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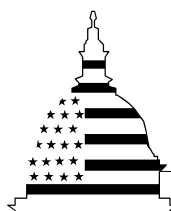
Report to the Chairman, Committee on  
Banking, Housing, and Urban Affairs,  
U.S. Senate

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October 2004

# FINANCIAL REGULATION

## Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-05-61](#), a report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

## Why GAO Did This Study

In light of the passage of the 1999 Gramm-Leach-Bliley Act and increased competition within the financial services industry at home and abroad, GAO was asked to report on the current state of the U.S. financial services regulatory structure. This report describes the changes to the financial services industry, focusing on banking, securities, futures, and insurance; the structure of the U.S. and other regulatory systems; changes in regulatory and supervisory approaches; efforts to foster communication and cooperation among U.S. and other regulators; and the strengths and weaknesses of the current regulatory structure.

## What GAO Recommends

While GAO is not recommending a specific alternative regulatory structure, Congress may wish to consider ways to improve the regulatory structure for financial services, especially the oversight of complex, internationally active firms. Options to consider include consolidating within regulatory areas and creating an entity primarily to oversee complex, internationally active firms, while leaving the rest of the regulatory structure in place. Federal financial regulators provided comments on these options.

[www.gao.gov/cgi-bin/getrpt?GAO-05-61](http://www.gao.gov/cgi-bin/getrpt?GAO-05-61).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas J. McCool at (202) 512-8678 or [mccoolt@gao.gov](mailto:mccoolt@gao.gov).

## FINANCIAL REGULATION

# Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure

## What GAO Found

The financial services industry has changed significantly over the last several decades. Firms are now generally fewer and larger, provide more and varied services, offer similar products, and operate in increasingly global markets. These developments have both benefits and risks, both for individual institutions and for the regulatory system as a whole. Actions that are being taken to harmonize regulations across countries, especially the Basel Accords and European Union Financial Services Action Plan, are also affecting U.S. firms and regulators. While the financial services industry and the international regulatory framework have changed, the regulatory structure for overseeing the U.S. financial services industry has not. Specialized regulators still oversee separate functions—banking, securities, futures, and insurance—and while some regulators do oversee complex institutions at the holding company level, they generally rely on functional regulators for information about the activities of subsidiaries. In addition, no one agency or mechanism looks at risks that cross markets or industry segments or at the system and its risks as a whole.

Although a number of proposals for changing the U.S. regulatory system have been put forth, the United States has chosen not to consolidate its regulatory structure. At the same time, some industrial countries—notably the United Kingdom—have consolidated their financial regulatory structures, partly in response to industry changes. Absent fundamental change in the overall regulatory structure, U.S. regulators have initiated some changes in their regulatory approaches. For example, starting with large, complex institutions, bank regulators, in the 1990s, sought to make their supervision more efficient and effective by focusing on the areas of highest risk. And partly in response to changes in European Union requirements, SEC has issued rules to provide consolidated supervision of certain internationally active securities firms on a voluntary basis. Regulators are also making efforts to communicate in national and multinational forums, but efforts to cooperate have not fully addressed the need to monitor risks across markets, industry segments, and national borders. And from time to time regulators engage in jurisdictional disputes that can distract them from focusing on their primary missions.

GAO found that the U.S. regulatory structure worked well on some levels but not on others. The strength and vitality of the U.S. financial services industry demonstrate that the regulatory structure has not failed. But some have questioned whether a fragmented regulatory system is appropriate in today's environment, particularly with large, complex firms managing their risks on a consolidated basis. While the structure of the agencies alone cannot ensure that regulators achieve their goals—agencies also need the right people, tools, and policies and procedures—it can hinder or facilitate their efforts to provide consistent, comprehensive regulation that protects consumers and enhances the delivery of financial services.

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**Abbreviations**

AFM	Netherlands Authority for the Financial Markets
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
BaFin	German Federal Financial Supervisory Authority (Die Bundesanstalt für Finanzdienstleistungsaufsicht)
CESR	Committee of European Securities Regulators
CFMA	Commodity Futures Modernization Act
CFTC	Commodity Futures Trading Commission
CRS	Congressional Research Service
CSE	consolidated supervised entity
EU	European Union
FBIIC	Financial and Banking Information Infrastructure Committee
FCM	futures commission merchant
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FSF	Financial Stability Forum
GLBA	Gramm-Leach-Bliley Act
IAIS	International Association of Insurance Supervisors
ILC	industrial loan companies
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISG	Intermarket Surveillance Group
Japan-FSA	Financial Services Authority of Japan
LTCM	Long-Term Capital Management
NAIC	National Association of Insurance Commissioners
NASDAQ	Nasdaq Stock Market Inc.
NCUA	National Credit Union Administration
NFA	National Futures Association
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency

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OTC	over the counter
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SIBHC	supervised investment bank holding company
SRO	self-regulatory organization
UK-FSA	Financial Services Authority of the United Kingdom

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United States Government Accountability Office  
Washington, D.C. 20548

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October 6, 2004

The Honorable Richard C. Shelby  
Chairman  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

Dear Mr. Chairman:

This report responds to your request that we analyze the present financial services regulatory structure. As you requested, this report (1) describes the changes in the financial services industry over recent decades, (2) describes changes that have occurred in the U.S. regulatory structure and those of other industrialized countries, (3) describes major changes in U.S. financial market regulation, (4) discusses efforts to communicate, coordinate, and cooperate across agencies in the present system, and (5) assesses the strengths and weaknesses of the present financial regulatory structure. This report includes a Matter for Congressional Consideration.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. We will then send copies to the Ranking Minority Member of the Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Minority Member of the House Committee on Financial Services; the Secretary of the Department of the Treasury; the Chairman of the Board of Governors of the Federal Reserve System; the Chairman of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; the Director of the Office of Thrift Supervision; the Chairman of the Securities and Exchange Commission; the Chairman of the Commodity Futures Trading Commission; the President of the National Association of Insurance Commissioners; and other interested parties. Copies will also be made available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.



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This report was prepared under the direction of James M. McDermott, Assistant Director. Please contact Mr. McDermott at (202) 512-5373 or me at (202) 512-8678 if you or your staff have any questions about this report. Major contributors to this report are listed in appendix VI.

Sincerely yours,

A handwritten signature in cursive script that reads "Thomas J. McCool".

Thomas J. McCool  
Managing Director, Financial Markets and  
Community Investment

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# Executive Summary

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## Purpose

It is 5 years since Congress passed the landmark Gramm-Leach-Bliley Act (GLBA). In some ways, this act recognized the blurring of distinctions among banking, securities, and insurance activities that had already happened in the marketplace and codified regulatory decisions that had been made to deal with these industry changes. While recognizing industry and regulatory changes, that act changed neither the number of regulatory agencies nor, in most cases, the primary objectives and responsibilities of the existing agencies. The result of the blurring of distinctions among the traditional financial services sectors, recognized by GLBA, has enlarged the number and types of competitors facing any firm, both domestically and internationally. Thus, what is happening abroad from a regulatory perspective could impact the competitive position of U.S. financial services institutions and the ability of U.S. regulators to achieve their objectives. On this front, many other industrialized countries are consolidating their financial regulatory structures, and international forums are nearing completion of important efforts to harmonize regulation across countries.

To better understand the effectiveness of the U.S. regulatory system in this changing environment, the Chairman of the Committee on Banking, Housing, and Urban Affairs requested an analysis of the present regulatory structure. In particular, this report

- describes the changes in the financial services industry over recent decades;
- describes changes that have occurred in the U.S. regulatory structure and those of other industrialized countries;
- describes major changes in U.S. financial market regulation;
- discusses efforts to communicate, coordinate, and cooperate across agencies in the present system; and
- assesses the strengths and weaknesses of the present financial regulatory structure.

To meet these objectives GAO drew on its past work, reviewed other relevant literature, conducted interviews with officials of federal and state regulatory agencies, financial services industry representatives, and other experts in the United States, the United Kingdom, Belgium, and Germany and collected and analyzed data on industry changes and regulatory

activities. We conducted our work between June 2003 and July 2004 in accordance with generally accepted government auditing standards in Washington, D.C.; Boston; Chicago; New York City; Brussels, Belgium; London; and Berlin, Bonn, and Frankfurt, Germany.

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## Background

An efficient and effective financial services sector promotes economic growth through the optimum allocation of financial capital. Achieving that outcome rests primarily with the industry; however, in some cases the market may not produce the most desirable outcomes and some form of regulatory intervention is needed. In the United States, laws define the roles and missions of the various regulators, which, to some extent, are similar across the regulatory bodies. Regulators generally have three objectives: (1) ensuring that institutions do not take on excessive risk; (2) making sure that institutions conduct themselves in ways that limit opportunities for fraud and abuse and provide consumers and investors with accurate information and other protections that may not be provided by the market; and (3) promoting financial stability by limiting the opportunities for problems to spread from one institution to another. However, laws and regulatory agency policies can set a greater priority on some roles and missions than others. In addition, the goals and objectives of the regulatory agencies have developed somewhat differently over time, such that bank regulators generally focus on the safety and soundness of banks, securities and futures regulators focus on market integrity and investor protection, and insurance regulators focus on the ability of insurance firms to meet their commitments to the insured.

Generally, banking and securities activities are regulated at both the state and federal levels, while futures are regulated primarily at the federal level and insurance at the state level. For banking activities, the Federal Reserve System (Federal Reserve)—including the Board of Governors and the 12 Federal Reserve Banks—the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) are the primary federal regulators. For securities activities, the Securities and Exchange Commission (SEC) is the primary federal regulator, and for futures products, the Commodity Futures Trading Commission (CFTC) is the primary regulator. In addition, self-regulatory organizations under SEC or CFTC jurisdiction provide oversight of securities and futures dealers and exchanges. State regulators also provide oversight of banking, securities, and insurance. For commercial and savings banks with state bank charters, state banking departments charter

the entity and have supervisory responsibilities, while the Federal Reserve or FDIC serve as the primary federal supervisor for these banks.<sup>1</sup> For securities, states generally provide oversight to protect fraud and abuse against within their jurisdictions. In contrast to these products or activities, which are either regulated primarily at the federal level or through a dual system of state and federal regulation, insurance products are regulated primarily at the state level. Organizationally, some regulatory agencies (OCC and OTS) are part of the Department of the Treasury (Treasury), while the others are independent entities or commissions. While OCC and OTS are part of Treasury, their heads are appointed by the President and approved by the Congress for fixed terms to ensure their independence.

The U.S. regulatory system for financial services is described as “functional,” so that financial products or activities are generally regulated according to their function, no matter who offers the product or participates in the activity. Broker-dealer activities, for instance, are generally subject to SEC’s jurisdiction, whether the broker-dealer is a subsidiary of a bank holding company subject to Federal Reserve supervision or a subsidiary of an investment bank. The functional regulator approach is intended to provide consistency in regulation and avoid the potential need for regulatory agencies to develop expertise in all aspects of financial regulation.

Some firms engaged in the provision of banking, insurance, securities, or futures products and activities in the United States are also required by statute to be regulated at the holding company level. These include bank holding and financial holding companies that are regulated by the Federal Reserve, and thrift holding companies that are regulated by OTS. In addition, SEC has statutory authority to oversee investment bank holding companies, if they choose to be overseen in that way.

U.S. regulators conduct their activities within a broad array of international forums and agencies. Some, such as the Basel Committee on Banking Supervision (Basel Committee), International Organization of Securities Commissions, and International Association of Insurance Supervisors, are voluntary organizations of supervisors from a number of countries. In addition, activities in the European Union—a treaty-based organization of European countries in which those countries cede some of their

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<sup>1</sup>OTS is the supervisor for state-chartered saving associations that belong to the Savings Association Insurance Fund.

sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level—often impact U.S. firms and regulators.

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## Results in Brief

Over the last few decades, the environment in which the financial services industry operates and the industry itself have undergone dramatic changes that include globalization, consolidation within traditional sectors, conglomeration across sectors, and convergence of institutional roles and products. As a result of these changes, a relatively small number of very large, diversified financial companies now compete globally to meet a broad range of customer needs. Moreover, the complexity of these firms and the products and services they offer and use are changing the kinds and extent of risks in the financial services industry. With regard to some risk, such as credit risk, diversification across products, services, and markets might be expected to reduce the risk faced by an individual institution. However, it may not reduce the extent of risk in the system as a whole. The increased sophistication in and interconnections throughout the industry now make it difficult to determine the location and extent of that risk. In addition, the difficulty of managing these large, complex, globally active firms may expose them to greater operational risk in that it is more difficult to impose adequate controls to prevent fraud and abuse or some other operational problem at home or in some small far-flung subsidiary. While there are fewer financial services firms, the U.S. financial services industry retains a large number of smaller entities that compete in more traditional segmented markets, where they generally offer less complex or varied services than the large, consolidated firms and compete more locally against institutions in their sector.

For some time, the United States has chosen not to change its regulatory structure substantially; however, since the mid-1990s, several other industrialized countries and some U.S. states have consolidated their regulatory structures, partially in response to changes in the industry. Today, instead of an array of government agencies and self-regulatory bodies, the countries GAO studied have one or two supervisory agencies. Germany, Japan, and the United Kingdom each have merged their regulatory structures into a single agency, while Australia and the Netherlands have consolidated their regulatory structures by assigning two of the major objectives of regulation—the safety and soundness of institutions and conduct-of-business, which includes market conduct, market integrity, and some aspects of corporate governance—to different regulatory agencies. Within these structures, the attainment of the third

major regulatory objective, financial stability, is shared with the central bank, which may also share regulatory responsibilities. Those countries that have consolidated their regulatory structures differ in some important respects from the United States in that their economies and financial sectors are smaller and generally less diverse. Several U.S. states have similarly consolidated their regulatory agencies to better deal with changes in the industry. Officials in the states GAO talked to said that they are better able to meet the needs of consumers and to cooperate across traditional industry lines; however, they report that they have also sought to maintain the specialized knowledge regulators brought from their respective agencies. Over the years, proposals have also been made to consolidate various aspects of the U.S. regulatory structure, but the United States has not chosen to adopt those changes in any substantive way.

While the U.S. financial services regulatory structure has changed little, regulators have modified their regulatory and supervisory approaches to respond to market changes. For example, during the 1990s, the bank regulatory agencies began risk-focused supervision of large, complex banks, focusing supervisory attention on management policies and procedures for areas believed to be the highest risk for the banking organizations rather than trying to cover all aspects of bank management; this risk-focused approach now applies to all banking organizations. Somewhat earlier, the National Association of Insurance Commissioners (NAIC) began to conduct groupwide financial analyses for nationally significant insurance companies—companies that are large or operate in several states. Some of the most pronounced changes in regulatory approach have or are coming about as a result of efforts to harmonize supervision across national boundaries. These efforts include the Basel Committee negotiations to update capital requirements for banks, generally referred to as Basel II,<sup>2</sup> and the European Union's Financial Services Action Plan, especially the Financial Conglomerates Directive, which requires most large, complex firms doing business in European Union countries to apply Basel capital standards and become subject to consolidated supervision sometime in 2005. These activities are leading to changes in the regulation and supervision of some large or complex U.S. financial services firms that are active in Europe. For example, SEC has,

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<sup>2</sup>The Basel Committee, a group of central bankers and regulators from 13 countries, adopted the Basel II capital standards in June 2004. Different countries will implement these standards at different times and to varying degrees. In addition, regulatory agencies in the United States that oversee different functional areas may implement these standards differently.

for the first time, adopted rules to provide holding company oversight for certain large securities firms on a voluntary basis. These rules incorporate some of the Basel II framework for capital adequacy regulation.

Congress and the regulators themselves have recognized the need for regulators in the U.S. system to communicate and coordinate activities within and across the traditional financial services sectors. Several formal and informal mechanisms exist to facilitate communication, both within and across sectors, but problems remain. For example, at the federal level, bank regulators coordinate examination and supervisory policy, including many rule-making initiatives, through the Federal Financial Institutions Examination Council and communicate internationally through the Basel Committee. Officials serving in the regional offices of the various federal bank regulators also reported that they communicate formally and informally with each other and with the state banking regulators in their region on a regular basis. However, problems between OTS and FDIC and between OCC and FDIC hindered a coordinated supervisory approach in bank failures in 2001 and 1999, respectively, and questions have arisen concerning the efficacy of having several U.S. bank regulators present different positions at Basel Committee negotiations. With regard to concerns about Basel II, the regulators say that the process was necessarily complex, they are required to air any disagreements through a transparent, public process and, in the end, all of the provisions the various U.S. bank regulators wanted were included in Basel II when it was adopted in June 2004. Similarly, securities regulators at the state and federal levels say they regularly coordinate enforcement actions, but in certain high-profile cases, some disagreements have emerged concerning the appropriateness and effectiveness of state and federal actions. With regard to coordination across sectors, regulators have taken some actions themselves, but have often been directed to coordinate by Congress or the President, especially in response to crises such as the stock market crash of 1987, the events of September 11, 2001, and recent corporate scandals. In a number of reports evaluating these cross sector efforts, GAO has noted that no mechanism exists for the monitoring of cross market or cross industry risks and that information sharing has not been sufficient for identifying and heading off potential crises. For example, in our report issued in 2000 on the President's Working Group, which includes the heads of the Federal Reserve, Treasury, SEC, and CFTC, GAO reported that although this group has served as a mechanism to share information during unfolding crises, its activities generally have not included such matters as routine surveillance of risks that cross markets or of information sharing that is specific enough to help identify potential crises.

Experts generally agree that the regulatory structure alone does not determine whether regulatory objectives are achieved. Having an adequate number of people with the right skills, clear objectives, appropriate policies and procedures, and independence are probably more important. However, the regulatory structure can often facilitate or hinder the attainment of regulatory objectives. U.S. regulators and financial market participants GAO spoke with generally emphasized that the current regulatory structure has contributed to the development of U.S. capital markets and overall economic growth and stability. Industry participants also noted that regulators are generally of a high quality. With the adoption of holding company supervision for a broader segment of firms, some regulators may be better able to understand and prepare for the risks that cut across functional areas within a given holding company. In addition, in conjunction with agency specific strategic planning activities, regulators may better monitor risks that cut across the industry segments they oversee. However, no agency or mechanism has the responsibility for monitoring risks that cut more broadly across functional areas. Further, no agency has the responsibility for analyzing the risks to the financial system as a whole or planning strategically to address those risks and problems that may develop in the future; there also is no mechanism for agencies to cooperate effectively to perform these tasks. Some characteristics of the U.S. regulatory structure—specialization of and competition among the agencies—facilitate the attainment of some regulatory objectives and hinder the attainment of others. On the positive side, specialization allows regulators to better understand the risks associated with particular activities or products and to better represent the views of all segments of the industry. And competition among regulators helps to account for regulatory innovation and vigilance, by providing businesses with a method to move to regulators whose approaches better match the businesses' operations. However, these very characteristics may hinder the effective and efficient oversight of large, complex, internationally active firms that compete across sectors and national boundaries. In addition, the specialized and differential oversight of holding companies in the different sectors has the potential to create competitive imbalances among firms in those sectors based on regulatory differences alone. Further, competition among the regulators may limit the ability to negotiate international agreements that would broadly be to the advantage of U.S. firms. Similarly, some legal experts and regulators note that because large, complex firms are managed centrally, regulators that specialize in understanding risks specific to their “functional” sector may not have the ability or authority to oversee the complex risks that span financial sectors or the risk management methodologies employed by these firms. Moreover, they note



that competition among supervisory authorities poses the risk that financial firms may well engage in a form of regulatory arbitrage that involves the placement of particular financial services or products in that part of the financial conglomerate in which supervisory oversight is the least intrusive.

