Federal Reserve—which hosted the forum at its Washington, D.C., headquarters—to identify a comprehensive and representative group of federal and state financial regulatory agencies.

We conducted this work from April 2008 to December 2008 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Agencies and Other Organizations That Reviewed the Draft Report

American Bankers Association
American Council of Life Insurers
Center for Responsible Lending
Commodity Futures Trading Commission
Conference of State Bank Supervisors
Consumer Federation of America
Consumers Union
Credit Union National Association
Department of the Treasury
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Federal Reserve
Financial Industry Regulatory Authority
Financial Services Roundtable
Futures Industry Association
Independent Community Bankers of America
International Swaps and Derivates Association
Mortgage Bankers Association
National Association of Federal Credit Unions
National Association of Insurance Commissioners
National Consumer Law Center
National Credit Union Administration
National Futures Association
Office of the Comptroller of the Currency
Office of Thrift Supervision
Public Company Accounting Oversight Board
Securities and Exchange Commission
Securities Industry and Financial Markets Association
U.S. PIRG

Appendix III: Comments from the American Bankers Association

AMERICAN BANKERS ASSOCIATION ®

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December 19, 2008

Ms. Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The American Bankers Association[1] (ABA) appreciates the opportunity to provide comments in connection with the Government Accountability Office's (GAO) draft report entitled, *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,* which we understand is to be published in January, 2009. The purpose of the report is to identify existing problems with the financial regulatory system and craft a framework to assist in the evaluation of reform proposals.

We believe that any review of the current regulatory system should begin with the recognition that banks have been and continue to be the primary institutions for saving, lending, and financing economic growth in our nation's communities. Banks are also the leading players in the payments system and the only institutions that can be found participating in every stage of the payments system. Held to high standards of financial strength and integrity of operations, banks are well-poised to be engines of economic recovery and continued economic growth and development thereafter.

Our customers include people and families from all walks of life and involve businesses of all sizes. The innovation and the diversity of the banking industry enable us to meet changing customer needs and interests. Through these efforts in recent decades more people have gained access to a wider array of banking products—and at lower costs—than ever before, and better than anywhere else in the world.

1 The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.6 trillion in assets and employ over 2 million men and women.

We support a regulatory program that fosters a climate in which we can build on these accomplishments and continue our progress in providing more and better services to more people and businesses at lower costs. With that in mind, we offer the following observations about ways in which changes to the current system could achieve these objectives.

The central objective of regulatory reform efforts should be to enhance banks' ability to meet the needs of their customers. This objective has several facets. First, regulation needs to foster safe and sound operations. Second, it must provide appropriate consumer protections. Third, it needs to promote competition. And fourth, it must foster innovation and facilitate banks' ability to meet changing customer needs. These facets, while distinct, are wholly compatible. A financial institution will best be able to achieve its business objectives by responsibly managing its risks; by providing a full range of products and services to all customers who can responsibly manage *their* risks; and by competing against others based on price, product quality, reputation, and other customer interests, not by undermining standards of integrity. We believe it is incumbent upon policy makers to create the legal framework that supports these goals.

Any regulatory reform effort must focus on solving the problems that caused the current market turmoil. This necessarily entails identifying what those problems are so that responses can be tailored accordingly. A business model that combines activities that are financial in nature and thereby draws from a diversified revenue mix has shown to be a solution to, and not a part of, the current problems. Thus reform efforts should facilitate banks offering a broad range of financial products and services. Conversely, reform efforts should be careful not merely to impose new regulations on the banking sector, which did not cause the crisis and which continues to provide credit; rather it should remove unnecessary regulations that impede sound lending and efficient operations.

The current system of bank regulation and oversight has many advantages, and we believe any reform efforts should build on those advantages. As the recent rush by non-bank actors to obtain bank charters has demonstrated, bank regulation and supervision has proven to be the most durable method to minimize risks to safety and soundness. Moreover, it provides a useful check against any one regulator neglecting its duties, becoming too calcified for an ever-changing financial marketplace, growing overly bureaucratic and ineffective, or otherwise imposing regulatory conditions inconsistent with the ability of financial firms to serve their customers. Thus, the ABA supports the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and the Office of Thrift Supervision with regard to their diverse supervision and oversight responsibilities within the U.S. banking system.

Just as there is a benefit in having multiple federal regulators, so too is there a benefit in having a dual banking system. States have for years operated as incubators for new products and services, such as NOW accounts and adjustable rate mortgages. The dual banking system has proven vital to the continued evolution of the U.S. banking. Close coordination between federal bank regulators and state banking commissioners within the Federal Financial Institutions Examination Council (FFIEC) as well as during joint bank examinations is a dynamic element of the dual banking system, resulting in a system of complementary supervision.

Recent economic turmoil has drawn attention to the need for a regulator with explicit jurisdiction to manage systemic risk. The primary responsibility of systemic risk regulation should be protecting the economy from major shocks and working with bank supervisors to avoid pro-cyclical directives within the supervisory process. The systemic risk regulator would gather information, monitor exposures throughout the system and take action in concert with domestic and international supervisors to minimize risks to the economy. For maximum effectiveness and ease of implementation, systemic risk regulation should rely on existing regulatory structures and restrict its oversight to a limited number of large market participants, both bank and non-bank.

There clearly is a need for better supervision and regulation of many non-bank actors, such as mortgage banks and brokers that are not affiliated with an insured depository institution. Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank-like services while operating under substandard or non-existent guidelines for safety and soundness. Lesser-regulated companies and individuals participating in bank-like activities or offering bank-like products and services should be subject to bank-like regulation and capital requirements. Regulatory reform should tackle these issues and bring appropriate oversight to inadequately or ineffectively regulated financial products and services.

This should be done within the context of agencies that have the authority and responsibility to supervise all aspects of an institution's activities. Safety and soundness issues and consumer protection are closely linked for banks and should be supervised as such. Treating consumers unfairly is inconsistent with safe and sound operations; so, too, is attempting to insulate consumers from any risk. Well-run institutions keep both facets in mind, and their regulators should as well. This argues in favor of continuing to place responsibility for both consumer protection and safety and soundness with the banking agencies.

It also should be done in a manner that preserves the independence of the Federal Reserve Board (Board) and keeps the Board's primary focus on the conduct of monetary policy. Any expansion of the Board's authority to serve as the systemic risk regulator should be made only if such authority would not create conflicts of interest for the Board or otherwise compromise its ability to carry out its responsibilities for monetary policy.

Any regulatory restructuring effort must recognize the benefits of charter choice. A robust banking sector requires participants of all sizes and business models, including community banks, development banks, and niche-focused financial institutions as well as regional, national, and international banks. Federal and state bank charter alternatives, a broad range of business models, as well as choice of ownership structure (encompassing S corporations, limited liability corporations, mutual ownership, and other forms of publicly-traded and privately-held banks) promotes responsiveness to changing customer needs, consumer preferences, and economic conditions. Only a diverse, well-regulated banking system can bring sustainable increases in homeownership and community development that are essential to economic recovery.

This diversity is not well-served by a system that treats any financial institution as if it were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole. Clear actions strengthening the competitive position of all banks are needed to address and ameliorate the negative effect on the majority of financial institutions when a select few are designated as too big to fail. Moreover, financial regulators should develop a program to identify, monitor, and respond effectively to market developments arising to the perception of an institution as too big or too complex to fail—particularly in times of financial stress. The ad hoc approach used in the resolution of Lehman Brothers and Bear Sterns is inadequate. Specific authorities and programs must be developed to manage the orderly transition or resolution of any systemically significant financial institution, bank or non-bank.

Any reform effort also must address issues in our accounting rules that create a pro-cyclical downward drag on the financial sector and the economy as a whole. Accounting should be a reflection of economic reality, not a driver. Reforms to accounting standards should make the standard setting process accountable to the market and implement standards that consider the real-world effects of the rules. Rules governing loan-loss reserves and fair value accounting should minimize pro-cyclical effects that reinforce economic highs and lows. A reformed accounting system would recognize that functioning accounting rules are essential to minimizing systemic risk and fostering economic growth.

Thank you for the opportunity to comment on this proposal. Should you have any questions, please contact the undersigned at 202-663-5333 or ddepierr@aba.com.

Sincerely,

Denyette DePierro

Appendix IV: Comments from the American Council of Life Insurers

ACLI
Financial Security. For Life.

Julie A. Spiezio
Senior Vice President, Insurance Regulation & Deputy General Counsel

December 15, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548
williamso@gao.gov

RE: Draft Report on Reforming the Financial Regulatory System

Dear Ms. Williams:

These comments are submitted on behalf of the American Council of Life Insurers (ACLI). The ACLI is a national trade association with 353 member companies that account for 93 percent of the industry's total assets, 93 percent of U.S life insurance premiums and 95 percent of U.S. annuity considerations. We appreciate being given an opportunity to comment on the draft report.

At GAO's invitation, ACLI staff undertook a brief review of the draft report at GAO headquarters early last week. Speaking from an insurance industry perspective, we were surprised that the draft report did not include discussion of the need for insurance regulatory reform as part of the broader financial services industry reform effort. We believe this is an important oversight and one that should be addressed before the final report is issued by the GAO.

Currently there is no insurance expertise in the federal government. Prior to the crisis that has beset the financial service industry since September of this year, this fact was proving to be a costly problem for American consumers and insurers alike. A regulatory system that provides for uneven consumer protections and policy availability nationwide is not compatible with the economic model of the 21st century. In addition, the lack of a federal insurance regulatory office prevents the United States from adequately addressing its citizens' needs in international trade negotiations and treaty developments involving insurance industry issues. These issues alone warrant discussion of the need for a federal role in insurance regulation via the availability of an optional federal insurance charter (OFC).

The economic crisis has only served to underscore this need. The crisis has highlighted for policymakers and the general public alike that insurers play a systemic role in our economy, both nationally and internationally. And today, after all that has taken place over the past few months, both the executive and legislative branches of the federal government remain handicapped in their ability to completely understand and respond to the underlying insurance issues that are part of the financial crisis because they lack any insurance industry regulatory expertise.

These facts make the lack of reference to the issue of insurance regulatory reform in the draft GAO report just that much more puzzling. The report directly addresses the need for the federal government

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to assume some regulatory responsibility over other areas of the financial services industry where it currently lacks such authority (e.g., hedge funds), but remains conspicuously silent on the insurance regulatory reform/OFC issue. We feel this is not simply an oversight, but is a lost opportunity to help Congress in its effort to effectively reform and modernize the whole of financial services industry regulation moving forward.

For all of these reasons, we respectfully request that prior to the final publication of this GAO report it be revised to include discussion of the need for insurance regulatory reform. It is our opinion that releasing the report without such a revision will render the report incomplete and therefore of less value to both the Congress and the public at large then it otherwise might be.

Thank you again for this opportunity to comment on the draft report. Please feel free to contact me directly if you have any questions or would like to discuss this issue further.

Very truly yours,

Julie A. Spiezio

Cc: Randy Fasnacht
Cody Goebel

Appendix V: Comments from the Conference of State Bank Supervisors

December 17, 2008

Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Williams:

Thank you for the opportunity to submit a second written comment in response to the GAO's upcoming report on the financial regulatory framework of the United States.

The Conference of State Bank Supervisors (CSBS) recognizes the current regulatory structure at both the state and federal level is sometimes complex for the industry, regulators, consumers, and policymakers to navigate. As financial institutions and service providers increase in size, complexity, and operations, our regulatory system must reflect this evolution. The current economic stresses have also shown that our financial regulatory system must better address the interconnected risks of the capital markets and our banking system.

CSBS is committed to working with the GAO, our federal counterparts, Congress, industry associations, and consumer advocates to further the development of a fair and efficient regulatory system that provides sufficient consumer protection and serves the interests of financial institutions and financial service providers, while ultimately strengthening the U.S. economy as a whole.

We believe that changes are needed in both regulation and the way our regulatory structure functions to better respond to consumer needs and address systemic risks and market integrity. We are very concerned, however, that federal policy that addresses nationwide and global regulatory business models continues to threaten—or perhaps eliminate—the greatest strengths of our system. Specifically, we see policies that promote the needs of the very largest financial institutions at the expense of consumers, important federal checks and balances and diversity of banking and other financial institutions that are critical to our state economies.