In this report, GAO recognizes that the specifics of a regulatory structure may not be the critical determinant in whether a regulatory system is successful because skilled regulators with the appropriate policies and procedures could potentially overcome any impediments of the structure through better communication and coordination across agencies. However, because the structure may hinder the attainment of certain regulatory goals, GAO suggests that Congress may want to consider ways to consolidate the regulatory structure to (1) better address the risks posed by large, complex firms and their consolidated risk management approaches, (2) promote competition domestically and internationally, and (3) contain systemic risk. Some of these ways may require that the lines that now define regulatory responsibility change to recognize the changed environment of financial services. This could be done in several ways, including making relatively small changes such as consolidating the bank regulators and, if Congress wishes to provide an optional federal charter for insurance, creating a federal insurance regulator, or making more dramatic changes such as creating a single regulatory agency. Alternatively, a small agency could be created to facilitate the oversight of all large, internationally active firms. Each alternative has potential benefits and costs. For example, consolidation could facilitate, but won't necessarily ensure, that regulators communicate and coordinate, provide for regulatory neutrality, and monitor risks across markets. However, larger regulatory agencies could be less accountable to consumers or the industry, possibly damaging the diversity that enriches our economy, or could lose expertise critical to overseeing certain aspects of the industry. In addition, change itself has certain costs, such as the costs of rewriting the various laws that support the current regulatory structure and any unintended consequences that could result during the movement from the current structure to a new structure.

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## GAO's Analysis

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### The Financial Services Industry Has Undergone Dramatic Changes

The environment in which the financial services industry operates and the industry itself have undergone dramatic changes. First, globalization has become a predominant characteristic of modern economic life and has affected and been affected by the financial services sector. Capital moves across national boundaries, and many financial services firms operate globally. For example, foreign firms increasingly own U.S. life insurers and many U.S. banks and securities firms are internationally active. In addition, Citigroup has a significant retail banking business in Germany, while ING, a Dutch firm, seeks to attract deposits in its U.S. thrift. Second, consolidation of firms within the “functional” areas of banking, securities, and insurance and conglomeration of firms across these areas have increasingly come to characterize the large players in the industry. Since 1995, 40 large banking organizations have merged or acquired each other to such an extent that today just 6 very large institutions remain. Similarly, the number of securities and futures firms and the number of insurance companies have also declined while generally the industry has grown. With regard to increased conglomeration, a research report by International Monetary Fund staff—based on a worldwide sample of the largest 500 financial services firms in terms of assets—shows that the percentage of U.S. financial institutions in the sample that were engaged to some significant degree in at least two of the functional sectors of banking, securities, and insurance increased from 42 percent in 1995 to 61.5 percent in 2000, and that these conglomerates held 73 percent of the assets of all of the U.S. firms included in the sample. Commonly, large firms will seek to use their size to meet a wider array of customer demand for different financial products and services and to diversify an individual firm’s risk profile. Third, the roles of financial institutions and the products and services they offer have converged, so that many of these institutions are competing to offer similar services to customers. While these changes are occurring, the U.S. economy still has a large number of smaller entities that compete in more traditional segmented markets, where they generally offer less complex or varied services than the large, consolidated firms and compete more locally against institutions in their sector.

As a result of changes in the industry, as well as the development of complex financial products, the financial services industry has become more complex, and thus the kinds and extent of risks the industry faces are changing. It is generally agreed that banks can better withstand defaults by

segments of their creditors, because they now serve a range of geographic markets and types of creditors. In addition, by securitizing assets, certain institutions have generally been able to reduce certain kinds of risks within an institution by passing them off to other financial institutions or investors. However, the overall risk to the industry may not have been reduced. Institutions that have purchased securitized assets, for instance, may not have risk management systems designed for the acquired risks. Further, the relationships between institutions that securitize assets and those buying these securitized assets range across regulatory and governmental jurisdictions. Changes in the industry, especially the growth of large institutions, have also affected the level and management of operational and reputation risk. Large, complex firms pose new risks for global financial stability because they can be brought down by fraud and abuse or some other operational problem in some small far-flung subsidiary. For example, the collapse of Barings, a British bank with global operations, demonstrates the potential vulnerability of firms to operational risk. In this case, management did not effectively supervise a trader in Singapore, and his actions brought down the whole bank.

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### While Some Countries Have Consolidated Regulatory Structures, the United States Has Chosen to Maintain Its Structure

Partly in response to industry changes, since the mid-1990s several major industrial countries have consolidated their regulatory structures. Germany, Japan, and the United Kingdom have each consolidated their regulatory structures so that they rely primarily on a single agency. The United Kingdom's move from nine regulatory bodies, including self-regulatory organizations (SRO), to a single agency, the Financial Services Authority (UK-FSA), is the most dramatic. UK-FSA focuses strategically on achieving a small number of statutory objectives—maintaining confidence in the financial system, promoting public understanding of the financial system, securing the appropriate degree of protection for consumers, and reducing the potential for financial services firms to be used for a purpose connected with financial crime—across a broad range of financial institutions and activities. In pursuing these goals, UK-FSA is required to take account of additional obligations, including achieving its goals in the most efficient and effective way and not damaging the competitive position of the United Kingdom internationally. To achieve its objectives under these proscribed constraints, UK-FSA focuses on the largest firms and on the needs of retail consumers. In addition, UK-FSA has taken actions to break down the traditional industry silos and to ensure that large, complex firms are overseen in consistent ways. While UK-FSA has sole responsibility for the safety and soundness of financial institutions and conduct-of-business, a tripartite group that includes the central bank and

Her Majesty's Treasury pursues the goal of financial stability. The German single regulator, which is still quite new, maintains the traditional silos of banking, securities, and insurance, adding crosscutting groups to handle conglomerate supervision and international issues. In addition, the new supervisory body shares some supervisory responsibilities with Germany's central bank. Because of persistent problems in the Japanese economy, especially in its banking sector, the Japanese experiment with a single regulator illustrates the point that a country's financial services regulatory structure alone is not the determining factor in promoting economic growth through the optimum allocation of financial capital.

GAO also reviewed documents for two other countries—Australia and the Netherlands—that have consolidated their regulatory structures into two agencies that have responsibility for a single regulatory objective. In each country, one agency is responsible for prudential regulation of all financial institutions and the other for ensuring that financial firms and markets conduct their businesses properly. These structures are based on the belief that government agencies should have a single focus, so that one objective will not take precedence over another. In the Netherlands, the Dutch central bank has become the prudential regulator, while in Australia, the prudential regulator is independent. In both cases, the central bank has the primary responsibility for achieving the objective of financial stability.

Some U.S. states have consolidated their structures in response to industry changes as well. The states GAO spoke with had created a single regulator structure, in part, because of the blurring of traditional boundaries in the industry. These states said they are better able to share information and cooperate across the sectors, but that maintaining expertise in the traditional sectors is still important. In addition, state officials said that while they did not consolidate to reduce the cost of regulation, consolidation had reduced costs.

The United States, which differs from the other countries that have consolidated their structures in significant ways, such as having a much larger and more diverse financial sector, has not consolidated its regulatory structure. While GLBA substantially removed many of the barriers that had previously separated commercial banking from investment banking and insurance underwriting, GLBA did not substantially change the U.S. regulatory structure. Over the years, however, many proposals have been made to change the U.S. regulatory structure, and these proposals continued to be made throughout the 1990s and early 2000s. These include proposals to consolidate the bank regulators, merge SEC and CFTC,

change the self-regulatory organization structure for securities, and create a federal insurance regulator to oversee those companies opting for the proposed federal insurance charter. Proposals have also been made that cut across sectors, including ones for a single federal regulator in each area, an oversight board, and a fully consolidated regulator.

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### Regulators Are Adapting Regulatory and Supervisory Approaches in Response to Industry Changes

Partly as a response to efforts to harmonize regulation internationally, regulators are adapting regulatory and supervisory approaches to industry changes. The major international efforts include the culmination of negotiations at the Basel Committee to update the framework for capital adequacy requirements for banks and bank holding companies, resulting in the Basel II framework, and European Union implementation of the Financial Conglomerates Directive, which will require most internationally active U.S. financial firms be subject to consolidated supervision. U.S. regulators will be implementing the Basel II requirements for large banking organizations over the next several years. Basel II has three pillars: the first concerns setting of minimum capital requirements, the second focuses on supervisory review of and action in response to banks' capital adequacy, and the third requires banks to publicly disclose information about their risk profile, risk assessment processes, and the adequacy of their capital levels to foster greater market discipline. The Financial Conglomerates Directive requires that non-European financial conglomerates, certain securities firms, and bank and financial holding companies operating in the European Union have adequate consolidated supervision, which includes application of Basel capital standards. Under the directive, which is expected to go into effect in 2005, a non-European financial conglomerate, securities firm, or bank or financial holding company that is not considered to be supervised on a consolidated basis by an equivalent home country supervisor would be subject to additional supervision by regulators in European Union member states. As a result, some major U.S. companies will need to demonstrate that they have consolidated home country supervision. Some companies that own thrift institutions may seek to meet these requirements by choosing OTS, which has the authority to oversee thrift holding companies, as their home country consolidated supervisor. For others, SEC has adopted rules for voluntary oversight of certain holding companies with large broker-dealers that are to be called Consolidated Supervised Entities. SEC is pursuing some changes to the Basel II standards that would make those requirements more relevant to securities activities undertaken by U.S. firms.

U.S. regulators have adapted other regulatory and supervisory approaches in response to industry changes. Beginning in the mid-1990s, OCC and the Federal Reserve adopted new supervisory protocols for large, complex institutions. Under this approach, examiners are assigned full time to a bank (and are often on-site) so that they can continually monitor and assess a banking organization's financial condition and risk management systems through the review of a variety of management reports and frequent meetings with key bank officials. Examiners focus examinations on a bank's internal control and risk-management systems; this risk-based approach is now used for banks of all sizes. Securities regulators had repeatedly revised their supervision protocols and had taken other actions to better understand derivatives activities of securities firms. The Commodity Futures Modernization Act of 2000—which had the primary goals of addressing changes in market conditions, such as the introduction of a wider variety of products—revamped many of the processes and goals of CFTC. And, NAIC adopted risk-based capital requirements and began analyzing significant insurance companies that do business in several states to identify issues that could affect groups across state lines.

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### Regulators Communicate and Coordinate in Multiple Ways, but Concerns Remain

Most of the communication among U.S. regulators takes place within a “functional” area. Within each of the four areas—banking, securities, insurance, and futures—federal regulators have established interagency groups to facilitate coordination and also communicate informally on a variety of issues. Generally, within sectors, these regulators communicate with each other, SROs, relevant state regulators, and their international counterparts. In insurance, NAIC is the primary vehicle for state regulators to communicate with each other and to coordinate with insurance regulators abroad. While regulators report frequent and regular meetings within their area, coordinated responses are not always reached on some major issues.

Bank regulators coordinate examination and supervisory policy, including many rule-making initiatives, through the Federal Financial Institutions Examination Council and communicate internationally through the Basel Committee. They also hold formal meetings at the national and regional levels and communicate informally on a regular basis.

Despite these practices, problems persist. In the 2001 failure of Superior Bank, FSB, problems between OTS, the primary supervisor, and FDIC hindered a coordinated supervisory approach, especially OTS's refusal to let FDIC participate in examinations. The failure resulted in a substantial

loss to the deposit insurance fund. Similarly, problems between OCC and FDIC were identified in the failure of the First National Bank of Keystone (West Virginia), which failed in 1999. (Regulators note that subsequent changes in policies should avoid similar problems in the future.) On the international front, several U.S. regulators joined the Basel II negotiations or presented their views late in the process. Regulators said that this ensured that concerns from all industry sectors were addressed in the negotiations, that a transparent process was used, and that the United States regulators obtained all of the provisions they wanted in the international agreement, reached in June 2004. Critics complain that having multiple regulators, particularly at the latest stages of negotiations, needlessly complicated the process and could have affected the outcome.

While SEC and state securities regulators told us that they coordinate activities, including enforcement actions, some high-profile cases have resulted in disagreements. SEC and state securities regulators have brought several enforcement actions together; however, SEC and the states have sometimes disagreed on what is an appropriate role for each, and on how effective each has been. Similarly, in the insurance area, where NAIC is a highly structured forum for communication, some critics have noted that NAIC does not have the power to force state regulators to adopt similar positions, while other critics have noted that, as a quasigovernmental body, NAIC has too much power over state insurance regulation.

Regulators themselves have identified the need to communicate across sectors. For example, nine securities SROs created the Intermarket Surveillance Group in 1983, and since then, futures SROs and foreign exchanges have joined as affiliated members. The purpose of this group is to coordinate and develop programs and procedures designed to assist in identifying possible fraudulent and manipulative acts and practices across markets and to share information. SEC and CFTC also jointly developed regulations implementing portions of the Commodity Futures Modernization Act, which lifted the ban on securities futures, but the process was difficult. Prior to the passage of the act, staff of both regulators had at times claimed sole jurisdiction over single stock futures, necessitating development of a memorandum of understanding that clarified joint oversight responsibilities for these instruments.

Congress and the President have often seen the need to direct regulators to communicate across “functional” areas, sometimes in response to crises. On a number of occasions, Congress has directed regulators to

communicate across “functional” areas. For example, in GLBA, Congress directed regulators to communicate to better oversee the risks of diversified holding companies; and following recent corporate and accounting scandals, Congress directed them to collectively draft guidance on complex structured finance transactions. Similarly, the President has issued executive orders directing regulators to form the President’s Working Group and the Financial and Banking Information Infrastructure Committee. The former was created to address issues related to the 1987 stock market crash and was formally reactivated in 1994 to consider other issues, including the 1997 market decline and threats to critical infrastructure. The latter was created after the events of September 11, 2001, to coordinate federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system.

In evaluating these and other efforts of financial regulators to communicate and coordinate, GAO has found that these ways do not allow for a satisfactory assessment of risks that cross traditional regulatory and industry boundaries and therefore may inhibit the ability to detect and contain certain financial crises. In addition, the existing ways regulators communicate and coordinate do not provide for the systematic sharing of information on enforcement actions across sectors, making it more difficult for regulators to identify potential fraud and abuse, and for consumers to identify the relevant regulator.

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## The U.S. Regulatory System Has Strengths, but Its Structure May Hinder Effective Regulation

Financial markets exist to serve the needs of businesses, households, and government, and financial regulation is judged, in part, by how well markets meet the needs of these users. U.S. regulators and financial market participants GAO spoke with generally emphasized that the current regulatory structure has contributed to the development of U.S. capital markets and overall growth and stability in the U.S. economy. Industry participants also noted that regulators are generally of a high quality. With the adoption of holding company supervision for a broader segment of firms, some regulators may be better able to understand and prepare for the risks that cut across functional areas within a given holding company. In addition, in conjunction with agency specific strategic planning activities, regulators may better monitor risks that cut across the industry segments they oversee. However, no agency or mechanism has the responsibility for monitoring risks that cut more broadly across functional areas. Further, no agency has the responsibility for analyzing the risks to the financial system as a whole or planning strategically to address those risks and problems that may develop in the future; there also is no



mechanism for agencies to cooperate effectively to perform these tasks. Agency structure alone does not determine whether regulators do their jobs efficiently and effectively, but it can facilitate or hinder achieving those goals. Experts outside the regulatory system and some foreign regulators have suggested that the U.S. regulatory system does not facilitate and may hinder the efficient and effective oversight of large, complex, internationally active firms. In particular, critics have noted that “functional” regulation—focusing the oversight of different regulators on specific activities within a financial services firm—is inconsistent with these firms’ centralized risk management. U.S. firms and regulators are also likely to be affected by efforts to harmonize regulation internationally. Large, internationally active firms say these efforts are critical to providing financial services in a cost-effective manner; however, the fragmented nature of the U.S. regulatory system may hinder these negotiations. In addition, the increasing need for a global perspective in the insurance industry where U.S. insurers are increasingly foreign-owned is difficult within the state insurance regulatory system.

While large U.S. firms compete across sectors, important differences remain among banking, insurance, securities, and futures businesses. In addition, many smaller firms operate only in a single sector or single local market. As a result, the regulatory system benefits from the specialized knowledge regulators acquire within their specialized agencies. Regulatory agencies, however, may become “captives” of the industries they are supposed to regulate and not be able to benefit from economies of scale and scope related to the need for skills that cut across regulatory agencies. In addition, the existence of specialized agencies affords firms the opportunity to conduct transactions in those parts of its organization with the least intrusive regulation.

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## Congress May Want to Consider Changes to the U.S. Regulatory Structure

The financial services industry is critical to the health and vitality of the U.S. economy. While the industry itself bears primary responsibility to effectively manage its risks, the importance of the industry and the nature of those risks have created a need for government regulation as well. While the specifics of a regulatory structure, including the number of regulatory agencies and the roles assigned to each, may not be the critical determinant in whether a regulatory system is successful, the structure can facilitate or hinder the attainment of regulatory goals. The skills of the people working in the regulatory system, the clarity of its objectives, its independence, and its management systems are critical to the success of financial regulation.

Because our regulatory structure relies on having clear-cut boundaries between the “functional” areas, industry changes that have caused those boundaries to blur have placed strains on the regulatory framework. While diversification across activities and locations may have lowered the risks being faced by some large, complex, internationally active firms, understanding and overseeing them have also become a much more complex undertaking, requiring staff that can evaluate the risk portfolio of these institutions and their management systems and performance. Regulators must be able to ensure effective risk management without needlessly restraining risk taking, which would hinder economic growth. Similarly, because firms are taking on similar risks across “functional” areas, to understand the risks of a given institution or those that span institutions or industries, regulators need a more complete picture of the risk portfolio of the financial services industry both in the United States and abroad.

Recognizing that regulators could potentially overcome the impediments of a fragmented regulatory structure through better communication and coordination across agencies, Congress has created mechanisms for coordination and on a number of specific issues has directed agencies to coordinate their activities. In addition, GAO has repeatedly recommended that federal regulators improve communication and coordination. While GAO continues to support these recommendations, it recognizes that the sheer number of regulatory bodies, their underlying competitive nature, and differences in their regulatory philosophies will continue to make the sharing of information difficult and true coordination and cooperation in the most important or most visible areas problematic as well. Therefore, Congress might want to consider some changes to the U.S. financial services regulatory structure that address weaknesses and potential vulnerabilities in our current system, while maintaining its strengths.

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## Matter for Congressional Consideration

While maintaining sector expertise and ensuring that financial institutions comply with the law, Congress may want to consider some consolidation or modification of the existing regulatory structure to (1) better address the risks posed by large, complex, internationally active firms and their consolidated risk management approaches; (2) promote competition domestically and internationally; and (3) contain systemic risk. If so, our work has identified several options that Congress may wish to consider:

- consolidating the regulatory structure within the “functional” areas;

- moving to a regulatory structure based on a regulation by objective or twin peaks model;
- combining all financial regulators into a single entity; or
- creating or authorizing a single entity to oversee all large, complex, internationally active firms, while leaving the rest of the structure in place.

If Congress does wish to consider these or other options, it may want to ensure that legislative goals are clearly set out for any changed regulatory structure and that the agencies affected by any change are given clear direction on the priorities that should be set for achieving these goals. In addition, any change in the regulatory structure would entail changing laws that currently govern financial services oversight to conform to the new structure.