The current financial regulatory structure allows for a diverse universe of financial institutions of varying sizes. While the financial industry continues to consolidate at a rapid pace, there are still well over 8,000 financial institutions operating within the United

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States, some of which are as small as $1 million in assets. Obviously, our nation's largest money center banks play a critical role in the economy. However, even the smallest bank in the country is absolutely critical to the economic health of the community in which it operates.

The complexity of the system is presented as a major source of the current financial crisis. While there are clearly gaps in our regulatory system and the system is undeniably complex, CSBS has observed that the greater failing of the system has been one of insufficient political and regulatory will, primarily at the federal level. We believe that decisions to consolidate regulation do not fix, but rather exacerbate this problem. Moreover, CSBS is deeply concerned that the GAO study does not fully appreciate the importance of creating an environment that promotes a diverse industry which serves our nation's diverse communities and avoids a concentration of economic and political power in a handful of institutions.

Specifically, we are offering the following comments to the elements of a successful supervisory framework.

Clearly Defined Regulatory Goals
Generally, we agree with the GAO's goals of a regulatory system that ensures adequate consumer protections, ensures the integrity and fairness of markets, monitors the safety and soundness of institutions, and acts to ensure the stability of the overall financial system. We disagree, however, with the GAO's claim that the safety and soundness goal is necessarily in direct conflict with the goal of consumer protection. It has been the experience of state regulators that the very opposite can be true. Indeed, consumer protection should be recognized as integral to safety and soundness of financial institutions and service providers. The health of a financial institution ultimately is connected to the health of its customers. However, we have observed that federal regulators, without the checks and balances of more locally responsive state regulators or state law enforcement do not always give fair weight to consumer issues or have the perspective to understand consumer issues. We consider this a significant weakness of the current system. Federal preemption of state law and state law enforcement by the Office of the Comptroller of the Currency and the Office of Thrift Supervision has resulted in less responsive consumer protections and institutions that are much less responsive to needs of consumers in our states.

Appropriately Comprehensive
CSBS disagrees that federal regulators were unable to identify the risks to the financial system because they did not have the necessary scope of oversight. As previously noted, we believe it was a failure of regulatory will and a philosophy of self-regulating markets that allowed for risks to develop. CSBS strongly believes a "comprehensive" system of regulation should not be construed as a consolidated regime under one single regulator. Instead, "comprehensive" should describe a regulatory system that is able to adequately supervise a broad, diverse, and dynamic financial industry. We believe that the checks and balances of the dual system of federal and state supervision are more likely to result in

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comprehensive and meaningful coverage of the industry. From a safety and soundness perspective and from a consumer protection standpoint, the public is better served by a coordinated regulatory network that benefits from both the federal and state perspectives. We believe the Federal Financial Institutions Examination Council (FFIEC) could be much better utilized to accomplish this approach.

Systemwide Focus
The GAO report states "a regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it was created." CSBS agrees with this assessment. Our current crisis has shown us that our regulatory structure was incapable of effectively managing and regulating the nation's largest institutions. CSBS believes the solution, however, is not to expand the federal government bureaucracy by creating a new super regulator. Instead, we should enhance coordination and cooperation among the federal government and the states. We believe regulators must pool resources and expertise to better manage systemic risk. The FFIEC provides a vehicle for working towards this goal of seamless federal and state cooperative supervision.

In addition, CSBS provides significant coordination among the states as well as with federal regulators. This coordinating role reached new levels when Congress adopted the Riegle-Neil Act to allow for interstate banking and branching. The states, through CSBS, quickly followed suit by developing the Nationwide Cooperative Agreement and the State-Federal Supervisory Agreement for the supervision of multi-state banks. Most recently, the states launched the Nationwide Mortgage Licensing System (NMLS) and a nationwide protocol for mortgage supervision. Further, the NMLS is the foundation for the recently enacted Secure and Fair Enforcement for Mortgage Licensing Act of 2008, or the S.A.F.E. Act. The S.A.F.E. Act establishes minimum mortgage licensing standards and a coordinated network of state and federal mortgage supervision.

Flexible and Adaptable
CSBS agrees that a regulatory system should be adaptable and forward-looking so that regulators can readily adapt to market innovations and chances to include a mechanism for evaluating potential new risks to the system. In fact, this is one of the greatest strengths of the state system. The traditional dynamic of the dual-banking system of regulation has been that the states experiment with new products, services, and practices that, upon successful implementation, Congress later enacts on a nationwide basis. In addition, state bank examiners are often the first to identify and address economic problems. Often, states are the first responders to almost any problem in the financial system. The states can—and do—respond to these problems much more quickly than the federal government as evidenced by escalating state responses to the excesses and abuses of mortgage lending over the past decade. Unfortunately, the federal response was to thwart rather than encourage these policy responses.

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Efficient and Effective
In the report, GAO asserts that a system should provide for efficient and effective oversight by eliminating overlapping federal regulatory missions and minimizing regulatory burden. CSBS believes efficiency must not be achieved at the cost of protecting consumers, providing for a competitive industry that serves all communities or maintaining the safety and soundness of financial institutions. We recognize that our regulatory structure is complex and may not be as efficient as some in the industry would prefer. There is undoubtedly a need for improved coordination and cooperation among functional regulators. However, this efficiency must not be met through the haphazard consolidation or destruction of supervisory agencies and authorities. CSBS strongly believes that it is more important to preserve a regulatory framework with checks and balances among and between regulators. This overlap does not need to be a negative characteristic of our system. Instead, it has most often offered additional protection for our consumers and institutions. We believe that the weakening of these overlays in recent years weakened our system and contributed to the current crisis.

In addition, we should consider how "efficient" is defined. Efficient does not inherently mean effective. Our ideal regulatory structure should balance what is efficient for large and small institutions as well as what is efficient for consumers and our economy. While a centralized and consolidated regulatory system may look efficient on paper or benefit our largest institutions, the outcomes may be inflexible and be geared solely at the largest banks at the expense of the small community institutions, the consumer or our diverse economy.