The first option would be to consolidate the regulatory structure within “functional” areas—banking, securities, insurance, and futures—so that at the federal level there would be a primary point of contact for each. The two major changes to accomplish this at the federal level would be consolidation of the bank regulators and, if Congress wishes to provide a federal charter option for insurance, the creation of an insurance regulatory entity. The bank regulatory consolidation could be achieved within an existing banking agency or with the creation of a new agency. In 1996, we recommended that the number of federal agencies with primary responsibilities for bank oversight be reduced. However, we noted that in the new structure, FDIC should have the necessary authority to protect the deposit insurance fund and that the Federal Reserve and Treasury should continue to be involved in bank oversight, with access to supervisory information, so that they could carry out their responsibilities for promoting financial stability. 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. Having a primary federal entity for each of the functional sectors would likely improve communications and coordination across sectors because it would reduce the number of entities that would need to be consulted on any issue. Similarly, it would provide a central point of communication for issues within a sector. Fewer bank regulators might reduce the cost of regulation and the opportunities for regulatory arbitrage, choosing charters so that transactions have the least amount of oversight. In addition, issues related to the independence of a regulator

from the firms they oversee with a given kind of charter would be alleviated. However, consolidating the banking regulators and establishing a federal insurance regulator would raise concerns as well. While improved communication and cooperation within sectors would help to achieve the objectives outlined above, it would not directly address many of them. In addition, some constituencies, such as thrifts, might feel they were not getting proper attention for their concerns; and opportunities for regulatory experimentation and the other positive aspects of competition in banking could be reduced. Further, while this option represents a more evolutionary change than some of the others, it might still entail some costs associated with change, including unintended consequences that would undoubtedly erupt as various banking agencies and their staff jockeyed for position within the new banking regulator. Similarly, the establishment of a federal insurance regulator might have unintended consequences for state regulatory bodies and for insurance firms as well.

Another option would be consolidating the regulatory structure using a regulation by objective, or twin peaks model. The twin peaks model would involve setting up one safety and soundness regulatory entity and one conduct-of-business regulatory entity. The former would oversee safety and soundness issues for insurers, banks, securities, and futures activities, while the latter would ensure compliance with the full range of conduct-of-business issues, including consumer and investor protection, disclosure, money laundering, and some governance issues. This could be accomplished by changing the tasks assigned to existing agencies or by restructuring the agencies or creating new ones. On the positive side, this option would directly address many of the regulatory objectives related to larger, more complex institutions, such as allowing for consolidated supervision, competitive neutrality, understanding of the linkages within the safety and soundness and conduct-of-business spheres, and regulatory independence. In addition, conduct-of-business issues would not become subservient to safety and soundness issues, as some fear. On the negative side, in addition to the issues raised by any change in the structure, this structure would not allow regulators to oversee the linkages between safety and soundness and conduct-of-business. As reputational risk has become more important, the linkages between these activities have become more evident. In addition, if the controls and processes for conduct-of-business issues and safety and soundness issues are coming from the top of the organization, they are probably closely related. Finally, combining regulators into multifunctional units might not allow the regulatory system to maintain some of the advantages it now has, including

specialized expertise and the benefits of regulatory competition and experimentation.

The most radical option would combine all financial regulators into a single entity, similar to UK-FSA. The benefits of the single regulator are that one body is accountable for all regulatory endeavors. It can more easily evaluate the linkages within and across firms, including those between conduct-of-business and safety and soundness considerations, plan strategically across sectors, and facilitate the allocation of resources to their highest priority use. However, achieving these goals would depend on having the right people and skills, clear regulatory objectives, effective tools, and appropriate policies and procedures. While the UK-FSA model is intriguing, this option raises some concerns for the United States. First, because of the size of the U.S. economy and the number of financial institutions, this entity would have to be very large and, thus, could be unwieldy and costly. UK-FSA has about 2,300 employees, while estimates of the number of regulators currently in the United States range from about 30,000 to 40,000. In addition, officials at UK-FSA have commented about the difficulty of setting priorities when a large number of issues have to be dealt with. Prioritizing these issues for the United States would be particularly difficult. Further, an entity with this scope and size might have difficulty responding to smaller players and might therefore damage the diversity that has enriched the U.S. financial industry. Also, staff at such an entity might lose or not develop the specialized skills needed to understand both large and small companies and risks that are specific to the different “functional” sectors. And, without careful oversight, such a large and all-powerful entity might not be accountable to consumers or the industry.

A more evolutionary change would be to have a single entity with responsibility for the oversight of all large, complex, or internationally active financial services firms that manage risk centrally, compete with each other within and across sectors, and, by their size and presence in a wide range of markets, pose systemic risks. Having a single regulatory entity for large, complex, or internationally active firms could be accomplished by giving this responsibility to an existing regulator or by creating a new entity. A new entity might consist of a small staff that would rely on the expertise of staff at existing regulatory agencies to accomplish supervisory tasks.

Having a single regulatory entity for large, complex, or internationally active firms would have the advantage of addressing industry changes, while leaving much of the U.S. regulatory structure unchanged. A single

regulatory entity for large, complex holding companies would have responsibilities that more closely align with the businesses' approach to risk than the current regulatory structure. In addition, this entity could promote competition between these firms by ensuring, to the greatest extent possible, that oversight is competitively neutral. A single regulatory entity for internationally active firms would also be better positioned to help coordinate the views of the United States in international forums, so that the U.S. firms are not competitively disadvantaged during negotiations. Finally, this entity would be better able to appraise the linkages across large, complex, internationally active firms and, thus, with the aid of the Federal Reserve and Treasury, could contribute to promoting financial stability. These potential improvements could be obtained without losing the advantages afforded by our current specialized regulators, who would continue to supervise the activities of regulated firms such as broker-dealers or banks. However, this option also has drawbacks. While the transition costs might be less than in some of the other options, the creation of a new entity or changing the role of an existing regulatory entity would still entail costs and likely some unintended consequences. It might also be difficult to maintain the appropriate balance between the interests of the large or internationally active firms and smaller, more-specialized entities. It also could involve creating one more regulatory agency in a system that already has many agencies.

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## Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of FDIC, the Comptroller of the Currency, and the Director of SEC's Division of Market Regulation. Their comments generally noted that the U.S. financial regulatory system had balanced effective regulation and market forces to promote a strong and innovative financial system. Where appropriate, we have changed the report to clarify this balance. In addition, the Chairman of the Federal Reserve Board of Governors and the Chairman of FDIC stressed the importance of the insured depository in the regulatory scheme. We provided a draft of the report to Treasury, CFTC, and NAIC, for possible comments, but no written comments were provided. All of the agencies provided technical comments that were incorporated, where appropriate.

The Director of the Office of Thrift Supervision provided comments on a draft of this report, saying that the report inadequately reflected OTS's authority to supervise thrift holding companies and OTS's international initiatives. While we have made some changes to the report to clarify these

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topics, we believe that the report does accurately discuss both topics. We also disagreed with the Director's request that we delete references to the failure of Superior Bank, FSB, which he thought did not reflect the causes of the failure or the significant costs to the insurance funds from other failures. We did change the report to make clear that this failure, and another commercial bank failure in 1999, were caused by actions of the banks themselves. However, these failures did highlight problems in coordinating actions by the primary federal bank regulators and FDIC, which also has authority to examine the banks it insures.

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# Introduction

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The U.S. financial services industry has four sectors—banking, securities, insurance, and futures,<sup>1</sup> which together had 5.8 million employees and were responsible for almost one-tenth of the U.S. gross domestic product in 2001. Traditionally, the financial services industry promoted economic growth by intermediating between households, businesses, and governments seeking to increase their assets through savings and those interested in increasing their current spending through borrowing. Intermediation differed in specific ways across the major sectors. All financial services firms are exposed to a variety of risks, including credit and market risk, and the industry as a whole is exposed to systemic risk, which is generally defined as the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) could cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole.

The U.S. regulatory structure is composed of several agencies that tend to specialize in given financial sectors and activities and has a tradition of both state and federal regulation of some sectors and activities. Generally, banking is regulated by several federal regulators and by state bank regulators; securities by the Securities and Exchange Commission (SEC), self-regulatory organizations (SROs), and state regulators; futures by the Commodity Futures Trading Commission (CFTC) and SROs; and insurance by state insurance departments. Federal agencies are charged with overseeing particular types of institutions and activities, and state agencies exercise a similar function for entities that are not regulated exclusively by the federal government. The federal agencies also operate within an international framework that includes a variety of entities.

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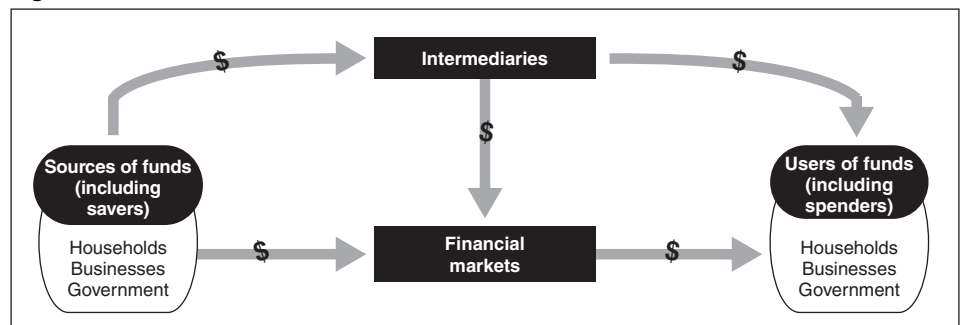
<sup>1</sup>Futures are one type of derivatives contract. The market value of a derivatives contract is derived from a reference rate, index, or the value of an underlying asset, including stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of underlying financial products. The regulation of derivatives generally varies depending on whether they are traded on exchanges (exchange-traded) or traded over-the-counter (OTC) and on the nature of the underlying asset, reference rate, or index. Futures obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified future date and are often traded on exchanges. Options—contracts that grant their purchasers the right but not the obligation to buy or sell a specific amount of the underlying asset, reference rate, or index at a particular price within a specified period—are also sometimes traded on exchanges. See chapter 2 for more information about derivatives.



## Traditionally, Financial Institutions Served as Intermediaries and Transferred Some Risks

Because those doing the saving in an economy and those doing the spending have not always had direct access to each other, financial services firms have traditionally served as intermediaries between them. Figure 1 illustrates how financial services firms perform this role. Different institutions—depositories, securities firms, insurance companies, and futures firms—facilitated intermediation differently, using different markets and products. In addition, some firms helped households and businesses manage risk.

Figure 1: Traditional Role of Financial Intermediaries



Source: *The Evolving Role of Commercial Banks in U.S. Credit Markets*, FDIC.

By most measures, depositories—commercial banks, thrifts,<sup>2</sup> credit unions,<sup>3</sup> and industrial loan companies (ILCs)<sup>4</sup>—make up the largest group of financial intermediaries. Traditionally, depositories used the funds they received as deposits to make loans directly to businesses and consumers, and various types of depositories were set up to serve different

<sup>2</sup>We use the term “thrifts” to refer to savings and loan associations and the term “thrift holding companies” to refer to savings and loan holding companies throughout this report.

<sup>3</sup>Our report *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, GAO-04-91 (Washington, D.C.: Oct. 27, 2003) discusses the credit union industry and the National Credit Union Administration (NCUA). Because credit unions have only about 9 percent of domestic deposits, this report does not discuss them in detail.

<sup>4</sup>ILCs are state-chartered institutions that may take deposits and offer some banking services, but generally are not permitted to offer a full range of bank services. GAO has an ongoing engagement looking at certain issues related to ILCs. Because ILCs have only about 1 percent of domestic deposits, this report does not discuss them in detail.

constituents. Today, their activities are considerably more diverse. For instance, banks and their affiliates are heavily involved in the OTC derivatives market, in which transactions involving financial derivatives are negotiated off exchanges. Depositories include commercial banks, with about 73 percent of domestic deposits at the end of 2003; thrifts, with about 14 percent of domestic deposits; credit unions, with about 9 percent of domestic deposits; and ILCS, with about 1 percent of domestic deposits. Although structural differences remain, most powers and services of depositories have converged over time, with few practical differences remaining in the activities they undertake. Thus, in this report we will generally refer to all depositories as banks.

Securities firms are second to banks in the amount of assets held and revenue generated. Securities firms facilitate the transfer of funds from savers to businesses or government through capital markets by underwriting corporate equity securities (stocks) and corporate and government debt securities (bonds). In addition, securities firms facilitate the buying and selling of existing securities so that funds move from all kinds of savers to all kinds of spenders. Several types of securities firms participate in this process. Brokers are intermediaries for those who buy and sell securities, and dealers are those who buy and sell securities for their own accounts. Investment banks underwrite new debt securities and equity securities and perform broker-dealer functions. Investment banks buy the new issues and, acting as wholesalers, sell them to institutional investors such as banks, mutual funds, and pension funds. Investment companies, such as mutual funds and hedge funds, gather funds from savers and collectively pass them to spenders by purchasing assets in capital markets. Investment advisers and transfer agents also play a role in this market but do not act directly as intermediaries. By offering savings products with varying risks and returns, securities firms also help savers manage risk.

Insurance companies, the third largest sector of the financial services industry, serve as intermediaries by taking the insurance premium payments of households and businesses in payment for insurance coverage and investing in corporate securities. The return on these investments is expected to fund insurance companies' future liabilities. Insurance premium payments come from the sale of products that usually fall into three categories: property-casualty, life and health, and reinsurance. Property-casualty insurance products cover business and household assets such as cars, houses, business structures, inventories, and goods in transit, as well as areas of liability such as product performance and professional

misconduct. Life insurance products provide a tax-free sum to the beneficiary of the policyholder in the event of the policyholder's death or other insured event. Health insurance, which covers expenses associated with medical care and often any financial losses individuals incur from injuries or illness, is not directly relevant to this study. Insurance companies purchase reinsurance, among other things, to spread risk and protect against catastrophic events. Along with their role as financial intermediaries, insurance companies have helped households and businesses manage risk by allowing them to insure themselves against certain contingencies. Agents who are employed by the insurance companies or work independently generally distribute insurance products.

While firms that deal in exchange-traded futures (futures firms) facilitate the transfer of funds, the primary role of futures markets involves transferring risk and providing a mechanism for price discovery. Market participants include hedgers, who are managing risks, and speculators, who are taking a position on the direction of market movement in hopes of making a profit. Futures contracts protect sellers and purchasers of assets, such as physical commodities like pork bellies or financial commodities like currencies, from changes in value over time and provide opportunities for speculators to take varying positions on the future value of these commodities in hopes of making a profit. Several types of futures firms participate in this process. Futures firms that execute orders and hold retail customer accounts are futures commission merchants (FCMs). In addition, floor brokers make trades for others and, along with floor traders, also make trades for themselves. Commodity pool operators serve a function similar to that of investment companies in securities markets in that they pool funds for the purpose of trading futures contracts. Commodity trading advisers and others also participate in futures markets.<sup>5</sup> The markets where exchange-traded futures contracts are traded are generally called boards of trade.

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<sup>5</sup>For example, associated persons who may act on behalf of other futures firms also play a role in futures markets.

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## The Financial Services Industry Faces Risks at the Institutional Level and Systemwide

To varying degrees, financial institutions are exposed to the following types of risks:<sup>6</sup>

*Credit risk*—the potential for financial losses resulting from the failure of a borrower or counterparty to perform on an obligation.

*Market risk*—the potential for financial losses due to the increase or decrease in the value or price of an asset or liability resulting from broad movements in prices, such as interest rates, commodity prices, stock prices, or the relative value of currencies (foreign exchange).

*Liquidity risk*—the potential for financial losses due to the inability of a firm to meet its obligations because of an inability to liquidate assets or obtain adequate funding, such as might occur if most depositors or other creditors were to withdraw their funds from a firm.

*Operational risk*—the potential for unexpected financial losses due to inadequate information systems, operational problems, and breaches in internal controls, or fraud. These can include risks associated with clearing and settling transactions, either as a principal or as an agent, as well as risks associated with custodial functions (e.g., holding securities on behalf of others).

*Reputational risk*—the potential for financial losses that could result from negative publicity regarding an institution's business practices and subsequent decline in customers, costly litigation, or revenue reductions.

*Legal risk*—the potential for financial losses due to breaches of law or regulation that may result in heavy penalties or other costs.

*Business/event risk*—the potential for financial losses due to events not covered above, such as credit rating downgrades (which affect a firm's access to funding), or factors beyond the control of the firm, such as major shocks in the firm's markets.

*Insurance/actuarial risk*—the risk of financial losses that an insurance underwriter takes on in exchange for premiums, such as the risk of premature death.

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<sup>6</sup>We recognize that there are alternative ways to categorize risks.

In addition to these risks, the financial system as a whole may be vulnerable to systemic risk, which is generally defined as the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) could cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole. The difficulties may be real in that institutions, markets, or settlement systems are linked by transactions or may result in customers panicking as a result of believing that failure at a given institution will affect similar institutions and taking actions such as removing deposits that precipitate systemic crises.

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## U.S. Financial Services Regulation Has Multiple Goals

Generally, the United States relies on markets to promote the efficient allocation of capital throughout the economy so as to best fund the activities of households, business, and government. Financial services are subject to oversight for several reasons that relate to the inability of the market to ensure that the efficient allocation of capital will take place. Essentially, markets cannot ensure that certain kinds of misconduct, including fraud and abuse or market manipulation, will not occur and that consumers/investors will have adequate information to discipline institutions with regard to the amount of risk they take on. In addition, because of systemic linkages, the system as a whole may be prone to instability. While financial services firms are aware of systemic risk, they will not likely take steps to minimize it.

In the United States, laws define the roles and missions of the various regulators, and to some extent these are similar across the regulatory bodies. However, laws and regulatory agency policies can set a greater priority on some roles and missions than others. In addition, the goals and objectives of the regulatory agencies have developed somewhat differently over time, such that bank regulators generally focus on the safety and soundness of banks, securities and futures regulators focus on market integrity and investor protection, and insurance regulators focus on the ability of insurance firms to meet their commitments to the insured.

In general, regulators help protect consumers/investors who may not have the information or expertise necessary to protect themselves from fraud and other deceptive practices, such as predatory lending or insider trading, and that the marketplace may not necessarily provide. Through monitoring activities, examinations, and inspections, regulators oversee the conduct of institutions in an effort to ensure that they do not engage in fraudulent activity and do provide consumers/investors with the information they need to make appropriate decisions and ultimately discipline the behavior

of financial institutions in the marketplace. However, in some areas providing information through disclosure and assuring compliance with laws are still not adequate to allow consumers/investors to influence firm behavior. In these cases, regulators oversee how risk is managed and seek to restrain excessive risk taking in order to promote the safety and soundness of institutions that engage in certain kinds of activities. In addition, by providing deposit insurance, overseeing other insurance or guarantee funds, or directly intervening in the marketplace, regulators take actions to ensure that the types of widespread financial instability that could seriously disrupt economic activity do not occur. However, with insurance or guarantee funds or the expectation that some firms are too big to fail, the normal disciplining of the market is disrupted, creating the “moral hazard” that institutions will take on more risk than they would in the absence of such insurance or expectations. As a result, the need for safety and soundness oversight is intensified.

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## U.S. Financial Regulatory System Includes a Variety of Regulatory Bodies

The objectives of U.S. financial services regulation are pursued by a complex combination of federal and state government agencies and self-regulatory organizations (SROs). Generally, regulators specialize in the oversight of financial entities in the various financial services sectors. This specialization stems largely from the laws that established these agencies and defined their missions. In addition, some regulators have responsibilities to regulate holding companies with subsidiaries that engage in various financial services activities. The Federal Reserve<sup>7</sup> and the Department of the Treasury (Treasury) play a special role in maintaining financial stability.