Consistent Consumer and Investor Protection
The states have long been regarded as leaders in the consumer protection arena. This is an area where the model of states acting as laboratories of innovation is clearly working. State authorities often discover troubling practices, trends, or warning signs before the federal agencies can identify these emerging concerns. State authorities and legislature then are able to respond quickly to protect consumers. Ultimately, Congress and federal regulators can then rely on state experience to develop uniform and nationwide standards or best practices. Ultimately, we believe the federal government is simply not able to respond quickly enough to emerging threats and consumer protection issues. State authorities have also been frustrated by federal preemption of state consumer protection laws. If Congress were to act to repeal or more clearly limit these preemptions, states would be able to more effectively and consistently enforce consumer protection laws.

CSBS also agrees that there were significant loopholes and unequal regulation and examination of the mortgage industry. In fact, the states led the way to address these regulatory gaps. However, in describing where subprime lending occurred, we believe the report should acknowledge the fact that subprime lending took place in nearly equal parts between nonbank lenders and institutions subject to federal bank regulation. Federal regulation of operating subsidiaries has been inconsistent at best and nonexistent at worst. As acknowledged in the report, affiliate regulation for consumer compliance simply did

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not exist at the federal level until a recent pilot project led by the Federal Reserve was initiated.

The report also fails to acknowledge the very significant reforms of mortgage regulation adopted by Congress under the S.A.F.E. Act or the major efforts the states have engaged in to regulate the nonbank mortgage lenders and originators.

Regulators Provided with Independence, Prominence, Authority, and Accountability
The dual-banking system helps preserve both regulator independence and accountability. The state system of chartering, with an independent primary federal regulator probably serves as the best model for this goal.

Consistent Financial Oversight
Consistency in regulation is important, but our financial system must also be flexible enough to allow our diverse institutions all to flourish. The diversity of our nation's banking system has created the most dynamic and powerful economy in the world, regardless of the current problems we are experiencing. The strength at the core of our banking system is that it is comprised of thousands of financial intuitions of vastly different sizes. Even as our largest banks are struggling to survive, the vast majority of community banks remains strong and continues to provide financial services to their local citizens. It is vital that a one-size-fits-all regulatory system does not adversely affect the industry by putting smaller banks at a competitive disadvantage with larger, more complex institutions.

It is our belief that the report should acknowledge the role of federal preemption of state consumer protections and the lack of responsiveness of federal law and regulation to mortgage lending and consumer protection issues. For example, the states began responding in 1999 to circumventions of HOEPA and consumer abuses related to subprime lending. Nine years later and two years into a nationwide subprime crisis and Congress has not yet been able to adopt a predatory lending law. We believe that some industry advocates have pushed for preemption to prevent the states from being able to develop legislative and regulatory models for consumer protection and because they have been successful in thwarting legislation and significant regulation at the federal level.

Minimal Taxpayer Exposure
CSBS strongly agrees that a regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. Part of this process must be to prevent institutions from becoming "too big to fail," "too systemic to fail," or simply too big to regulate. Specifically, the federal government must have regulatory tools in place to manage the orderly failure of the largest institutions rather than continuing to prop up failed systemic institutions.

CSBS Principles of Regulatory Reform
While numerous proposals will be advanced to overhaul the financial regulatory system, CSBS believes the structure of the regulatory system should:

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1. Usher in a new era of cooperative federalism, recognizing the rights of states to protect consumers and reaffirming the state role in chartering and supervising financial institutions.
2. Foster supervision that is tailored to the size, scope, and complexity of the institution and the risk they pose to the financial system.
3. Assure the promulgation and enforcement of consumer protection standards that are applicable to both state and nationally chartered financial institutions and are enforceable by locally-responsive state officials against all such institutions.
4. Encourage a diverse universe of financial institutions as a method of reducing risk to the system, encouraging competition, furthering innovation, insuring access to financial markets, and promoting efficient allocation of credit.
5. Support community and regional banks, which provide relationship lending and fuel local economic development.
6. Require financial institutions that are recipients of governmental protection or pose systemic risk to be subject to safety and soundness and consumer protection oversight.

The states, through CSBS and the State Liaison Committee's involvement on the FFIEC, will be part of any solution to regulatory restructuring or our current economic condition. We want to ensure consumers are protected, and preserve the viability of both the federal and state charter to ensure the success of our dual-banking system and our economy as a whole.

CSBS believes there is significant work to be done on this issue, and we commend the GAO for undertaking this report.

Best regards,

John W. Ryan
Executive Vice President

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Appendix VI: Comments from Consumers Union

Consumers Union

Via Electronic Mail

December 16, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Re: GAO Report on Reforming the Financial Regulatory System

Dear Ms. Williams,

Consumers Union, the nonprofit publisher of *Consumer Reports*, is deeply interested in creating a more effective structure for the regulation of financial institutions and other participants in the financial markets. Financial regulation must be designed to protect individuals as consumers of credit and deposit services, as investors, and as taxpayers.

The spark for the financial crisis was unsuitable, poorly underwritten loans being sold to individual homeowners. The risk was amplified by widespread sale of financial instruments based on those mortgages. The resulting crisis of confidence has led to reduced credibility for the U.S. financial system, gridlocked credit markets, loss of equity for homeowners who accepted subprime mortgages and for their neighbors who did not, empty houses and reduced property tax revenue.

Any future financial regulatory structure must include active federal and state oversight, a priority on consumer protection, steps to make the pricing and features of financial products less complex, and more accountability by financial entities at each step of a financial transaction.

1. Regulators must be required to proactively monitor new products and practices to address dangers before they spread. Financial system regulators must identify, evaluate, and mitigate emerging risks both to the financial system and to individuals. Regulators must abandon the old "wait and see" regulatory approach, where a problem has to grow to be national in scope, and perhaps be in the public eye, before it is addressed. Financial regulators must have independence from the entities they oversee and an express charge to regulate for the prevention of harm both to individuals and to the financial system.

2. Financial system regulators should give the same priority to consumer protection as to safety and soundness. The mortgage crisis and its aftermath dramatically illustrate that the consumer protection and safety and soundness are inextricably linked. Regulators must increase the priority placed on consumer protection.