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## Regulators Specialize in the Oversight of Financial Entities in Various Sectors

Five federal agencies oversee banks, including those chartered and overseen by state regulatory agencies. The specific regulatory configuration depends on the type of charter the banking institution chooses. Banks may be regulated by the federal government alone, if they are chartered by a federal regulator such as the Office of the Comptroller of the Currency (OCC) or Office of Thrift Supervision (OTS), or by both federal and state governments, if they are state-chartered institutions. Securities and futures firms are regulated at the federal level by the

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<sup>7</sup>We use the term Federal Reserve throughout this report to refer to the Federal Reserve's Board of Governors, the 12 Federal Reserve Banks, or both, unless otherwise specified.

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Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), respectively, which, in turn, rely on SROs to assist with their oversight. State regulators also have oversight and enforcement responsibilities for securities. Insurance entities are overseen largely at the state level. There are also regulators for government sponsored enterprises and pension funds, which lie outside the scope of this report.

### Multiple Regulators Oversee Banking Entities

Banking institutions can generally determine their regulators by choosing a particular kind of charter—commercial bank, thrift, credit union, or industrial loan company. These charters may be obtained at the state level or the national level for all except industrial loan companies, which are chartered only at the state level. State regulators charter institutions and participate in the oversight of those institutions; however, all of these institutions have a primary federal regulator if they have federal deposit insurance. State-chartered commercial banks that are members of the Federal Reserve are subject to supervision by that institution. Other state-chartered banks, such as nonmember state banks, state savings banks, and ILCs, with federally insured deposits are subject to Federal Deposit Insurance Corporation (FDIC) oversight, while OTS supervises state-chartered savings associations that are members of the Savings Association Insurance Fund. Federally chartered institutions are subject to oversight by their chartering agencies. OCC supervises national banks, OTS supervises federally chartered thrifts, and the National Credit Union Administration (NCUA) supervises federally chartered credit unions. To the extent that OTC derivatives activities take place in these institutions, they are subject to oversight by the appropriate regulator. In addition, FDIC has backup supervisory authority for those banks that are members of the insurance funds it oversees and have a different primary supervisor.

The primary objectives of federal bank regulators include ensuring the safe and sound practices and operations of the institutions they oversee and the stability of financial markets. To achieve these goals, regulators establish capital requirements, conduct on-site examinations and off-site monitoring to assess a bank's financial condition, and monitor compliance with banking laws. Regulators also issue regulations, take enforcement actions, and close banks they determine to be insolvent. In addition, federal regulators oversee and take enforcement actions to ensure compliance with many consumer protection laws such as those requiring fair access to banking services and privacy protection.

The current bank regulatory structure evolved over time. OCC was created by the National Currency Act of 1863, which was rewritten as the National Bank Act of 1864. The Federal Reserve Act of 1913 created the Federal Reserve, partly in response to the financial panic of 1907. FDIC was established under the Banking Act of 1933. In 1933, Congress also authorized the federal chartering of savings and loans by the Federal Home Loan Bank Board, and, in 1934, the National Housing Act established the Federal Savings and Loan Insurance Corporation to provide for federal regulation of federally insured, state-chartered thrifts. In 1989, OTS replaced the Federal Home Loan Bank Board as the federal thrift institution regulator.<sup>8</sup> Organizationally, OCC and OTS are within the Department of the Treasury; however, the Comptroller of the Currency and the Director of OTS are appointed by the President and confirmed by the Senate for fixed terms, an arrangement intended to help ensure the independence of these agencies. The Federal Reserve's Board of Governors and FDIC are independent federal agencies; the Comptroller of the Currency and Director of OTS sit on FDIC's five-person board of directors. The three other board members are appointed by the President for fixed terms with one appointed as Chairman and another as Vice Chairman. As with the Comptroller of the Currency and the Director of OTS, the Federal Reserve's Board of Governors are appointed by the President and confirmed by the Senate for fixed terms.

## SROs Contribute to Security and Futures Regulation

The Securities Exchange Act of 1934 established the regulatory structure of U.S. securities markets. These markets are regulated under a combination of self-regulation (subject to SEC oversight) and direct SEC regulation. This regulatory structure was intended to give SROs responsibility for administering their own operations, including most of the daily oversight of the securities markets and their participants. One of the SROs—NASD—is a national securities association that regulates registered securities broker-dealers.<sup>9</sup> Other SROs include national securities exchanges that operate the markets where securities are traded.<sup>10</sup> These SROs are primarily

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<sup>8</sup>See Financial Institution Reform, Recovery and Enforcement Act of 1989 (FIRREA) § 407, 103 Stat. 363.

<sup>9</sup>NASD is registered as a national securities association under section 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3, (2000 & Supp. 2004) and is considered an SRO pursuant to section 3(a)(26), 15 U.S.C. & 78c(a)(26).

<sup>10</sup>These SROs include those dealing in exchange-traded options. SEC shares oversight of exchange-traded options with CFTC depending on the nature of the underlying.



responsible for establishing the standards under which their members conduct business; monitoring business conduct; and bringing disciplinary actions against their members for violating applicable federal statutes, SEC's rules, and their own rules. SEC oversees the SROs by inspecting their operations and reviewing their rule proposals and appeals of final disciplinary proceedings.

The Securities Exchange Act also created SEC as an independent agency to oversee the securities markets and their participants. SEC has a five-member commission headed by a chairman who is appointed by the President for a 5-year term. In overseeing the SROs' implementation and enforcement of rules, SEC may use its statutory authority to, among other things, review and approve SRO-proposed rule changes and abrogate (or annul) SRO rules.

The futures market's regulatory structure consists of federal oversight provided by CFTC and industry oversight provided by SROs—the futures exchanges and the National Futures Association (NFA). Futures SROs are responsible for establishing and enforcing rules governing member conduct and trading; providing for the prevention of market manipulation, including monitoring trading activity; ensuring that futures industry professionals meet qualifications; and examining members for financial strength and other regulatory purposes. Their operations are funded by the futures industry through transaction fees and other charges. In regulating the futures market, CFTC independently monitors, among other things, exchange trading activity, large trader positions, and certain market participants' financial condition. CFTC also investigates potential violations of the Commodity Exchange Act and CFTC regulations and prosecutes alleged violators. Additionally, CFTC oversees the SROs to ensure that each has an effective self-regulatory program. In this regard, CFTC designates and supervises exchanges as contract markets and NFA as a registered futures association, audits SROs for compliance with their regulatory responsibilities, and reviews SRO rules and products that are traded on designated exchanges.

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States Have Primary  
Responsibility for Regulating  
Insurance Entities

Unlike other financial service sectors, the U.S. insurance industry is regulated primarily at the state level.<sup>11</sup> To help coordinate their activities, state insurance regulators established a central structure, the National Association of Insurance Commissioners (NAIC), in 1871. Members of this organization are the heads of the insurance departments of 50 states, the District of Columbia, and 4 U.S. territories and possessions. NAIC's basic purpose is to encourage consistency and cooperation among the various states and territories as they individually regulate the insurance industry. To that end, NAIC promulgates model insurance laws and regulations for state consideration and provides a framework for multistate examinations of insurance companies. State insurance regulators have tended to stress safety and soundness issues, but have also taken action in the conduct-of-business area, especially with regard to sales practices. The McCarran-Ferguson Act of 1945 generally asserted the view that insurance regulation should be undertaken by the states.

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Some U.S. Regulators  
Engage in Holding Company  
Oversight

Many of the largest financial legal entities are part of holding company structures—companies that hold stock in one or more subsidiaries. Many companies that own or control banks are regulated by the Federal Reserve as bank holding companies, and their nonbanking activities generally are limited to those that the Federal Reserve has determined to be closely related to banking. Under the Gramm-Leach-Bliley Act (GLBA), bank holding companies can qualify as financial holding companies and thereby engage in a range of financial activities broader than those permitted for “traditional” bank holding companies. Savings and loan or thrift holding companies (thrift holding companies), which own or control one or more savings and loan companies, are subject to supervision by OTS and, depending upon the circumstances of the holding company structure, may not face the types of activities restrictions imposed on bank holding companies. Investment bank holding companies that have a substantial presence in the securities markets can elect to be supervised by SEC as a supervised investment bank holding company (SIBHC) if the holding company does not own or control certain types of banks. Holding companies that own large broker-dealers can elect to be supervised by SEC

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<sup>11</sup>SEC regulates sales of discrete products, such as certain types of annuities considered to be securities. Also, banks engage in certain types of insurance activities, such as underwriting credit insurance and, under certain circumstances, acting as an insurance agent either directly or through a subsidiary. Although these activities are subject to OCC regulation, national banks can be subject to nondiscriminatory state laws applicable to certain insurance-related activities.

as consolidated supervised entities (CSE). SEC would provide groupwide oversight of these entities unless they are determined to already be subject to “comprehensive, consolidated supervision” by another principal regulator. While holding company supervisors oversee, to varying degrees, the holding company, the appropriate functional regulator, as described above, remains primarily responsible for supervising any functionally regulated subsidiary within the holding company.

## Bank and Financial Holding Companies

The Bank Holding Company Act of 1956, as amended, generally requires that holding companies with bank subsidiaries register with the Federal Reserve as bank holding companies.<sup>12</sup> Among other things, the Bank Holding Company Act restricts the activities of bank holding companies to those the Federal Reserve determined, as of November 11, 1999, to be closely related to banking. However, under amendments to the Bank Holding Company Act made in 1999 by GLBA, a bank holding company can qualify as a financial holding company that, under GLBA, may engage in a broad range of additional financial activities, such as securities and insurance underwriting. The Federal Reserve has primary authority to examine and supervise a bank holding company, financial holding company, and their respective nonbank affiliates, except for those that are “functionally regulated” by some other regulator.<sup>13</sup> The Federal Reserve’s authority to require reports from, examine, or impose capital requirements on a functionally regulated affiliate is limited. For example, the Federal Reserve has limited authority under GLBA to examine broker-dealer affiliates of bank and financial holding companies. These limitations were designed to lessen the regulatory burden on and provide for consistent regulation of a financial activity, such as securities, regardless of whether the entity conducting the activity is affiliated with a commercial bank. In this report, we sometimes refer to banks, bank holding companies, and financial holding companies as banking organizations.

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<sup>12</sup>The Bank Holding Company Act exempts certain types of depository institutions, such as ILCs chartered in certain states, from its definition of “bank,” as well as some grandfathered banks. Consequently, a company’s ownership or control of an ILC does not necessarily subject the company to supervision by the Federal Reserve.

<sup>13</sup>The “functionally regulated” affiliates (and their respective functional regulators) are: registered broker-dealers, investment advisers, and investment companies (SEC); state-regulated insurance companies (state insurance authority); and CFTC-regulated firms (CFTC).

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Thrift Holding Companies

Under the Home Owners' Loan Act of 1933, as amended, companies that own or control a savings association are subject to supervision by OTS. Historically, most thrift holding companies were designated as "exempt" and permitted to engage in a wide range of activities, including insurance, securities, and nonfinancial activities.<sup>14</sup> GLBA expanded the activities authorized for nonexempt thrift holding companies to include those authorized for financial holding companies. However, GLBA curtailed the availability of exempt status to only those that meet all of the following criteria: the organization was a thrift holding company on May 4, 1999, or became a thrift holding company under an application pending with OTS on or before that date; the holding company meets and continues to meet the requirements for an exempt thrift holding company; and the thrift holding company continues to control at least one savings association (or successor savings association) that it controlled on May 4, 1999, or that it acquired under an application pending with OTS on or before that date. As a result, GLBA in effect redefined the requirements for an exempt thrift holding company.

SEC's Consolidated Supervision

Beginning with the Market Reform Act of 1990, SEC has been undertaking supervisory activities aimed at assessing the safety and soundness of securities activities at a consolidated or holding company level.<sup>15</sup> That act authorized SEC to collect information from registered broker-dealers about the activities and financial condition of their holding companies and material unregulated affiliates. In 1992, SEC began receiving risk-assessment reports from firms that permitted it to assess the potential risks that affiliated organizations might have on broker-dealers. By June 2001, SEC was meeting monthly with major securities firms in connection with their risk reports. SEC rules regarding more complete oversight of the activities of some holding companies—SIBHC and CSE—became effective

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<sup>14</sup>Before the enactment of GLBA, a unitary thrift holding company whose subsidiary thrift was a qualified thrift lender generally could operate without activity restrictions. Additionally, a multiple thrift holding company that acquired all, or all but one, of its subsidiary thrifts as a result of supervisory acquisitions generally could operate without activity restrictions if all of the subsidiary thrifts were qualified thrift lenders. These thrift holding companies have been referred to as "exempt." The majority of thrift holding companies qualify as exempt. Nonexempt thrift holding companies were permitted to engage only in those nonbanking activities that were: specified by the Home Owners' Loan Act; approved by regulation as closely related to banking by the Federal Reserve; or authorized by regulation on March 5, 1987.

<sup>15</sup>Pub. L. No. 101-432§ 4(a), 15 U.S.C. § 78q(h) (providing for, among other things, SEC risk assessment of holding company systems).

in August 2004.<sup>16</sup> GLBA had amended the Securities Exchange Act of 1934 to permit an investment bank holding company that is not affiliated with certain types of banks and has a subsidiary broker-dealer with a substantial presence in the securities markets to elect to become an SIBHC and be subject to SEC supervision on a groupwide basis. SEC established a similar set of rules for holding companies with the largest broker-dealers to voluntarily consent to consolidated supervision by becoming a CSE. Under the CSE rules, broker-dealers may apply to SEC for a conditional exemption from the application of the standard net capital calculation and, instead, use an alternative method of computing net capital that permits utilization of mathematical modeling methods. As a condition for granting the exemption, broker-dealers' ultimate holding companies must consent to capital requirements consistent with Basel standards and groupwide SEC supervision unless they are determined to already be subject to "comprehensive, consolidated supervision" by another principal regulator. For companies that choose to become SIBHCs or CSEs, SEC would have supervisory authority over OTC derivatives transactions undertaken in previously unregulated affiliates.

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## Federal Reserve and U.S. Treasury Play Roles in Maintaining Financial Stability

As the U.S. central bank, the Federal Reserve also has responsibility for ensuring financial stability. In practice, this has entailed providing liquidity to financial markets during periods of crisis. For example, in the immediate aftermath of the September 11, 2001, attacks, the Federal Reserve provided about \$323 billion to banks to overcome problems that resulted from the inability of a major bank to clear trades in government securities. In addition, the Federal Reserve is also both a provider and regulator of clearing and payment services.<sup>17</sup>

The Department of the Treasury shares in the responsibility for maintaining financial stability and has other responsibilities related to financial institutions and markets as well. Treasury shares responsibility for managing systemic financial crises, coordinating financial market regulation, and representing the United States on international financial market issues. Treasury, in consultation with the President, may also

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<sup>16</sup>For the SEC rules regarding consolidated supervised entities, see 69 Fed. Reg. 34428 (June 21, 2004). For the SEC rules regarding supervised investment bank holding companies, see 69 Fed. Reg. 34472 (June 21, 2004).

<sup>17</sup>See GAO, *Federal Reserve System: Mandated Report on Potential Conflicts of Interest*, GAO-01-160 (Washington, D.C.: Nov. 13, 2000).

approve special resolution options for insolvent financial institutions whose failure could threaten the stability of the financial system. Two-thirds of the members of the Federal Reserve's Board of Governors and of the FDIC Directors must approve any extraordinary coverage.

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## The United States Participates in International Organizations Dealing with Regulatory Issues

U.S. regulators meet with regulators from other nations in a number of different forums:

- Basel Committee on Banking Supervision (Basel Committee). Agency principals from OCC, FDIC, and the Federal Reserve<sup>18</sup> participate as members in the Basel Committee, along with central bank and regulatory officials of other industrialized countries.<sup>19</sup> The committee formulates broad supervisory standards and guidelines, including those for capital adequacy regulation, and recommends best practices in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—that are best suited for their own national systems. One of the objectives of the Basel Committee is to close gaps in international supervision coverage so that no internationally active banks escape supervision and supervision is adequate. The committee encourages convergence toward common approaches and common standards without attempting detailed harmonization of member country supervisory techniques.
- International Organization of Securities Commissions (IOSCO). IOSCO is the principal international organization of securities commissions, and is composed of securities regulators from over 105 countries. SEC is a member of IOSCO, and CFTC participates as an associate member. IOSCO develops principles and standards for improving cross-border securities regulation, reviews major securities regulatory issues, and coordinates practical responses to these concerns. Areas addressed by IOSCO include: multinational disclosure, accounting, auditing, regulation of the secondary markets, regulation of intermediaries,

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<sup>18</sup>The Federal Reserve is represented by principals from the Federal Reserve Board of Governors and the Federal Reserve Bank of New York. OTS officials say that they participate in the Basel Committee as a temporary member pending acceptance of OTS's request for permanent membership.

<sup>19</sup>The committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

enforcement and the exchange of information, investment management, credit rating agencies, securities analysts' conflicts of interest, and securities activity on the Internet.

- International Association of Insurance Supervisors (IAIS). Established in 1994, IAIS represents insurance supervisory authorities of some 180 jurisdictions. It was formed to promote cooperation among insurance supervisors, set standards for insurance supervision and regulation, provide training for members, and coordinate work with regulators in the other financial sectors and international financial institutions. NAIC works with IAIS.
- Joint Forum. Established in early 1996 under the aegis of the Basel Committee, IAIS, and IOSCO, the Joint Forum publishes papers addressing supervisory issues that arise from the continuing emergence of financial conglomerates and the blurring of distinctions between the banking, securities, and insurance sectors.<sup>20</sup> The Joint Forum comprises an equal number of senior insurance, bank, and securities supervisors representing 13 countries.<sup>21</sup>
- Financial Stability Forum (FSF). Convened in April 1999, FSF brings together national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. FSF seeks to coordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk. The Federal Reserve, SEC, and Treasury participate in FSF.

The International Monetary Fund (IMF) also plays a role in promoting effective regulation of financial services. IMF is an organization of 184 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and

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<sup>20</sup>The Joint Forum was initially referred to as "The Joint Forum on Financial Conglomerates." During 1999, its name was shortened to "The Joint Forum" to recognize that its new mandate went beyond issues related to financial conglomerates to other issues of common interest to all three sectors.

<sup>21</sup>The countries are Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

sustainable economic growth, and reduce poverty. As part of its surveillance activities, IMF and the World Bank have taken a central role in developing, implementing, and assessing internationally recognized standards and codes in areas that are crucial for the efficient functioning of a modern economy, including central bank independence, financial sector regulation, corporate governance and policy transparency, and accountability. In response to banking crises in the 1990s, they created the Financial Sector Assessment Program to assess the strengths and weaknesses of countries' financial sectors. The staffs of these institutions also conduct research related to these activities.

These international institutions and forums have generally agreed on a set of principles or prerequisites for achieving the objectives of financial regulation. These generally include

- formulating clear objectives for regulators;
- ensuring regulatory independence, but with appropriate accountability;
- providing regulators with adequate resources, including staff and funding;
- giving regulators effective enforcement powers; and
- ensuring that regulation is cost efficient.

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## Objectives, Scope, and Methodology

Our objectives were to describe changes over recent decades in (1) the financial services industry; (2) the U.S. regulatory structure and those of several other industrialized countries; and (3) U.S. financial market regulation, focusing on capital requirements, supervision, market discipline, and domestic and international coordination. Our objectives also included assessing (4) U.S. regulators' efforts to communicate, coordinate, and cooperate with each other and with regulators abroad, and (5) the strengths and weaknesses of the present U.S. financial regulatory system. While housing finance is often considered part of the financial services industry, this report does not include government-sponsored



enterprises with a major role in housing finance or their regulators.<sup>22</sup> In addition, because credit unions have only about 9 percent of domestic deposits and ILCs have only 1 percent of domestic deposits, this report does not discuss them in detail.<sup>23</sup> Finally, we have not included pension funds or their regulator in this report. In addition, we do not discuss the role of the Federal Trade Commission or the impact of tax policy on the financial services industry.