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3. Practices and features that make financial products sold to individuals too complex to understand must be stopped. The report speaks in several places about the need for financial literacy or improved disclosure. However, financial products which are too complex for the intended consumer carry special risks that no amount of additional disclosure or information will fix. In subprime mortgages, for example, many homeowners were induced to refinance an existing loan for one that would offer a reduced payment for just the first two years. Others were assured that they could refinance later, yet the loan documents contained an expensive prepayment penalty. Many of the tens of thousands of individuals who filed comments in the Federal Reserve Board's Regulation AA docket on unfair or deceptive credit card practices reported that they learned about harmful card issuer practices apparently permitted by the cardholder agreement only when the practice was first invoked against them. Regulatory reform will be incomplete unless regulators identify and stop practices that make credit and deposit products difficult for individuals to understand and evaluate.

4. Federal and state regulatory diversity is essential to robust oversight. We agree with report that it is important to eliminate the bottlenecks that can be caused by the coordination process between multiple federal regulators. However, no single federal agency leader can foresee all of the consequences of new practices and products. For this reason, Consumers Union supports both an independent federal consumer protection agency for financial services products (with concurrent jurisdiction with existing banking agencies), and the power of states to develop and enforce consumer protections. The swift and troubling developments in the financial meltdown show that we cannot rely on a single federal agency leader to anticipate all of the risks in new practices and products, nor to have the inclination or the resources to pursue all of the areas where law enforcement is needed.

5. Accountability must be built into the financial system. During the build-up to the crisis, loan originators and securitization packagers got fees even if loans couldn't later be repaid. Regulatory restructuring should include changing the incentives in the private market by requiring that everyone who gets a fee in connection with a credit product also keeps some of the risk of future nonpayment and the risk of problems with the loan. In addition, everyone who offers financial products to consumers should be subject to suitability requirements and fiduciary duties.

We appreciate the work of the GAO in this important issue area. Creating a strong, trusted regulatory structure for financial products and the financial markets is essential to rebuilding the public confidence in the U.S. financial markets.

Very truly yours,

Gail Hillebrand

Gail Hillebrand
Financial Services Campaign Manager
Consumers Union of U.S., Inc.

Appendix VII: Comments from the Credit Union National Association

CUNA
Credit Union National Association
cuna.org

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-638-5777 | FAX: 202-638-7734

December 18, 2008

Mr. Cody Goebel
Assistant Director
Financial Markets and Community Investment U.S. Government Accountability Office
441 G Street, NW, Room 2440B
Washington, DC 20548

Dear Mr. Goebel:

On behalf of the Credit Union National Association, thank you for the opportunity Bill Hampel, Ryan Donovan, and I had December 12, 2008 to review the Government Accountability Office's draft report on restructuring the financial regulatory system. CUNA is the largest advocacy organization representing the nation's 8,200 state and federal credit unions, which serve approximately 91 million members.

The report's treatment of credit unions is understandably abbreviated, given the fact that credit unions were not the cause of the financial market meltdown -- although a limited number have experienced serious collateral effects. In line with GAO's approach, our letter focuses only on the independence of the National Credit Union Administration Board.

Unlike the Treasury's "Blueprint for Financial Modernization," which reflects a complete disregard for and lack of understanding of credit unions, the GAO draft stops short of offering specific recommendations. Even so, the report indicates there is merit to consideration of regulatory consolidation for certain purposes, such as consumer protection, and to address threats to the overall stability of the financial system. While we recognize the factors that support such consideration and appreciate that with four federal bank regulators, some consolidation there may be appropriate, we would strongly oppose any efforts to combine NCUA or its insurance function with another agency, as addressed below.

The draft report sets out several defined goals for an appropriate regulatory system, which include: a comprehensive approach to regulation that is system wide, flexible, efficient, and independent while providing consistent consumer protection and financial oversight.

CUNA likewise supports these objectives, which we believe are wholly consistent with the continuation of a separate regulator for credit unions. Earlier this month, CUNA's Governmental Affairs Committee reaffirmed strong support for a distinct

AMERICA'S CREDIT UNIONS
OFFICES: WASHINGTON, D.C. | MADISON, WISCONSIN

Mary Dunn
December 18, 2008
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federal regulator as long as it provides rigorous, effective supervision that enhances their financial strength and is well-tailored to the level of risk credit unions demonstrate. At the same time, credit unions need and deserve a regulator that will facilitate, not stymie, their capabilities to provide innovative yet safe services to their consumer-members at favorable rates. While urging NCUA's independence, credit unions also appreciate the need for the agencies to address certain issues collectively, and to that end CUNA has recommended NCUA be included in the Presidential Working Group, which is currently comprised of the banking regulators but not NCUA.

Another goal the GAO draft includes is to minimize taxpayers' exposure in the event problems arise. To that end, the credit union regulatory structure combines the enforcement of demanding safety and soundness standards under NCUA's prompt corrective action provisions with an approach that seeks to contain credit union problems within the system. Virtually all of the funds to operate NCUA and the NCUSIF are provided by the credit union system, without reliance on taxpayer dollars, and since its inception in 1978, the NCUSIF has achieved a commendable record in managing problem cases and avoiding taxpayer losses. Another example of credit unions' self-sustaining efforts is their advocacy for the use of NCUSIF funds to purchase troubled assets from the limited number of natural person credit unions that might need such assistance first, before seeking back-up assistance from the Treasury's Troubled Asset Relief Program.

For many credit unions, maintaining a separate regulator is critical to their preservation as institutions with fundamentally different motivations than other financial intermediaries have. Credit unions are operated by volunteer boards who do not receive economic inducements to serve but rather serve to meet the financial needs of their member-owners. Banks are motivated by the need to reward their stockholders first, and then their customers. Because of these core differences, only a separate, effective regulator will provide the singular focus necessary to further credit unions' distinctiveness, thereby ensuring consumers will continue to have choices in the financial marketplace.

Again, thank you for the opportunity to provide these comments following the review of your draft. Please do not hesitate to contact any one of us if you have questions about credit unions or this letter. All the best for happy holidays.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
CUNA Deputy General Counsel and
Senior Vice President

Appendix VIII: Comments from the Federal Deposit Insurance Corporation

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

December 10, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The FDIC appreciates the opportunity to provide comments on the GAO's report titled Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. We understand that this report is self-initiated, and is intended to provide a set of principles by which policymakers can evaluate various proposals to restructure the U.S. financial regulatory system. We commend the GAO for undertaking this important project.

As an overarching premise, the report states that the U.S. financial regulatory structure is in need of modernization. The FDIC agrees that effective reform of the U.S. financial regulatory system would help avoid a recurrence of the economic and financial problems we are now experiencing.

As we consider recent experience, two issues related to U.S. financial regulatory performance stand out to us as being of particular concern. First, our regulatory structure collectively did not address a systematic breakdown in lending standards in wide segments of the U.S. mortgage market. An important lesson that should be incorporated in any regulatory reform proposal is that irresponsible or abusive lending practices are consistent neither with safe-and-sound banking nor with sustainable economic growth.

Second, the regulatory structure collectively permitted excessive leverage in the non-bank financial system. Facing no explicit leverage constraints, and lulled by quantitative models and agency ratings into believing risks were minimal, a variety of large investment banks, financial guarantee insurers and hedge funds operated with a degree of leverage that significantly diminished their ability to withstand financial stress. An important lesson from recent years is that unconstrained leverage places not only individual firms at risk, but greatly increases the severity of financial market downturns and imposes significant costs on taxpayers.

These two issues were not addressed as effectively as they should have been, in part because of regulatory gaps, and in part because of regulatory choices about how to exercise existing authority. Thus, while the role of regulatory structure is an important part of improving regulatory performance, statutory mandates for the regulators are of equal importance. Existing prompt corrective action law is a good example of a successful mandate. Any regulatory reform proposal should include consideration of appropriate mandates in the area of consumer protection. For example, some lending practices can be so egregious as to warrant their outright prohibition, as opposed to placing sole reliance on promoting financial literacy or improving disclosures. Regulatory reform proposals should also consider statutory mandates for leverage constraints for non-bank financial firms, and well-defined mechanisms to protect taxpayers from the cost of financial bailouts.

We believe the experience of recent years strongly supports the importance of an independent FDIC with the resources and authority to safeguard the government's financial stake in federal deposit insurance and promote public confidence in the banking system. The FDIC's independent perspective has been evidenced in recent years by its actions addressing both individual troubled financial institutions and systemic risk, strengthening our deposit insurance system, ensuring capital safeguards in the implementation of Basel II's advanced approaches, and promoting confidence in the banking system by promoting financial literacy, educating consumers about deposit insurance and taking actions to protect consumers.

Thank you once again for the opportunity to comment on this report. As always, we have appreciated the professionalism with which the GAO's review team conducted this assignment.

Sincerely,

Sandra L. Thompson
Director

Appendix IX: Comments from the Mortgage Bankers Association

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

December 18, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The Mortgage Bankers Association greatly appreciates the opportunity to comment on the forthcoming report of the United States Government Accountability Office entitled "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Regulatory System." MBA strongly supports the improvement of the regulatory requirements and the regulatory structure for mortgage lending and commends GAO's efforts in this vital area.

MBA's main comments are that the report should recognize that: (1) responsibility for the current financial crisis is diffuse; (2) solutions recommended for the lending sphere should include consideration of a uniform mortgage lending standard that is preemptive of state lending standards; and (3) federal regulation of at least independent mortgage bankers deserves discussion.

In MBA's view, the factors contributing to the current crisis are manifold. They include, but are not limited to, traditional factors such as unemployment and family difficulties, high real estate prices and overbuilding, extraordinary appetites for returns, lowering of lending standards to satisfy investor and borrower needs, the growth of unregulated and lightly regulated entities and, to some degree, borrower misjudgment and even fraud.

In MBA's view no single actor or actors can fairly be assigned sole or even predominant blame for where we are today. On the other hand, MBA strongly believes that all of these factors contributing to the crisis deserve review as we fashion regulatory solutions. Specifically, respecting mortgage lending, MBA believes that the crisis presents an unparalleled opportunity to reevaluate the current regulatory requirements and structure for mortgage lending to protect the nation going forward.

MBA has long supported establishment of a uniform national mortgage lending standard that establishes strong federal protections, preempts the web of state laws and updates and expands federal requirements. Currently, lending is governed, and consumers are protected by, a patchwork of more than 30 different state laws which are piled on top of federal requirements. Some state laws are overly intrusive and some are weak. The federal requirements in some cases are duplicative and in some areas are out-of-date. In some states, there are no lending laws and borrowers have little protection beyond federal requirements.

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MBA believes legislators should look at the most effective state and federal approaches and work with stakeholders to fashion a new uniform standard which is appropriately up-to-date, robust, applies to every lender, and protects every borrower. It should be enacted by the Congress and preempt state laws. A uniform standard would help restore investor confidence and be the most effective and least costly means of protecting consumers against lending abuses nationwide. Having one standard would avoid undue compliance costs, facilitate competition and ultimately decrease consumer costs.

MBA recognizes that one of the key objections to a preemptive national standard is that it would not be flexible and adaptable and preclude state responses to future abuse. MBA believes this problem is surmountable and could be resolved by injecting dynamism into the law. One approach would be to supplement the law as needed going forward with new prohibitions and requirements formulated by federal and state officials in consultation.

Currently, some mortgage lenders are regulated as federal depository institutions, some as state depositories and some as state-regulated non-depositories. MBA believes that along with establishment of a uniform standard, a new federal regulator for independent mortgage bankers and mortgage brokers should be considered and MBA is interested in exploring that possibility.

A new regulator should have sufficient authorities to assure prudent operations to address financing needs of consumers. If such an approach is adopted, states also could maintain a partnership with the federal regulator in examination, enforcement and licensing. MBA believes the combined efforts of state and federal officials in regulatory reviews and enforcement under a uniform standard would greatly increase regulatory effectiveness and focus.

Notably, any new regulatory scheme should address the differing regulatory concerns presented by mortgage bankers and by mortgage brokers, considering their differing functions and the differing policy concerns which the respective industries present. MBA has written extensively on this subject and commends to GAO's attention the attached report entitled *Mortgage Bankers and Mortgage Brokers: Distinct Businesses Warranting Distinct Regulation* (2008).