To address the objectives of this report, we conducted interviews with senior supervisory and regulatory officials at the federal level, including the Federal Reserve, FDIC, OCC, OTS, SEC, and CFTC. At the state level, we interviewed supervisory and regulatory officials in Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York as well as trade associations representing state regulators, including supervisors of the Conference of State Bank Supervisors, North American Securities Association of Administrators, and National Association of Insurance Commissioners. Finally, we spoke to a variety of SROs, including the New York Stock Exchange (NYSE), NASD (formerly the National Association of Securities Dealers), Municipal Securities Rulemaking Board, National Futures Association, Chicago Mercantile Exchange, Chicago Board of Trade, and Chicago Board Options Exchange. These agencies provided us with documents and statistics, including research studies, examination manuals, annual and strategic reports, performance plans, and financial and budgetary data. In addition to our interviews with supervisory and regulatory officials, we also met with officials representing financial services firms and exchanges and their trade associations, and academic experts. Information about depository institutions identified in this report was obtained from publicly available sources.

This report also draws on extensive work we have done in the past on the financial services regulatory structure and includes information gathered from many sources. These sources include studies of the history of the financial services industry; records from congressional hearings related to regulatory restructuring; and professional literature concerned with the industry structure and regulation. We also reviewed relevant banking, securities, insurance, and futures legislation at the federal level.

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<sup>22</sup>We recently reviewed our work on regulation of government-sponsored enterprises in *Government-Sponsored Enterprises: A Framework for Strengthening GSE Governance and Oversight*, [GAO-04-269T](#) (Washington, D.C.: Feb. 10, 2004).

<sup>23</sup>See [GAO-04-91](#).

To address issues of international harmonization and to compare the U.S. regulatory regime with more consolidated structures abroad, we conducted fieldwork in Belgium, Germany, and the United Kingdom. During our field visit, we interviewed officials from the European Union (EU), European Central Bank, Financial Services Authority in the United Kingdom (UK-FSA), The Bank of England, Her Majesty's Treasury (HM-Treasury), Federal Financial Supervisory Authority in Germany (BaFin), Deutsche Bundesbank (Bundesbank), and German Treasury. Many of the officials we interviewed provided us with documents and research studies on their regulatory processes and the reasons for implementing more consolidated structures. We also interviewed officials from financial services firms, including subsidiaries of U.S. firms as well as two firms headquartered in the countries we visited. In addition, we spoke with trade associations and other experts on the EU and regulatory consolidation within various countries. For those countries we did not visit (Australia, Japan, and the Netherlands), we reviewed documents and provided our findings for review by government officials from the relevant country or other recognized experts. We did not conduct a full legal review of the regulatory regimes for any of these countries.

To develop certain other information, we collected data from federal and state regulators and SROs on the resources they devoted to supervision from 1999 to 2003. We also collected information about ongoing regular communication these entities had with other regulatory bodies between January 2003 and March 2004. We did not use any nonpublic supervisory data in conducting our work for this report.

We provided a draft of this report to the Department of the Treasury, Board of Governors of the Federal Reserve System, CFTC, FDIC, NAIC, OCC, OTS, and SEC for review and comment. The written comments of the Board of Governors, FDIC, OCC, OTS, and SEC are printed in appendixes I through V and are discussed at the end of chapter 7. The staffs of these agencies also provided technical comments that have been incorporated, as appropriate. The Department of the Treasury, CFTC, and NAIC did not provide written comments, but their staffs provided technical comments that have been incorporated, as appropriate. We conducted our work between June 2003 and July 2004 in accordance with generally accepted government auditing standards in Washington, D.C.; Boston; Chicago; New York City; Brussels, Belgium; London; and Berlin, Bonn, and Frankfurt, Germany.

# The Financial Services Industry Has Undergone Dramatic Changes

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The environment in which the financial services industry operates and the industry itself have undergone dramatic changes that include globalization, consolidation, conglomeration, and convergence. These forces have affected financial services firms, markets, and products. First, globalization that includes the financial services industry has become a characteristic of modern economic life. Second, consolidation (merging of firms in the same sector) and conglomeration (merging of firms in other sectors) have increasingly come to characterize the large players in the financial services industry. Third, the roles of financial institutions and the products and services they offer have converged so that institutions often offer customers similar services, although sectors still specialize to some extent. As a result of these changes, as well as the development of innovative financial products, the financial services industry has become more complex, and thus the kinds and extent of risks the industry faces have changed.

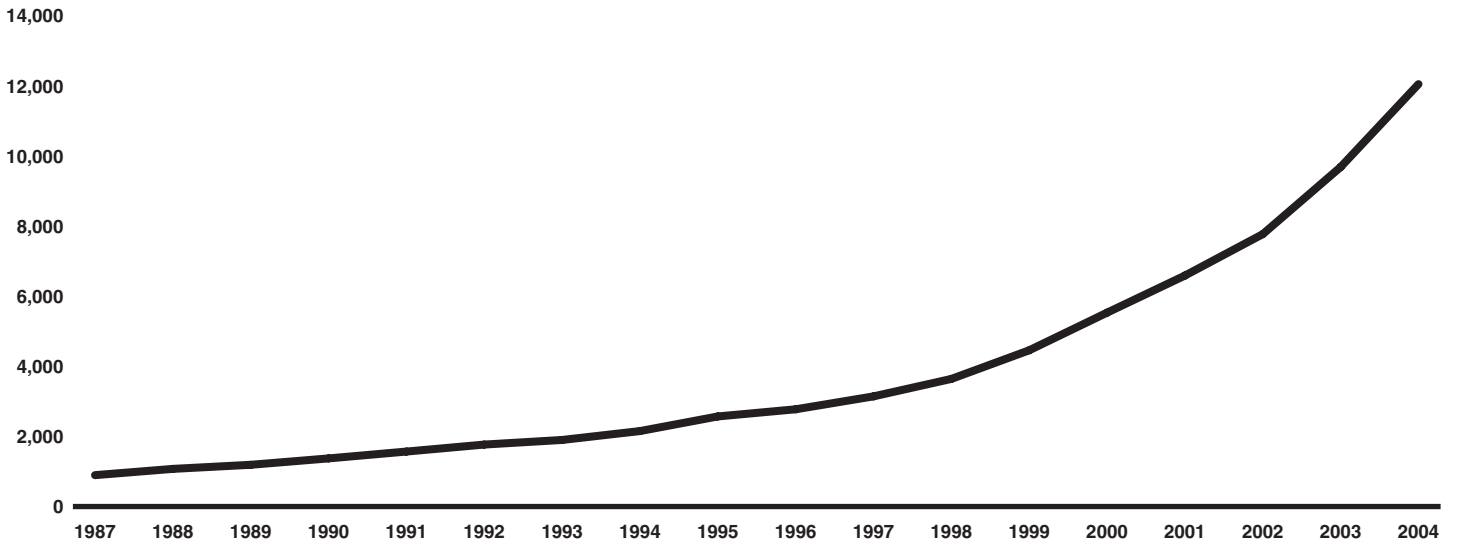
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## Financial Services Have Played an Integral Part in Globalization

Globalization has had a major impact on a broad range of economic activities, including financial markets. Figure 2, which shows the ongoing growth of international corporate and sovereign debt, illustrates the linkages among financial markets around the globe.

**Figure 2: International Debt Securities, 1987-2004**

Dollars in billions



Source: Bank for International Settlements.

The financial services industry—firms, markets, and products—have been an integral part of the globalization trend. At present, firms have a greater capacity and increased regulatory freedom to cross borders, creating markets that either eliminate or substantially reduce the effect of national boundaries. U.S.-owned financial services firms have increased their international activities, and a significant number of foreign-owned financial services companies are operating within the United States. In banking, for example, Citibank has substantial and growing retail banking activities in Germany and ING Direct, a Dutch-owned company, has a large deposit base in the United States. In the securities sector, in 2003 U.S. investors held \$2.5 trillion of foreign securities, and foreign holdings of U.S. securities other than U.S. Treasury securities rose to \$3.4 trillion. In the insurance sector, a significant portion of U.S. insurers and the U.S. market are now foreign controlled. In 2001, 142 U.S. life insurers were foreign-owned, up from 69 in 1995. And, according to the International Insurance Institute, from 1991 to 1999, sales by foreign-owned property-casualty insurers doing business in the United States grew by 62.8 percent.

Deregulation and technological change have facilitated globalization. Barriers that once limited international financial transactions have been substantially reduced or removed, and greater computing power and better

telecommunications networks have driven the technological revolution. These technological changes have had a major effect on wholesale securities and futures markets around the world. Many securities and futures products can be traded 24 hours a day from any place in the world. Electronic trading and other changes have made this transformation possible. Large U.S.-based institutional investors can now buy stock in publicly traded foreign companies by accessing foreign stock markets. Smaller retail investors can participate in the equity markets of foreign countries by buying mutual funds that specialize in developed or emerging foreign markets.

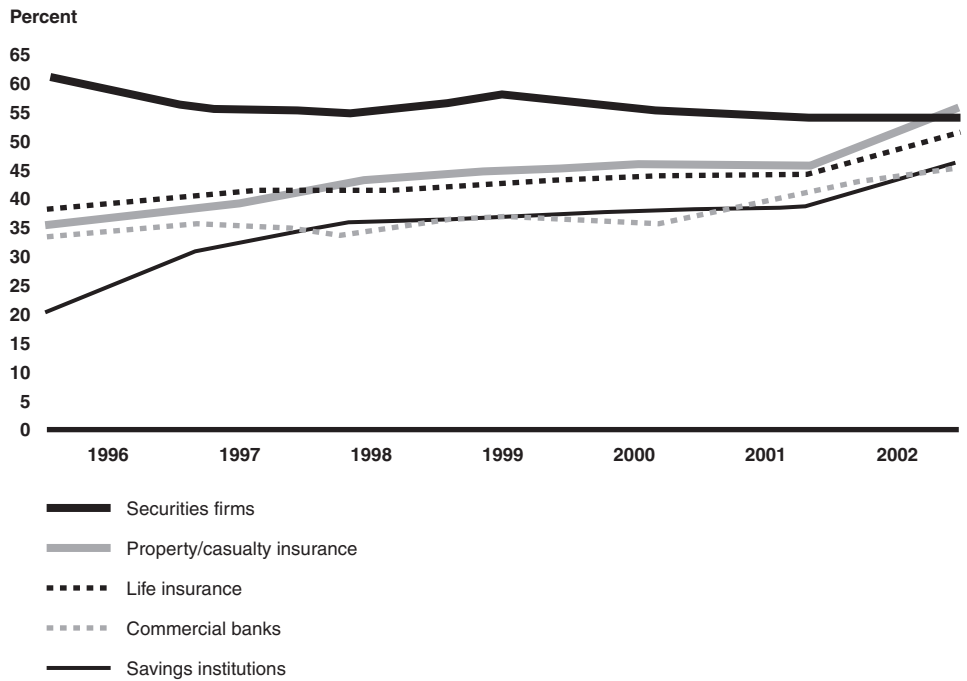
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## Large Institutions Have Become Larger through Consolidation and Conglomeration

Generally, over the last several decades, large financial institutions have consolidated by merging with or acquiring other companies in the same line of business. Consolidation has occurred in all of the industry segments discussed in this report—banking, securities, futures, and insurance. While the number of firms declined, the percentage of industry assets concentrated in the largest 10 commercial banks, thrifts, life insurers, and property-casualty insurers rose between 1996 and 2002, as shown in figure 3. While the percentage of assets of the largest 10 securities firms has fallen somewhat, these firms still have more than 50 percent of the industry's assets. The same technological and improvements and deregulation that have driven globalization have also contributed to consolidation and conglomeration. While large firms have gotten larger and often account for an increasing share of each industry, there are still a large number of firms in each industry segment. Some observers believe that the financial services sectors will come to be characterized by a few large players and lots of small, niche-market players, with few in between.

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**Figure 3: Share of Assets in Each Sector Controlled by 10 Largest Firms, 1996-2002**



Source: TowerGroup.

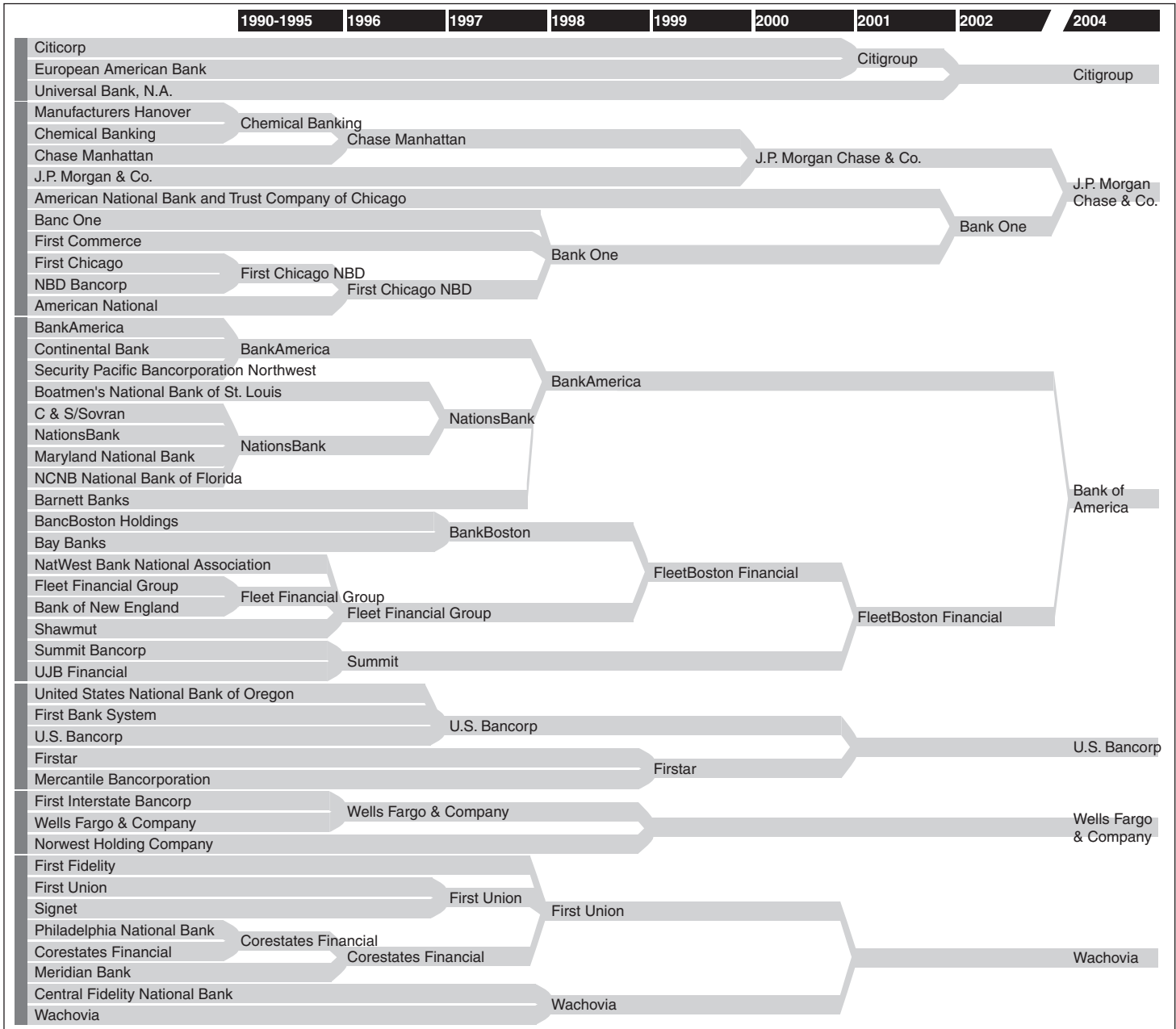
The change in the banking sector has been especially dramatic, as it has been driven by both technological change and significant deregulation. In the early 1980s, bank holding companies faced limitations on their ability to own banks located in different states. Some states did not allow banks to branch at all. With the advent of regional interstate compacts in the late 1980s, some banks began to merge regionally. Additionally, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 removed restrictions on bank holding companies' ability to acquire banks located in different states and permitted banks in different states to merge, subject to a process that permitted states to opt out of that authority.<sup>1</sup> While the U.S. banking industry is still characterized by a large number of small banks and researchers have questioned whether economies of scale and scope exist, the larger banking organizations have grown significantly through mergers after 1995. As figure 4 shows, 40 large banking organizations operating in 1990 had consolidated into 6 banking organizations by August 2004. These six banking organizations had about 40 percent of total bank assets in the United States.

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<sup>1</sup>Pub. L. No. 103-328, 108 Stat. 2238 (1994).

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**Figure 4: Merger Activity among Banking Organizations, January 1990-June 2004**



Source: GAO.



Many of the larger financial services firms are part of holding companies that operate in more than one of the traditional sectors. These firms are called conglomerates. A research study by IMF staff shows that based on a worldwide sample of the top 500 financial services firms in assets, the percentage of firms in the U.S. that are conglomerates—firms having substantial operations in more than one of the sectors (banking, securities, and insurance)—increased from 42 percent of the U.S. firms in the sample in 1995 to 61.5 percent in 2000; however, for the sample of U.S. firms, the percentage of assets controlled by conglomerates declined from 78.6 percent in 1995 to 73 percent in 2000.<sup>2</sup> The largest banks in the United States have brokerage operations, and many sell insurance and mutual fund products. While much of the conglomeration in the United States took place prior to GLBA, that important piece of legislation removed restrictions on the extent to which conglomerates could engage in banking and nonbanking financial activities, thus, for example, making it possible for financial conglomerates to purchase insurance companies and other financial institutions to purchase banks.

To facilitate and recognize the trend toward conglomeration, GLBA authorized new regulatory regimes. The act authorized bank holding companies to qualify as financial holding companies and provided for voluntary SEC supervision of investment bank holding companies. While rules for the latter were issued only in June 2004, financial holding companies grew from 477 in 2000 to 630 in March 2003. Metropolitan Life Insurance Company, one of the largest life insurance companies in the United States, and Charles Schwab & Co., a sizable securities firm, acquired or opened banks and became financial holding companies. In addition, several major insurance and commercial companies, including American International Group, General Electric, and American Express, have thrifts and Merrill-Lynch has chartered an ILC in addition to its commercial bank and thrift. As a result, a consumer can make deposits, obtain a mortgage or other loan, or purchase insurance products from the same company. Although some had expected that conglomeration would intensify after GLBA, as yet, this does not seem to have happened. The reasons vary: Many firms were already conglomerates before the passage of GLBA, the removal of some limitations on bank-affiliated broker-dealers allowed banks to grow internally, banks did not see any synergies with insurance

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<sup>2</sup>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).

underwriting, and a general slowdown occurred in merger and acquisition activity across the economy in the early 2000s. While merger and acquisition activity in banking has picked up, sizable mergers between firms in different sectors have not materialized so far. It may be that these mergers are not economically efficient, the regulatory structure set up under GLBA is not advantageous to these mergers, or it may simply be too soon to tell what the impact will be. In addition, some cross-sector mergers have been unwound. For example, Citigroup sold off the property-casualty unit of Travelers, which had been affiliated with Citibank since their merger in 1998.

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## Roles of Large Financial Services Firms Have Changed and Financial Products Have Converged, but Some Differences Remain

Increasingly, financial intermediaries are relying on fee-based services, including asset management, for their profitability. Firms in all of the sectors are also increasingly involved in activities to manage their and their institutional customers' risks. In addition, product offerings by firms in different segments of the financial services industry have converged so that product offerings that might appear to be different are competing to meet similar customer needs, such as having access to liquid transaction accounts, saving for retirement, or insuring against the failure of a party to live up to the terms of a commercial contract.