Again, MBA strongly believes today's financial difficulties present an unparalleled opportunity to establish better regulation in the years to come. Today's financial crisis reminds us daily that financial markets are national and international in scope. As the crisis worsened, the world looked to national and international governments for solutions. MBA believes it would be unwise not to use this moment to establish a national standard and cease dispersing regulatory responsibility, to help prevent crises ahead.

Thank you again for the opportunity to comment.

Sincerely,

John A. Courson

John A. Courson
Chief Operating Officer
Mortgage Bankers Association

Appendix X: Comments from the National Association of Federal Credit Unions

National Association of Federal Credit Unions
3138 10th Street North • Arlington, VA 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax (703) 524-1082
NAFCU www.nafcu.org • nafcu@nafcu.org

December 15, 2008

Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, D.C. 20548

RE: Report of the U.S. Government Accountability Office on the Financial Markets and Financial Regulatory Structure

Dear Ms. Williams:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions (FCUs), I am providing the following comments regarding the upcoming report by the U.S. Government Accountability Office (GAO) regarding the state of the financial industry and the regulatory structure.

NAFCU would first like to express our appreciation for the opportunity to meet with GAO staff and to review the draft GAO Report. As a trade association that represents federal credit unions, which are uniquely structured to provide provident thrift at lower cost to persons whom they are chartered to serve, we believe we provide unique and specific insight regarding the crisis in the financial sector and the regulatory structure under which financial institutions operate. We applaud the GAO for preparing a well written draft Report. We would like, however, to use this opportunity to provide the following specific comments and suggestions.

References to Credit Unions

The draft Report references comprehensive regulations to which "some institutions, such as banks ..." are subject. To ensure that readers of the Report do not misunderstand, we request the Report adds "credit unions." We specifically ask that the phrase "credit unions" is added in the following places of the draft report: (1) page 5 after "For example, some institutions, such as banks"; (2) page 8, line 1 after the word "banks"; and (3) on page 23, in the first full paragraph, add "credit unions" after "banks" and before "broker-dealers."

Ms. Orice M. Williams
December 15, 2008
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Also, we ask that the phrase "non-credit union" is added after "non-bank" on page 17, Figure 2. Similarly, "non-credit unions" should follow "non-banks" on page 23 in the subheading that presently reads "Activities of NonBank Mortgage Lenders Played A Significant Role." As you are aware, the non-banks referenced in the figure are also non-credit unions. As such, we believe the figure would be clearer if it more clearly explains that the non-banks are also not credit unions.

Framework for Regulatory Restructuring

A key aspect of the draft report is the provision of nine elements as a framework to restructure the financial regulatory system. While we believe the framework contains sound ideas, we strongly recommend that you fully incorporate the need to ensure that smaller institutions, particularly credit unions, are not inadvertently overlooked in any restructuring that Congress may institute.

We are particularly concerned about Element Two and Element Eight. Element Two recommends a single "market stability regulator." Element Eight recommends consistent financial oversight. As we have previously expressed to GAO staff, we believe an independent regulator should continue to oversee and examine federal credit unions. The distinctive characteristics of federal credit unions, including their cooperative structure and mission to provide provident service at lower cost to those they are chartered to serve, necessitates that they are regulated by an independent entity. Accordingly, we request that these two elements are revised to reflect the need of an independent regulator for federal credit unions.

NAFCU appreciates this opportunity to share its comments on this interim rule. Should you have any questions or require additional information please call me at (703) 522-4770 or (800) 336-4644 ext. 268.

Sincerely,

Tessema Tefferi
Associate Director of Regulatory Affairs

Appendix XI: Comments from the Center for Responsible Lending, the National Consumer Law Center, and the U.S. PIRG

December 16, 2008

VIA EMAIL AND U.S. MAIL

Ms. Orice M. Williams (williamso@gao.gov)
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

with copies via email to:
Mr. Cody Goebel, Assistant Director (goebelc@gao.gov)
Mr. Randall Fasnacht (fasnachtr@gao.gov)

Re: Comments on Draft Report, GAO-09-216

Dear Ms. Williams:

We appreciate the opportunity to review the draft report at your offices on December 4, and to offer comments. These are offered jointly by CRL, the National Consumer Law Center and USPIRG.

The report is a thoughtful and thorough review of the structural issues regarding regulatory reform. We especially appreciate that your report notes the problem of charter competition and the distorting impact of the funding structure for the banking regulators.

We would like to preface our comments by stating the obvious – that this review does not occur in a vacuum, but rather in the context of a major crisis which exposed fundamental weaknesses on many fronts. The structural problems in the federal regulator system are but one. Some of these comments derive not from the specific content of the report, but the messages conveyed by some of the references to other aspects of the crisis, such as the nature of the market and consumer behavior. Another especially important comment derives as much from what is left unsaid. Perhaps it seems as though it should go without saying, but given much of the debate that this crisis has engendered, we fear that without at least an acknowledgement of what is not addressed by your report, necessary reminders of other integral parts of regulatory reform may be lost.

While the structure of regulation can create its own problems, such as the potential for charter competition and regulatory capture that you note, regulators also need tools (in the form of laws to enforce, or directives to promulgate rules in furtherance of such laws), adequate resources and, above all, the will to regulate. No amount of structural reform will succeed if regulators have no charge to fulfill in their job, nor the will to do so. We have had three decades of a deregulatory agenda, and without a change in that overarching view, structural changes will be insufficient. We recognize that the prevailing philosophy of regulation was not the focus of this report. However, we believe that any discussion of regulatory structural reform must be accompanied by an explicit caveat that it addresses only one aspect of the overall regulatory issues that contributed to

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this crisis, and that changing the structure, alone, will be insufficient if these other necessary conditions for effective oversight are not reformed, as well.

Beyond that overarching context for regulatory reform, we offer the following comments.

1. The best way to avoid systemic risk is to address problems that exist at the level of individual consumer transactions, before they pose a threat to the system as a whole.

The report appropriately addresses the need to effectively monitor and regulate problems that threaten the financial system as a whole. However, the most effective way to address systemic risk is to identify market failures that threaten abuse of individual consumers, and to address these failures before they threaten the system as a whole. The crisis today would not have reached its current state had problems been addressed and prevented before they evolved into the foreclosure epidemic now underway.

The report correctly notes that most *subprime* lending was done by nonbank lenders who were not subject to oversight by the federal banking agencies.[1] However, the market failures that contributed to the current crisis are not limited to the subprime market. The failure of the Alt-A market, including poorly underwritten non-traditional loans, are also significant contributors, as is becoming increasingly apparent. The failures of IndyMac and Washington Mutual, among others, are largely the function of overly aggressive lending of risky products that were unsuitable for far too many borrowers, and these did occur under the watch of the federal banking agencies. Though the federal banking agencies issued some guidelines for nontraditional lending, it was too little and too late. Further, to judge from the performance of the late vintages of these loans, even then, they were insufficiently enforced.

But in any case, neither bank nor nonbank lenders were subject to adequate consumer protection laws. Both banks and non-bank lenders pressed legislators and regulators not to enact such protections. Furthermore, banks subject to federal regulation also contributed to the problem by being part of the secondary market's demand for the risky products that permeated the subprime and Alt-A markets.[2] The report should make clear that to adequately protect consumers, and avoid systemic risk in the future, whatever regulatory structure emerges will need to be more robust and effective in protecting consumers than the current system has been to date.

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[1] Further, the threat of federal preemption and its absence of suitable consumer protection gave the nonbank lenders the argument that they just wanted a "level playing field," –on a field largely without rules. To that extent, the regulatory structure played into the separate thread of whether there were adequate tools for regulators. The preemption agenda was part of the momentum to the lowest common denominator for the substance of regulation.

[2] Recent studies have found that the securitization process in fact contributed to the aggressive lending and poor underwriting. *See, e.g.* Benjamin J. Keys, Tanmoy Mikherjee, Amit Seru, Vikrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities*, pp. 26-27 (January 2008), available at http://www2.law.columbia.edu/contracteconomics/conferences/laweconomics S08/Vig%20paper.pdf

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2. To effectively protect consumers the regulatory system must prohibit unsustainable lending; disclosures and "financial literacy" are not enough.

The fundamental problem at the heart of today's crisis is that loan originators pushed borrowers into loan products that were inherently risky and unsustainable by design, and they did so notwithstanding the availability of the more suitable and affordable loans for which they qualified.[3] The most common product in the subprime market in recent years was not merely an adjustable rate mortgage, but rather an adjustable rate mortgage with built-in payment shock that lenders anticipated most borrowers could not afford, but that they could avoid only by refinancing before the payment shock took effect, typically paying typically 3% to 4% of the loan balance as a "prepayment penalty" in order to refinance.

According to a Wall Street Journal study, 55% of the borrowers who received such loans in 2005, and 60% of those who received them in 2006, had credit scores high enough to have qualified for lower cost prime loans.[4] And even those borrowers who did not qualify for prime could have had 30-year fixed rate loans for approximately 65 basis points above the introductory rate on the loans they received.[5] The report suggests incorrectly (pp. 43-44) that subprime loans "help[] borrowers afford houses" they could not otherwise afford, when in fact, most subprime loans refinanced existing loans, rather than purchased new homes.[6] But in either case, had borrowers been offered the more suitable loans for which many qualified, many more borrowers could have sustained homeownership.[7]

The experience with the recent vintages of Alt-A loans are similarly instructive. Chris Ferrell, an economics editor with the NPR program Marketplace referred to the Payment Option ARM product (many of which are Alt-A) as "the most complicated mortgage product ever marketed to consumers." The greater the complexity, the less suitable that disclosure is as a "market perfecting" tool. Further, the huge jump in payment option ARMS, (from $145 billion to $255 billion from 2004-2007), was primarily possible only by the increasingly poor underwriting. Countrywide, one of the major issuers of these

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[3] For more detail on causes of the crisis, *see* Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (October 16, 2008), http://banking.senate.gov/public/_files/RevisedSenateTestimony101608HearingSteinFinalFinal.pdf.

[4] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

[5] Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[6] *See, e.g.* Subprime Lending: *A Net Drain on Homeownership*, CRL Issue Paper, No. 14 (March 27, 2007).

[7] *See, e.g.* Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, Center for Community Capital, Univ. of North Carolina & Center for Responsible Lending (Working Paper, Sept. 13, 2008).

loans (that issued them under both its national bank and federal thrift charters, as well as some of its non-depository entities) admitted that an estimated 80% of its recent POARMs would not meet the late 2006 federal guidelines.[8]

The Federal Reserve has noted that, given the misaligned incentives of originators and the complexity of products and loan features, even with increased information or knowledge, borrowers could not have defended against poorly underwritten, risky products and deceptive practices. The main problem with these loans was not the inadequacy of the disclosures or the financial literacy of the borrowers. Rather, the fundamental problem was that – as the federal banking regulators belatedly recognized with respect to non-traditional loans in late 2006 and subprime lending in 2007 -- lenders should not have made loans that they knew borrowers would be unable to sustain without refinancing.

3. To effectively protect consumers, the regulatory system must monitor and address market incentives that encourage loan originators to push risky or unsuitable loan products.

The report correctly notes that market incentives encouraged loan originators to extend excessive credit (p. 22). It should also note that these same incentives encouraged them to push riskier productions and features than the borrowers qualified for.[9] The report should note the need for regulatory oversight of market failures that reward market participants for irresponsible behavior.

We understand that philosophies of consumer protection and the adequacy of consumer protection laws is not your intended focus. However, there were occasional statements in the report which, intended or not, seemed to convey a message that improved disclosure or literacy would be adequate. Yet more people – including some of the regulators themselves – are recognizing that in an era of highly complex products and unseen perverse incentives, disclosure is an insufficient tool, and literacy is an elusive goal.

We would be happy to provide further information.

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[8] Countrywide, *3Q 07 Earnings Supplemental Presentation* (October 26, 2007). To again emphasize that the federal banking regulators contributed to the problem, some $161 billion of those payment option ARMs were issued when Countrywide was under the OCC's watch.

[9] After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?" Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages,* New York Times *(*January 26, 2007).

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Sincerely,

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Related GAO Products

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Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed. GAO-08-200. Washington, D.C.: January 24, 2008.

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