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## Market Developments Have Forced Financial Services Firms to Adapt

Generally, financial services firms, especially banks, have had to adapt to the ease with which corporations can now directly access capital markets for financing, rather than depending on loans. For example, with the emergence of the commercial paper market, many large firms with strong credit ratings that had been dependent on bank loans were able to access capital markets more directly. As a result, those large banks that had been major lenders to these firms have had to find new sources of revenue. Banks are now relying more on fee-based income that is generated by structuring and arranging borrowing facilities, providing risk management tools and products, and servicing the loans they have sold off to other institutions as well as from fees on deposit and credit card activity, including account holder fees, late fees, and transactions fees. Many large banking institutions have moved into investment banking activities, including arranging OTC derivative transactions for their corporate customers. These institutions also earn fees on their investment banking activities as well as from their sales of insurance and mutual fund products.

These role changes have been facilitated by the development of new products, such as securitized assets, that depend on sophisticated mathematical models and the technology needed to support them. In its simplest form, asset securitization is the transformation of generally illiquid assets into securities that can be traded in capital markets. The process includes several steps: the firm that issued the loans creates a legal entity (a “pool”), segregates loans or leases into groups that are relatively homogeneous with respect to their cash-flow characteristics and risk profiles, including both credit and market risks, and sells the group to the pool. The pool then issues securities and sells them to an underwriter, who prices them and sells them to investors. Securitized assets generally consist of mortgage-backed securities and other asset backed securities where loans for products such as credit cards or commercial loans are securitized and sold. Mortgage-backed securities<sup>3</sup> grew from about \$1,123 billion in 1990 to about \$3,796 billion in 2003, while other asset-backed securities grew by a factor of 12 over that same period of time. Because the risk embedded in securitized assets can be structured and priced so that financial institutions and others may be better able to manage credit and interest rate risk with these instruments.

Because banks and insurance companies could reduce their capital requirements by securitizing assets and removing those assets from their balance sheets, securitization was also driven by changes in capital requirements implemented in these industries in the early 1990s that required firms to hold more capital for certain assets.<sup>4</sup>

Along with securitized assets, derivatives have been used increasingly by financial institutions to manage assets and risks for themselves and others or to take a position on the direction of market movements in hopes of making a profit. Derivatives are contracts that derive their value from a reference rate, index, or the value of an underlying asset, including stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of underlying financial products. There are several types of derivatives, including the following:

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<sup>3</sup>Mortgage-backed securities numbers are from the Federal Reserve’s flow of funds data and include federal agency and government sponsored enterprise-backed mortgage pools and mortgages backing privately issued pool securities and collateralized mortgage obligations.

<sup>4</sup>See chapter 4 for information about capital requirements.

- Futures and forwards—contracts that obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index (underlying) at a specified price on a specified future date. Futures and forwards are used to hedge against changes or to speculate by attempting to make money off of predicting future changes in the underlying. Futures are often traded on exchanges and forwards are traded as OTC transactions and generally result in delivery of an underlying. (See ch. 1.)
- Options—contracts that grant their purchasers the right but not the obligation to buy or sell a specific amount of the underlying at a particular price within a specified period. Options can allow their holders to protect themselves against certain price changes in the underlying or benefit from speculating that price changes in the underlying will be greater than generally expected.
- Swaps—agreements between counterparties to make periodic payments to each other for a specified period. Swaps are often used to hedge market risk or speculate on whether interest rates or currency values will change in a particular direction.
- Credit default swaps—a contract whereby the protection buyer agrees to make periodic payments to the protection seller for a specified period of time in exchange for a payment in the event of a credit event such as a default by a third party referenced in the swap. Credit default swaps allow market participants to keep loans or loan commitments on their books and essentially purchase insurance against borrower default.

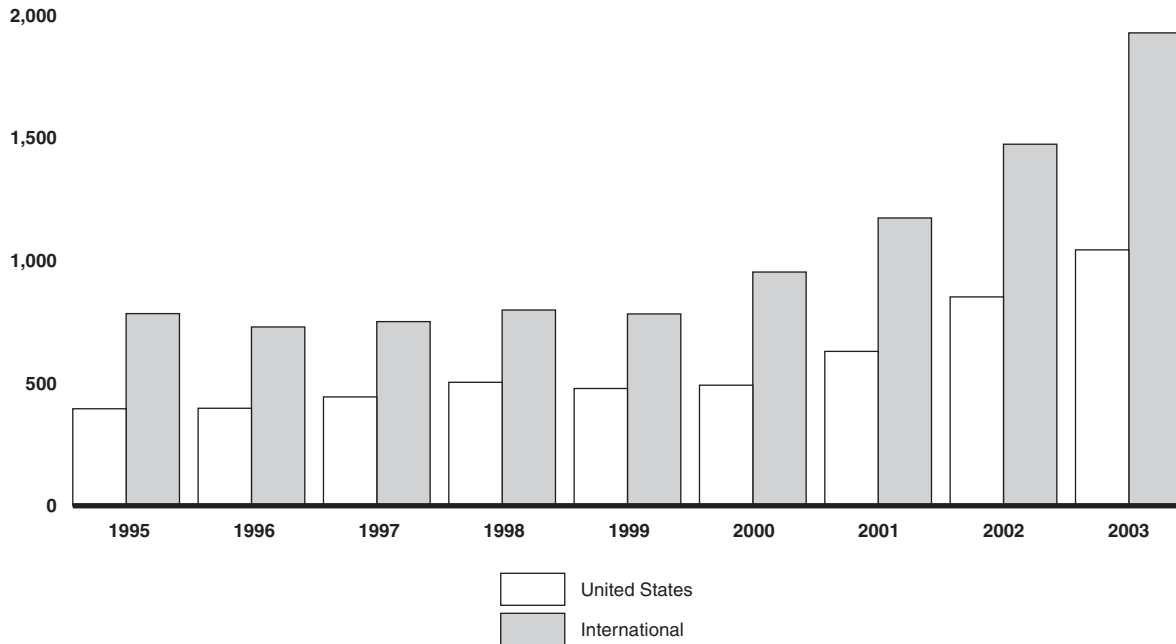
Figure 5 shows the growth in the number of exchange-traded futures since 1995.<sup>5</sup> In addition, Bank for International Settlements' estimates of the notional amounts of OTC derivatives outstanding increased globally by about 146 percent between 1998 and 2003, going from about \$80 trillion in 1998 to about \$197 trillion in 2003.

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<sup>5</sup>For earlier information on derivatives, see GAO, *Financial Derivatives: Actions Needed to Protect the Financial System*, [GAO/GGD-94-133](#) (Washington, D.C.: May 18, 1994); and *Financial Derivatives: Actions Taken or Proposed Since May 1994*, [GAO/GGD/AIMD-97-8](#) (Washington, D.C.: Nov. 1, 1996).

**Figure 5: Number of Futures Contracts Traded, 1995-2003**

Number of futures contracts in millions



Source: GAO analysis of Futures Industry Association data.

The growth of derivatives activity attests to the usefulness of these instruments to the participants, but there are concerns about the management of derivatives risk. The complexity of some of these instruments can make it difficult for the users to understand and estimate the potential value or loss; moreover, the reliance on a counterparty to make an expected flow of payments during future years means that the recipient is exposed to the credit risk that the counterparty might default in the meantime.

### Product Offerings in Different Sectors Have Also Converged

While convergence has taken place among firms using similar securitized products and derivatives to manage assets and risks, it has also taken place in product offerings by firms in different segments of the financial services industry. These firms are competing against each other to provide households, businesses, and governments with the same basic services. For example, table 1 illustrates how financial firms in the various sectors, regardless of whether they are affiliated with firms in other sectors, are

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offering functionally similar products to satisfy the same retail customer needs.

**Table 1: Selected Retail Products by Financial Institution and Function<sup>a</sup>**

<b>Financial institution</b>	<b>Transaction accounts</b>	<b>Fixed return investments</b>	<b>Variable return investments</b>	<b>Risk management</b>	<b>Raising money</b>
Banks	Checking, savings	Certificates of deposit, corporate bonds, municipal bonds, Treasuries	Variable annuities	Insurance distribution <sup>b</sup>	Loans (all types)
Broker-dealers	Cash management account	Corporate bonds, municipal bonds, Treasuries	Stocks, mutual funds, variable annuities	Options	Loans associated with margin accounts
Investment companies	Money market mutual fund	Guaranteed investment contracts	Mutual funds, variable annuities		
Insurers		Fixed annuities, guaranteed investment contracts	Variable annuities, mutual funds	Property-casualty, life insurance	
Futures firms				Futures, options	
Other financing companies					Consumer loans

Source: GAO

<sup>a</sup>While most of these products could be offered by any financial institution through its affiliates, the products are classified here according to whether a stand-alone financial institution would offer the product.

<sup>b</sup>Subject to a grandfathering provision, GLBA prohibits national banks from engaging in title insurance activities, except that national banks and their subsidiaries may act as agents to sell title insurance in states where state banks are permitted to engage in that activity. 15 U.S.C. 6713 (2000 & Supp. 2004). Also, national banks may underwrite certain insurance products, such as credit insurance, where the activity is incidental to the business of banking, and may act as insurance agents directly only under certain circumstances, although they may engage fully as insurance agents through subsidiaries.

Similarly, firms in different sectors compete by offering products that have similar ability to meet some business needs. Issuance of commercial paper can provide financing similar to commercial loans, and catastrophe bonds and reinsurance provide similar protection, as do surety bonds and standby letters of credit.

Although financial services firms and products have converged in numerous ways, firms in the various sectors, especially smaller firms, continue to specialize in some traditional functions. Commercial banks still make commercial loans to businesses, especially those smaller businesses

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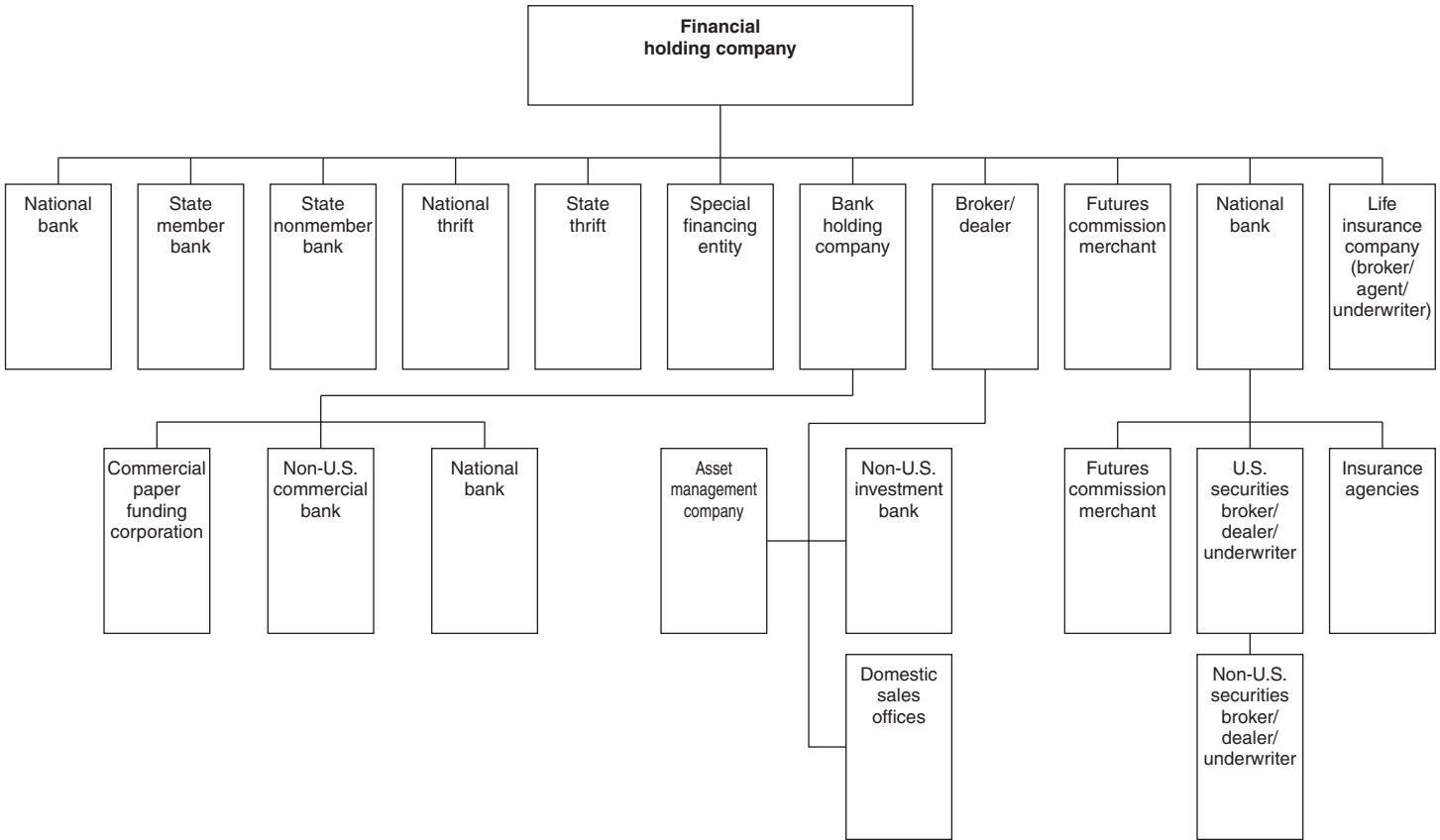
that may not be able to raise funds directly in capital markets; insurance firms still underwrite the risks involved in insuring a life or property or casualty; and investment banks still underwrite new securities and advise firms on mergers and acquisitions.

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**As Financial Services  
Institutions Have  
Diversified, Introduced  
New Products, and  
Become More  
Complex, Risks Have  
Changed**

Globalization, consolidation, conglomeration, and convergence of financial institutions have changed the risk profile of the institutions and the linkages among them. Today, a large modern financial firm may operate in a variety of product and geographic markets. Figure 6 illustrates how such a complex firm might be organized.

Figure 6: Structure of a Hypothetical Financial Holding Company



Source: GAO.

Generally, diversification into new geographic and product markets would be expected to reduce risk, while securitized and derivative products have given firms new tools to manage risk. Because risks interact, however, the net result on the risk of an individual institution or the financial system cannot be definitively predicted. In addition, managing risks in an environment that crosses industry and geographic lines along with new products have increased the complexity of institutions and the industry. As a result of all of these factors, the risks facing the industry have changed in some ways.



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## Credit Risks Have Changed as a Result of Industry Changes

Generally, diversification of borrowers will reduce the credit risk of a financial services firm, and many of the changes in the industry have done just that. U.S. banks have consolidated and spread across the country so that they are no longer operating in a single small town, city, or state. If a town or even a region falls on hard times and borrowers increasingly default on loans, the bank, or other institution that made the loans, may be less affected than they once would have been, because borrowers in other markets may be enjoying positive economic circumstances and defaults in those markets may be dropping. The same is true for firms diversifying their types of products and for those diversifying to other parts of the world. In addition, by securitizing loans and selling them off or by using credit derivative products, individual firms or sectors may also reduce credit risk. For example, in its *Global Financial Stability Report* issued in April 2004, the IMF reported that, for many years, banks have been transferring risk, especially credit risk, to other financial institutions, such as mutual funds, pension funds, insurers, and hedge funds.<sup>6</sup>

Many of the same forces that may have reduced credit risk for some institutions, as well as other forces, may have increased risk as well. For example, while globalization allows for diversification, it also complicates the evaluation of credit risk. Because bankruptcy laws differ among countries, the assets of a failed household or corporate borrower in another country may be less available to U.S. creditors. In addition, little recourse exists when foreign governments default on their debt. Further, the extent to which diversification and new products reduce credit risk depends on how the firm to which the risk is passed understands, measures, and manages its new markets and products—as well as the combined risks of old and new exposures. If it does not manage them well, these normally credit reducing activities could actually increase credit or other kinds of risks.

The degree to which diversification and new products reduce credit risk will also depend on the linkages between markets, products, and firms, and the relationship or correlation among the risks. For example, securitized products and credit derivatives can allow one institution to pass on risk to another. Regulators and others have expressed concern that this risk can become concentrated in a few firms or be passed to buyers that may be less

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<sup>6</sup>IMF, *Global Financial Stability Report: Market Developments and Issues, April 2004* (Washington, D.C., April 2004).

equipped to handle it. Some research has been conducted because regulators and others were concerned that the banking sector was passing credit risk to the insurance sector or ultimately to households and that these developments could have implications for overall financial stability.<sup>7</sup> For example, IMF reported in April 2004 that on a global basis the transfer of credit risk from banks to life insurers might increase financial stability because life insurers generally hold longer-term liabilities. However, the report notes that in recent years, many insurers have changed their products in ways that have begun to shorten the duration of their liabilities, raising questions about their advantage in handling credit risk. And as insurers in some parts of the world take steps to manage their balance sheet risk, they would likely transfer that risk to others—including the household sector, which might be less able to manage the risk.

Because financial services firms are competing and cooperating with each other across traditional industry and geographic boundaries, there are increased linkages that may not be well understood. Thus, downturns somewhere in the world, such as those in Russia in 1998 or Mexico in 1995, can have a large impact on all of the major financial institutions. In addition, if the large financial institutions are linked to each other as counterparties in various transactions, a major credit failure at one could send systemic shockwaves through the United States and even the world's economy.

Many of the concerns raised here were evident in the near collapse of Long-Term Capital Management (LTCM)—one of the largest U.S. hedge funds—in 1998 following the Russian downturn.<sup>8</sup> Most of LTCM's balance sheet consisted of trading positions in government securities of major countries, but the fund was also active in securities markets, exchange-traded futures, and OTC derivatives. According to LTCM officials, LTCM was counterparty to over 20,000 transactions and conducted business with over 75 counterparties. Further, the Bank for International Settlements reported that LTCM was “perhaps the world's single most active user of interest rate

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<sup>7</sup>See IMF, *Global Financial Stability Report, April 2004*; FSA, *Cross-Sector Risk Transfers* (London, U.K., May 2002); and Committee on the Global Financial System of the Bank for International Settlements, *Global Credit Risk Transfer* (Basel, Switzerland, January 2003).

<sup>8</sup>GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999).

swaps.”<sup>9</sup> In addition many of the financial institutions that LTCM dealt with failed to enforce their own risk management standards.

Comparing the largest U.S. financial firms today with some large failures resulting from credit risk that did not appear to have systemic implications in the past can help shed light on the potential for systemic disruptions today. Bank of New England, which failed, in part, because of bad real estate loans, had \$19.1 billion in assets at the time of its failure. In comparison, the largest bank holding company today had bank subsidiaries with assets of \$823 billion in March 2004. Similarly, in the insurance area, one of the largest U.S. insurers has assets of \$678 billion, while the largest insurance failure on record is Mutual Benefit, which had assets of only \$13.5 billion. While the unwinding of Drexel, Burnham, Lambert Group is sometimes pointed to as evidence that the failure of a major securities firm would not necessarily raise concerns about systemic risk sufficient to warrant intervention, some experts suggest that four trends in the international financial system since that collapse suggest that the outcome for a future failure of a major securities firm might be different:<sup>10</sup> (1) Leading securities firms have become increasingly international, operating in markets around the world and through a complex structure of affiliates in countries with differing bankruptcy regimes; (2) securities firms are increasingly parts of conglomerates that include banks, and thus the systemic concerns related to bank failures might extend to securities firms; (3) securities firms themselves have grown in size so that while they may be less likely to fail, any failure is more likely to have systemic implications; and (4) the largest securities firms have become increasingly involved in global trading activities, particularly OTC derivatives. An SEC staff member told us that while they believe that a gradual unwinding of one of the largest securities firms today could still be handled without systemic implications, the sudden failure of one of these firms would likely have major implications for a broad swath of markets and investors. Because of the sheer size of today’s financial institutions, some question whether these firms are too big to be allowed to fail. This belief could skew the incentives facing managers and investors to manage risk effectively.

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<sup>9</sup>Bank for International Settlements, *69th Annual Report, 1 April 1998-31 March 1999* (Basel, Switzerland; June 7, 1999).

<sup>10</sup>Richard Herring and Til Schuermann, “Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies” (paper at the Conference on Risk-Based Capital: The Tensions between Regulatory and Market Standards, Program on International Financial Systems, Harvard Law School (Cambridge, Massachusetts; June 10, 2003).

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Other Risks Have Also Been  
Affected by Changes in the  
Industry

Changes in the industry, especially the growth of large institutions that cross industry and national boundaries, have also affected the level and management of operational and reputation risk. An official at one of the large securities firms told us that opportunities for fraud or other violations of law or regulation in some part of the organization increase immediately after a merger of entities with different corporate cultures. And to the extent that a firm operates centrally and the public believes the parts are connected, the ability to isolate such problems in some part of an organization will be more difficult. The collapse of Barings, a British bank, demonstrates the potential vulnerability to operational risk of firms operating across a wide range of markets. In this case, management did not effectively supervise a trader in Singapore, and his actions brought down the bank.<sup>11</sup> Further, a firm's reputation can be damaged by disreputable practices, such as happened when a major institution violated derivatives sales practices and when it was discovered that ownership of a U.S. bank in Washington, D.C., was tied to BCCI, a corrupt bank headquartered in Luxembourg. Regulators have recognized the increased importance of operational risks, including reputation risk, in the new capital standards adopted by the Basel Committee in June 2004. (See ch. 4.)

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<sup>11</sup>The failure of Barings did not involve the use of British government funds. In addition, officials at the Federal Reserve note that Barings was much smaller than many of today's banking organizations.

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# While Some Countries Have Consolidated Regulatory Structures, the United States Has Chosen to Maintain Its Structure

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Since the mid-1990s, several major industrial countries, including Australia, Germany, Japan, the Netherlands, and the United Kingdom, have consolidated their regulatory structures, and some U.S. states have consolidated their structures as well. While proposals have been advanced that would change the U.S. regulatory structure, the United States, most notably with the passage of GLBA, has chosen not to adopt any substantial changes. Proposals to change the U.S. regulatory structure made throughout the 1990s and early 2000s included consolidating bank regulators, merging SEC and CFTC, changing the SRO structure for securities, and creating a federal regulator to oversee those companies opting for the proposed federal insurance charter. Proposals have also been made that would cut across sectors, including proposals for a single federal regulator in each area, an oversight board, and a fully consolidated federal regulator.

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## Some Countries and States Have Consolidated Their Regulatory Structures

During the 1990s and early 2000s, some other countries consolidated their regulatory structure. According to a research report by World Bank staff,<sup>1</sup> by 2002, 29 percent of the countries that supervise banking, securities, and insurance had consolidated their regulatory structure to include only a single regulator, and another 30 percent of the countries had consolidated regulators across two of the three sectors. The remaining countries had multiple regulators, with a minimum of one for each of the sectors. Countries within the EU<sup>2</sup> made changes that sometimes reflect steps to create an integrated financial market but not an EU-wide regulatory regime. Generally, these countries' industries and regulatory structures historically had differed from those in the United States, largely because banking, securities, and insurance activities had not been legally separated as they were in the United States under the Glass-Steagall Act. The products and services that financial services firms in these countries offered had changed, however, reflecting the financial innovations that have also transformed the U.S. financial services industry. Some U.S. states have also consolidated their regulatory structure. In addition, many states have combined some aspects of their banking, insurance, and securities

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<sup>1</sup>José de Luna Martínez and Thomas A. Rose, "International Survey of Integrated Financial Sector Supervision" (World Bank Policy Research Working Paper 3096, July 2003).

<sup>2</sup>The EU is a treaty-based organization of European countries in which those countries cede some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level.

regulators, and some have chosen to combine all of their financial regulation in a single government agency.

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**The EU Has Taken Steps  
Designed to Create an  
Integrated Financial Market  
but Not an EU-Wide  
Regulatory Regime**

EU member states that have consolidated their regulatory structures have done so in the larger context of efforts to create an integrated financial market in the EU. Building on long-term actions to create a single financial market in Europe, the EU has taken several actions that are influencing regulatory frameworks in European countries. First, in 1998 the European Central Bank was established, and this has diminished the roles of the central banks in countries that began using the euro in 2002.<sup>3</sup> Second, the European Commission proposed an extensive Financial Services Action Plan (Action Plan) in 1999 that it expects to fully implement by 2005. Under the Action Plan, the EU would not create any EU-wide financial services regulatory bodies, but would instead enact legislation that would be adopted by the individual countries and implemented by their regulators. Since under the EU charter, firms can do business in all EU countries if they are located in one of them (the so-called Single Passport), EU officials and others have said that convergence is necessary to prevent duplicative requirements and regulatory arbitrage. That is, companies should not have an incentive to choose their location based on the regulatory regime in a particular country and should not be able to pit one regulator against another to get favorable regulatory decisions. Finally, to streamline European lawmaking and stimulate regulatory and supervisory convergence, the EU has created a process under which committees of securities, banking, and insurance regulators from the individual member states now consult and coordinate their work at several stages in the process between adoption of more detailed rules. These supervisory committees are the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors, and the Committee of European Insurance and Occupational Pensions Supervisors.

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**The United Kingdom,  
Germany, and Japan Have  
Adopted a Single Regulator  
Structure**

Along with other countries, the United Kingdom, Germany, and Japan have each adopted versions of the single regulator model. However, the regulatory organizations in these countries differ significantly. The United Kingdom's consolidation is the most notable in that, according to a

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<sup>3</sup>Together with the state central banks, the European Central Bank conducts monetary policy for the EU, but has no regulatory or supervisory powers.

research paper by IMF staff, it provided an enormous impetus for other countries to unify their supervisory agencies.

## United Kingdom

Beginning in 1997, the United Kingdom consolidated its financial services regulatory structure, combining nine different regulatory bodies, including SROs, into the Financial Services Authority (UK-FSA). While UK-FSA is the sole supervisor for all financial services, other government agencies, especially the Bank of England and Her Majesty's Treasury (HM-Treasury), still play some role in the regulation and supervision of financial services. Formal financial regulation and supervision are relatively new to the United Kingdom; before 1980, according to officials at the Bank of England, a "raised eyebrow" from the Head of the Bank of England was used to censure inappropriate behavior. Thus, most of the agencies and SROs that were replaced did not have long histories.

Government officials and experts cited important changes in the financial services industry as some of the reasons for consolidating the regulatory bodies that oversee banking, securities, and insurance activities. These included the blurring of the distinctions between different kinds of financial services businesses, and the growth of large conglomerate financial services firms that allocate capital and manage risk on a groupwide basis. Other reasons for consolidating included some recognition of regulatory weaknesses in certain areas and enhancing the United Kingdom's power in EU and other international deliberations.

U.K. officials have reported that the United Kingdom did not separate its regulators by objective—the twin peaks model, which usually includes a prudential or safety and soundness regulatory agency and a conduct-of-business or market conduct regulatory agency—because the same senior management and groupwide systems and controls that determine a firm's ability to manage financial risk effectively also determine a firm's approach to market conduct. Similarly, while British experts acknowledge that groupwide supervision could be managed with regulators who specialize in the regulation of specific sectors, they say that the need for communication, coordination, cooperation, and consistency across the specialist regulatory bodies would make it exceedingly difficult to operate within a multiple regulator system.

According to documents provided by UK-FSA officials, the agency's enabling legislation stipulated four goals:

- maintaining confidence in the financial system;

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- promoting public understanding of the financial system;
- securing the appropriate degree of protection for consumers; and
- reducing the potential for financial services firms to be used for a purpose connected with financial crime.

In pursuing these goals, UK-FSA is directed to take account of additional obligations, including achieving its goals in the most efficient and effective way; relying on senior management at financial services companies for most regulatory input; applying proportionality to regulatory decisions, including the costs and benefits of each act; not damaging the competitive position of the United Kingdom internationally; and avoiding any unnecessary distortions in or impediments to competition, including unnecessary regulatory barriers to entry or business expansion.

UK-FSA is organized as a private corporation with a chairman and chief executive officer and a 16-person board of directors. Eleven members of the board are independent, while the other five are UK-FSA officials. UK-FSA is ultimately answerable to HM-Treasury and the British Parliament. The statute provides for a Practitioner Panel and a Consumer Panel to oversee UK-FSA for their respective constituencies. In addition, there are requirements for consultation on rules and an appeals process for enforcement actions.

UK-FSA documents and officials present UK-FSA as an organization strategically focused on achieving its statutory objectives. It has adopted a risk analysis model that it believes allows it to allocate resources so as to minimize the chance that UK-FSA will fail to meet its goals. As a result of this analysis, it focuses on the largest firms—the ones most likely to pose significant costs of failure—and on the needs of retail consumers. To assure that UK-FSA accomplishes its goals efficiently, it is required to submit cost-benefit analyses for its proposals. In addition, UK-FSA must report annually on its costs relative to the costs of regulation in other countries and must provide its next fiscal year's budget for public comment three months prior to the end of the current fiscal year.

UK-FSA officials say that they have also taken actions, within the institution, to break down the barriers—often called stovepipes or silos—between those regulating the different industries. From the beginning, they forged a new common language across industry segments and traditional regulatory boundaries. Staff have to explain why a requirement imposed on



one segment should differ from that imposed on other sectors. The current organizational structure is designed around retail and wholesale divisions. The structure also includes crosscutting teams looking at various issues, including asset management, financial crime, and financial stability as well as the traditional areas of banking, securities, and insurance.

Most of the representatives of firms we spoke to in the United Kingdom, including U.K. subsidiaries of U.S. companies, felt that UK-FSA was doing a good job, but some industry representatives have raised concerns. Much of UK-FSA's success is attributed to the caliber of the people working there. For example, we heard that the ability to pull off the creation of UK-FSA depended greatly on the caliber of the early leadership and that using high-quality bank supervisors to supervise in other areas has had benefits, even though these staff may not have expertise specific to a particular business. However, some industry participants were concerned about the future and about the lack of expertise in some areas such as insurance. In addition, the Practitioner Panel in its 2003 annual report expressed concerns about UK-FSA's cost-benefit analyses, saying that certain costs are often unrepresentative or not included at all, and that there is a disregard for the total cost of regulation and the industry's ability to absorb the incremental cost of rule changes. They also suggested that analyses should include potential areas of consumer disadvantage, such as a reduction in choice and the possibility of unintended consequences. However, a UK-FSA official said that while the agency is working to improve its cost-benefit analysis, one industry trade association working on the issue had noted that UK-FSA is a world leader in the area.

Since UK-FSA took over, a major crisis in the life insurance area has come to light. Equitable Life is a mutual insurer in the United Kingdom that inappropriately sold policies in the high interest rate environment in the 1970s and 1980s that are now coming due and failed to reserve appropriately for them. A major study of this problem, the Penrose report, was issued in March 2004. The report concluded that the crisis was due to the "light touch, reactive regulatory environment" that preceded UK-FSA and that UK-FSA's work since 1997 "has sought to anticipate many of the lessons that might be drawn by this inquiry and it should come as no surprise that it has largely succeeded." The report also concluded that the lack of coordination between safety and soundness and market conduct regulation in the past was unacceptable. HM-Treasury is now undertaking an extensive review of UK-FSA's authorizing legislation, in part, to determine the impact UK-FSA might be having on competition in the U.K. financial services sector.

While UK-FSA is the sole financial services supervisor, other government entities still play a role in regulating the financial services industry. A tripartite agreement lays out the roles of the Bank of England, HM-Treasury, and UK-FSA. While UK-FSA is responsible for supervision of financial entities, the Bank of England retains primary responsibility for the overall stability of the financial system. It retains the lender of last resort responsibilities but must consult with HM-Treasury if taxpayers are at risk. High-level representatives from the three agencies meet monthly to discuss issues of mutual concern. According to officials at the Bank of England, it is difficult to tell how well the system is working because it has not yet had to weather a significant banking crisis.

## Germany

In 2002, Germany combined its securities, banking, and insurance regulators into BaFin; however, the changes appear less dramatic than at UK-FSA. Although crosscutting groups have been added to handle conglomerate supervision, international issues, and other cross-sectoral topics that concern all of the supervisory divisions, the new structure still maintains the old divisions related to banking, securities, and insurance. In addition, the insurance and banking divisions are housed in Bonn, while the securities markets regulators are in Frankfurt. Finally, BaFin shares supervisory responsibilities in the banking area with the Bundesbank, Germany's central bank.

Organizationally, BaFin is a federal agency overseen by the treasury that must follow civil service laws. BaFin has an administrative board composed of the ministers of Finance, Economics, and Justice, members of Parliament, officials of the Bundesbank, and representatives of the banking, insurance, and securities industries. The Advisory Council made up of industry, union, and consumer representatives also advises BaFin.

BaFin's statutory mandate is to take supervisory or enforcement actions to counteract developments that may

- endanger the safety and soundness of the assets entrusted to institutions in the banking, insurance, and other financial services sectors;
- impair the proper conduct of banking, insurance, and securities business or provision of financial services; or
- involve serious disadvantages to the German economy.

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Much of the immediate impetus for the creation of BaFin came from developments in the EU. However, the new organization also recognizes the blurring of industry lines and the need for reducing the costs of supervision to the government. Specifically German government officials cited the following reasons for the creation of a consolidated regulator:

- Financial institutions that are taking on similar risks must be treated the same.
- Conglomerates need effective oversight.
- The cost of regulation could be reduced through greater efficiency and by providing for industry funding of BaFin's operations.
- The role of the Bundesbank, in light of the creation of the European Central Bank, would be clarified.
- International standing and clout could be increased.

Like the United States, Germany has a state system of financial institutions and regulators as well as the federal system. The banking system consists of private banks and state banks, or *Sparkassen*, that are owned by a city or other government entity. The fragmentation of the banking industry has impacted the commercial banking industry in that private banks have difficulty expanding their retail banking operations. In addition, securities exchanges, as well as some insurance activities, are overseen at the state level.

Statutes and agreements lay out the complex relationship between BaFin and the Bundesbank. When we last reviewed the German bank regulatory system in 1995, we noted that while the Bundesbank played a role in the oversight of banks, this role was not then spelled out statutorily. With creation of the European Central Bank, the role of the Bundesbank in the supervision of credit institutions was also clarified. While BaFin conducts its own document analyses and, if required, its own investigations of troubled institutions and institutions of relevance to the system, BaFin is required to consult with the Bundesbank on new rules, and the Bundesbank is responsible for most of the ongoing monitoring of institutions. Officials at one of the German subsidiaries of a U.S. investment bank we spoke with said that most of their dealings are with the Bundesbank.

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Japan

Japan consolidated and modified its financial services regulatory structure in response to persistent problems in that sector. Japan's financial markets sector had certain similarities to that of the United States. Most notably, until 1996, Japan maintained legal separations between commercial banking, investment banking, and insurance. Japanese law, however, did allow cross ownership of financial services and commercial firms, permitting development of industrial groups or *keiretsu* that dominated the Japanese economy. These groups generally included a major or lead bank that was owned by other members of the group and that provided financial services to the members.

Problems in Japan's financial sector are generally accorded some responsibility for the persistent stagnation of its economy through the 1990s. The Financial Reform Act of 1992 allowed the Ministry of Finance to impose capital requirements for banks and banks to own securities affiliates and created the Securities Exchange and Surveillance Commission. According to one author, while these laws were designed to reduce the Ministry of Finance's control over the financial sector, the ministry retained its role. In 1998, the Financial Supervisory Agency, renamed the Financial Services Agency (Japan-FSA) in 2000, was created, with functions and staff transferred from the Ministry of Finance. The Securities Exchange and Surveillance Commission was also moved into that organization. Japan-FSA has overseen the mergers of several large banks and reports progress in addressing the issue of nonperforming loans held by Japanese banks. In the review of Japan-FSA issued in 2003, however, IMF raised questions about the independence and enforcement powers of the agency.

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The Netherlands and  
Australia Have Consolidated  
Their Regulatory Structure  
Using the Twin Peaks Model

Both the Netherlands and Australia consolidated their regulatory structure, but they did not adopt the single regulator structure. Instead, they adopted a structure that separates the regulators by objective,<sup>4</sup> such that one regulatory body is responsible for prudential regulation and another for conduct-of-business regulation—often referred to as the twin peaks model.

In 2001, when the Netherlands Ministry of Finance proposed a restructuring of the financial regulatory structure, the country had three

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<sup>4</sup>Officials in the Netherlands call this functional regulation as do officials in other countries that have adopted a similar structure.

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regulatory bodies—the Dutch Central Bank regulated banks, the Pensions and Insurance Supervisor regulated insurance, and the Securities Board regulated securities. Both the Central Bank and the Insurance Supervisor had some responsibility for financial stability. Since 1999, the Council of Financial Supervisors had helped to coordinate regulatory activities between the three agencies, but has received less attention as the country moves to the new structure.

The Netherlands is now in the final stages of consolidating its regulatory system and separating it into prudential and market conduct activities. The Pensions and Insurance Supervisor is merging with the Dutch Central Bank so that all prudential supervision will be done within the central bank, and in 2003, the Securities Board became the Netherlands Authority for the Financial Markets (AFM), the body responsible for market conduct in all segments of financial services.

As with the other countries, several factors contributed to the Netherlands' decision to change its regulatory structure. The Netherlands is the home of several of the largest, most globally active conglomerates. Supervision of these conglomerates had been divided among the three regulatory bodies and was not always consistent. As with the other central banks of other countries that adopted the Euro, the Dutch Central Bank no longer has primary responsibility for monetary policy or for the nation's currency. Like Germany, the Netherlands needed to clarify the role of its central bank after the formation of the European Central Bank.

With regard to its regulatory and supervisory roles, the Dutch Central Bank operates as an autonomous administrative authority. After the merger with the Pensions and Insurance Supervisor, its main objective is to ensure that banks, insurance companies, pension funds, and other financial service providers are sound businesses that can meet their liabilities to others now and in the future. The supervision focuses on protecting as well as possible the interests of consumers of financial services, whether they are individuals or businesses.

A three-person executive board, subject to oversight by a five-person supervisory board appointed by the Minister of Finance, manages AFM. According to its 2003 Annual Report, this authority's objectives are to

- promote access to financial markets;

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- promote the efficient, fair, and orderly operation of financial markets; and
- ensure confidence in financial markets.

AFM is not organized around traditional industry sectors, but around three clusters of activities: Supervision Preparation, Supervision Implementation, and Business Operations.

In 1998, Australia's regulatory reforms provided for the establishment of the Australian Prudential Regulation Authority (APRA) to regulate the safety and soundness of financial institutions and the Australian Securities and Investments Commission (ASIC) to regulate corporations, market conduct, and consumer protection in relation to financial products and services. These changes followed a major study of Australia's regulatory regime—called the Financial System Inquiry or Wallis Report—that reported to the Australian Government in March 1997. This report identified the following reasons for recommending reform:

- to achieve a more competitive and efficient financial system while maintaining financial market stability, prudence, integrity, and fairness;
- to design a regulatory framework that is adaptable to future financial innovations and other market developments; and
- to ensure that the regulation of similar financial functions, products, or services is consistent between different types of institutions.

APRA, the safety and soundness regulator, provides prudential regulation for deposit-taking institutions, insurers, and pension funds. APRA consolidated prudential regulation responsibilities at the national level, taking on the responsibilities of nine regulatory agencies (the Reserve Bank of Australia, the Insurance Superannuation Commission and seven state-based regulators). It is an independent authority that is overseen by a three-person executive group. Its structure includes a risk management and audit committee and has four major divisions—diversified institutions, specialized institutions, supervisory support and policy, research and statistics.

ASIC is an independent commonwealth government body that has responsibility for regulating financial markets and corporations as well as consumer protection in relation to the provision of financial products and

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services, including securities, derivatives, pensions, insurance, and deposit taking. As one ASIC official put it, ASIC looks after consumers as individual customers, ensuring they receive proper disclosure, are dealt with fairly by qualified people, and continue to receive useful information about their investments. ASIC replaced the Australian Securities Commission, which had replaced the National Companies and Securities Commission at the federal level and the Corporate Affairs offices of the states and territories in 1991.

Along with APRA and ASIC, the Wallis report recommended that a Council of Financial Supervisors, initially composed of representatives of APRA, ASIC, and the central bank, be formed to deal with issues of coordination and cooperation. The council comprises high-level executives from each group and meets at least quarterly to discuss issues of mutual interest. As part of regulatory reforms flowing from a recent significant failure of an insurer, representatives of the treasury have also been included on the council.

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**Some U.S. States Have Also**  
**Consolidated Their**  
**Regulatory Structures**  
**Largely in Response to**  
**Industry Conglomeration**  
**and Product Convergence**

According to information provided by the Conference of State Bank Supervisors, in July 2004, 23 states supervise banking and either insurance or securities in one department. That information also shows that 14 states have consolidated financial regulatory structures, combining banking, securities, and insurance regulation into one department.<sup>5</sup> We interviewed officials in large states—Florida, Michigan, and Minnesota—that had consolidated their regulatory structures. Regulatory officials from each of these states told us they consolidated in response to industry changes that were blurring the traditional demarcations between banking, securities, and insurance activities. In all three states, officials said that although consolidation was not designed to conserve resources, they believed there had been cost savings due to consolidation.

State officials from Florida, Michigan, and Minnesota told us that consolidation had improved information sharing across different financial services sectors, specifically in the areas of licensing and customer complaints. Michigan has consolidated licensing of all sales agents, including mortgage, insurance, and securities. Now that all financial

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<sup>5</sup>Regarding exchange-traded futures, federal law generally pre-empts state authority. However, states may have jurisdiction to enforce anti-fraud laws related to activities involving futures contracts.

licensing is housed in one division, the state can more easily detect and discipline fraudulent behavior. For instance, individuals who have recently lost their license to sell securities due to fraudulent or other criminal acts cannot apply for a license to sell insurance or mortgages. Consolidation of customer complaints call centers has enabled Florida, Michigan, and Minnesota to downsize personnel and provide better services to consumers of financial products, according to officials from those states.

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### **United States Has Chosen to Maintain the Federal Regulatory Structure, although Proposals Have Been Made to Change It**

While GLBA removed restrictions against affiliations among financial services providers across sectors, it did not change the financial services regulatory structure. Over the years, many proposals had been made to change the U.S. regulatory structure. Many of the proposals, including one we made in 1996, have concerned reducing the number of federal bank regulators. Suggestions have also been made to combine SEC and CFTC, and to consolidate the securities SRO structure. In addition, proposals for an optional federal charter for insurance companies are currently being considered. Finally, some proposals for consolidating across sectors were made in the discussions leading up to the passage of GLBA, and that law did not end calls for regulatory restructuring across sectors.

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### **GLBA Permitted Affiliations across Areas without Changing the Regulatory Structure**

While GLBA removed many of the barriers that had restricted firms from engaging in banking, securities, and insurance activities, thus allowing many financial services firms to offer a wider array of services, it did not change the regulatory structure. By allowing banking organizations, securities firms, and insurance companies to affiliate with each other through a financial holding company structure, GLBA addressed several regulatory developments that had already permitted the affiliation of depository institutions with providers of nonbanking financial services. In 1998, the Federal Reserve had permitted Citicorp, at the time the largest bank holding company in the United States, to become affiliated with Travelers Group, a diversified financial services firm engaged in insurance and securities activities.<sup>6</sup> Without the adoption of GLBA, the combined entity would have been subject to a requirement to divest or otherwise restructure many of its securities and insurance activities. In addition, OCC had promulgated regulations permitting national bank subsidiaries to

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<sup>6</sup>See Federal Reserve Board, Order Approving Formation of a Bank Holding Company and Notice to Engage in Nonbanking Activities, 84 Fed. Res. Bull. 985 (1998).



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engage in activities that were not permissible for the banks themselves.<sup>7</sup> Moreover, as discussed earlier, most thrift holding companies were not subject to activities restrictions. GLBA codified regulatory developments that had already allowed expanded services within a holding company or from a national bank subsidiary.

After GLBA, banking, securities, and insurance activities continued for the most part to be regulated by the same primary federal regulator that had regulated them when only separate firms could participate in each activity. For instance, SEC primarily regulates securities activities regardless of where they occur within a financial holding company structure.<sup>8</sup> Similarly, states continue to be responsible for regulation of insurance underwriting and other insurance-related activities undertaken by insurance companies.<sup>9</sup> However, because the blurring of distinctions that once separated the financial products and services of banks, securities firms, and insurance companies also could blur the regulatory responsibilities of their respective regulators, GLBA contains provisions designed to enhance regulatory consultation and coordination. For example, with respect to insurance activities by insurance companies that are part of a financial holding company, the act calls for consultation, coordination, and information sharing among federal financial regulators and state insurance regulators.<sup>10</sup> In addition, although GLBA established the Federal Reserve as the umbrella regulator of financial holding companies, the act requires the Federal Reserve generally to coordinate with and defer to the “functional” regulators with respect to the institutions they regulate.<sup>11</sup> Federal Reserve supervision of holding companies is to focus primarily on the consolidated

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<sup>7</sup>Under OCC regulations effective December 31, 1996, national banks were permitted to engage in a broader range of activities through subsidiaries than the Comptroller permitted within the banks themselves. See 61 Fed. Reg. 60351-52 (Nov. 27, 1996).

<sup>8</sup>National banks can be subject to SEC broker registration requirements if they execute orders for customers that involve securities not exempt from SEC jurisdiction or transactions not subject to an exception under the securities laws. See 15 U.S.C. § 78c(a)(4) (2000 & Supp. 2004).

<sup>9</sup>Subject to the preemption standard set forth in GLBA and prohibitions against discriminatory state laws, GLBA authorizes limited state regulation of insurance sales by banks and savings associations. Pub. L. No. 106-102 § 104, 15 U.S.C. § 6701 (2000 & Supp. 2004).

<sup>10</sup>Pub. L. No. 106-102 § 307, 15 U.S.C. § 6716 (2000 & Supp. 2004).

<sup>11</sup>Pub. L. No. 106-102 §§ 111, 112, 12 U.S.C. §§ 1844(c), (g).

risk position of the entire holding company, the risks the holding company system may pose to the safety and soundness of any of its depository institution subsidiaries, and compliance with consumer protection laws it is charged with enforcing.<sup>12</sup> GLBA also retained OTS responsibility for supervising thrift holding companies, although it did limit the ability of nonfinancial companies to obtain thrift charters after May 4, 1999. In addition to establishing the scheme for the regulation of consolidated financial organizations involving a bank or thrift, GLBA provided for a program allowing for consolidated supervision by the SEC of investment bank holding companies.

One area for which GLBA discussed a potential new regulatory agency was insurance. As an incentive for states to modernize and achieve uniformity in insurance regulation, GLBA provided for a federal licensing agency, the National Association of Registered Agents and Brokers, that was to come into existence three years after the enactment of GLBA, if a majority of states failed to enact legislation for state uniformity or reciprocity.<sup>13</sup> However, that agency has not come into existence because a majority of the states adopted the types of laws and regulations called for in the section.

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**Since 1990, Various**  
**Proposals Have Sought to**  
**Simplify the Bank**  
**Regulatory Structure and**  
**Reduce the Number of**  
**Regulators**

According to FDIC, many regulatory restructuring proposals concerned the restructuring of the multiagency system for federal oversight of banking institutions in the United States have been made since the 1930s, when federal deposit insurance was introduced. Since 1990 several additional proposals have been made, including the following three made between 1993 and 1994:

- 1994 Treasury proposal.<sup>14</sup> This proposal would have realigned the federal banking agencies by core policy functions—that is, bank supervision and regulation function, central bank function, and deposit insurance function. Generally, this proposal would have combined OCC, OTS, and certain functions of the Federal Reserve and FDIC into a new

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<sup>12</sup>Pub. L. No. 106-102 § 111, 12 U.S.C. § 1844(c).

<sup>13</sup>Pub. L. No. 106-102 § 321.

<sup>14</sup>This proposal was outlined in the statement of the Honorable Lloyd Bentsen, Secretary of the Treasury, before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate (Mar. 1, 1994).

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independent agency, the Federal Banking Commission, that would have been responsible for bank supervision and regulation. FDIC would have continued to be responsible for administering federal deposit insurance, and the Federal Reserve would have retained central bank responsibilities for monetary policy, liquidity lending, and the payments system. Although FDIC and the Federal Reserve would have lost most bank supervisory rule-making powers, each would have been allowed access to all information of the new agency as well as limited secondary or backup enforcement authority. In addition, the Federal Reserve would be authorized to examine a cross section of large and small banking organizations jointly with the new agency. FDIC would have continued to oversee activities of state banks and thrifts that could pose risks to the insurance funds and to resolve failures of insured banks.

- H.R. 1227 (1993).<sup>15</sup> This proposal would have consolidated OCC and OTS in an independent Federal Bank Agency and aligned responsibilities among the new and the other existing agencies. It also would have reduced the multiplicity of regulators to which a single banking organization could be subject, while avoiding the concentration of regulatory power of a single federal agency. The role of the Federal Financial Institution Examination Council would have been strengthened; it would have seen to the uniformity of examinations, regulation, and supervision among the three remaining supervisors. According to a Congressional Research Service (CRS) analysis, this proposal would have put the Federal Reserve in charge of more than 40 percent of banking organization assets, with the rest divided between the new agency and a reorganized FDIC.<sup>16</sup>
- 1994 LaWare proposal.<sup>17</sup> The LaWare proposal was outlined in congressional testimony, but never presented as a formal legislative proposal, according to Federal Reserve officials. It called for a division of responsibilities defined by charter class and a merging of OCC and OTS responsibilities. The two primary agencies under the proposal

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<sup>15</sup>H.R. 1227: The Bank Regulatory Consolidation and Reform Act of 1993 (Mar. 4, 1993).

<sup>16</sup>CRS, *Bank Regulatory Agency Consolidation Proposals: A Structural Analysis* (Washington, D.C.; Mar. 18, 1994).

<sup>17</sup>This proposal was outlined in the statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate (Mar. 2, 1994).

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would have been an independent Federal Banking Commission and the Federal Reserve, which would have supervised all independent state banks and all depository institutions in any holding company whose lead institution was a state-chartered bank. The new agency would have supervised all independent national banks and thrifts and all depository institutions in any banking organization whose lead institution was a national bank or thrift. FDIC would not have examined financially healthy institutions, but would have been authorized to join in examination of problem banking institutions. Based on estimates of assets of commercial banks and thrifts performed by CRS, the LaWare proposal would have put the new agency in charge of somewhat more commercial bank assets than the Federal Reserve.

In 1996, we also recommended ways to simplify bank oversight in the United States in accord with four principles for effective supervision:

- consolidated and comprehensive oversight of entire banking organizations, with coordinated functional regulation and supervision of individual components;
- independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight;
- consistent rules, consistently applied for similar activities; and
- enhanced efficiency and as low a regulatory burden as possible consistent with maintaining safety and soundness.

We recommended consolidating the primary supervisory responsibilities of OTS, OCC, and FDIC into a new, independent federal banking agency or commission. This new agency, together with the Federal Reserve, would be assigned responsibility for consolidated, comprehensive supervision of those banking organizations under its purview, with appropriate functional supervision of individual components. We also recommended that in order to carry out its primary responsibilities effectively, the Federal Reserve should have direct access to supervisory information as well as influence over supervisory decision making and the banking industry. In addition, we recommended that Treasury have access to supervisory information, including information on the safety and soundness of banking institutions that could affect the stability of the financial system. Furthermore, we recommended that under any restructuring, FDIC should have an explicit backup supervisory authority to enable it to effectively discharge its

responsibility for protecting the deposit insurance funds. In coordination with other regulators, such authority should allow FDIC to go into any problem institution on its own without the prior approval of any other regulatory agency.

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**Partly in Response to  
Market Convergence,  
Proposals Have Been Made  
to Consolidate Securities  
and Futures Regulators**

Over the years, proposals have been made to consolidate SEC and CFTC, partly in response to increasing convergence in new financial instruments and trading strategies of the securities and futures markets. For instance, according to a 1990 CRS study, futures contracts based on financial instruments such as stock indexes are used by securities firms and large institutional investors simultaneously and are sometimes interchangeable with certain securities products. However, these transactions are regulated separately by CFTC and SEC. Prior to the passage of the Commodity Futures Modernization Act (CFMA) in 2000, the two agencies had disagreed on the jurisdiction of certain derivatives. In addition, new trading strategies involving both securities and futures transactions that have significant potential impacts on price movements have called for the need for better monitoring. Treasury also proposed three options to address these industry changes: (1) merging SEC and CFTC, (2) giving SEC regulatory authority over all financial futures, or (3) transferring regulation of stock index futures from CFTC to SEC.

In 1995, Members of Congress introduced the Markets and Trading Reorganization and Reform Act, which was intended to improve the effectiveness and efficiency of financial services regulation by merging SEC and CFTC. In testimony before the House Committee on Banking and Financial Services, we presented the major benefits and risks of merging SEC and CFTC, as well as specific issues related to this bill, to be considered in merging the two agencies. The anticipated benefits of a merger would have included reduced regulatory uncertainty concerning the two agencies' regulatory jurisdictions over particular financial products, a clarification that would likely have enhanced market efficiency and innovation. Another potential benefit we identified was greater ease in conducting international regulatory negotiations. We also identified some risks involved in such a merger, including (1) a potential for over-regulation that might have resulted in decreased market innovation and (2) a potential dominance of one market and regulatory perspective to the detriment of the other. In addition, we noted some operational risk that might arise during the transition to a single government agency, such as differences in institutional cultures and histories. Finally, we cautioned those considering the merger about the difficulty of quantifying both potential benefits and

risks, and noted further that a merger might yield only small budgetary cost savings.

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### Efforts Have Been Made to Change the SRO Structure for Securities

In 2002, NASD completed the sale of its subsidiary Nasdaq Stock Market Inc. (NASDAQ), in recognition of the inherent conflicts of interest that exist when SROs are both market operators and regulators. These conflicts had become evident in the mid-1990s when NASD was under scrutiny for price fixing. Concerns about conflicts of interest and regulatory inefficiencies also prompted proposals to simplify the SRO structure for securities. In January 2000, the Securities Industry Association (SIA) detailed the following three possibilities for changing the SRO structure.<sup>18</sup>

- Hybrid SRO model. Under this model, a single consolidated entity unaffiliated with any market would have assumed responsibility for broker-dealer self-regulation and cross-market issues, such as those related to sales practices, industry admissions, financial responsibility, and cross-market trading. Individual SROs would have remained responsible for market-specific rules, such as those related to listings, governance, and market-specific trading. The majority of SIA members believed that the hybrid SRO model would reduce member-related conflicts of interest and SRO inefficiencies. Eliminating duplicative SRO examinations, in their view, would have reduced inefficiencies in areas such as rule making, examinations, and staffing. SEC officials agreed that consolidating member regulation into one SRO could be an advantage of the hybrid SRO model. They noted that the industry was moving toward a hybrid model as NASDAQ separated from NASD and NASD contracted to provide regulatory services to more SROs.
- Single SRO model. Under this model, a single SRO would have been vested with responsibility for all regulatory functions currently performed by the SROs, including market-specific and broker-dealer regulation. According to SIA, the single SRO model could have eliminated the conflicts of interest and regulatory inefficiencies associated with multiple SROs, including those that would remain under

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<sup>18</sup>SIA, *Reinventing Self-Regulation, White Paper of the Securities Industry Association's Ad Hoc Committee on Regulatory Implications of De-Mutualization* (Washington, D.C.; Jan. 5, 2000). We discussed this report and SEC's views in our report *Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation*, [GAO-02-362](#) (Washington, D.C.: May 3, 2002).

the hybrid SRO model. However, SIA did not endorse this alternative, primarily because of the risk that self-regulation would have become too far removed from the functioning of the markets. In May 2002, we reported that, according to SEC officials, it might not be appropriate or feasible to give a single SRO responsibility for surveilling all of the markets, such as NASDAQ and NYSE, which have different rules that reflect differences in the way trades are executed.<sup>19</sup>

- SEC-only model. Under this model, SEC would have assumed all of the regulatory functions currently performed by SROs. SIA did not endorse the SEC-only model because doing so would have eliminated self-regulation of the securities industry, taking with it the expertise that market participants contribute. SIA also expected the SEC-only model would have been more expensive and bureaucratic, because implementing it would have required additional SEC staff and mechanisms to replace SRO regulatory staff and processes. In addition, according to SIA's report and SEC, a previous SEC attempt at direct regulation was not successful, owing to its high cost and low quality (relative to self-regulation), and this convinced SEC and other market participants that it was not a feasible regulatory approach.<sup>20</sup>

We reported in 2002 that at that time, none of the models appeared to have the support from market participants that would be needed for implementation. However, since that time the governance structures of SROs have been under greater scrutiny.

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## Proposals Have Been Made for an Optional Federal Insurance Charter

While proposals to regulate insurance at the federal level have been made from time to time, since 2000 this idea has been gathering steam. Several trade associations have made proposals for some federal regulation of insurance, and bills have been introduced in Congress. According to a CRS study, two bills introduced in the 107th Congress—the National Insurance Chartering and Supervision Act and the Insurance Industry Modernization

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<sup>19</sup>GAO-02-362.

<sup>20</sup>In 1965, SEC became responsible for direct regulation of a small number of broker-dealers that traded only in the over-the-counter market. This program, called the Securities and Exchange Only program, was designed to provide participating firms with a regulatory alternative to NASD. In 1983, SEC concluded that the industry would be better served if the program were discontinued, because needed improvements would be costly and not an efficient use of agency resources.

and Consumer Protection Act—included an optional federal charter for insurance companies that would be similar to a national bank charter. The proposals would have required the creation of a federal insurance regulator. These proposals suggested creating a new federal agency (similar to OCC and OTS) in Treasury. A bill introduced in July 2003, the Insurance Consumer Protection Act, would create a federal commission within the Department of Commerce to regulate the interstate business of property-casualty and life insurance and require federal regulation of all interstate insurers. It thus would pre-empt most current state regulation of insurance. Generally, these proposals differed in whether a federal charter would include insurance agencies, brokers, or agents and where a federal regulator would be housed.

Supporters of an optional federal charter include members of trade associations that generally represent the interests of larger life and property-casualty insurers—the American Council of Life Insurers, the American Bankers Insurance Association, and the American Insurance Association. These and other supporters have argued that an optional federal charter had benefited the banking sector by encouraging competition, regulatory efficiency, and product expansion and would benefit insurers by (1) removing the disadvantage large insurers have in competing with other financial service providers because large insurers have to comply with multiple state insurance standards; (2) allowing for more innovation among insurers because they would no longer have to secure product approval from different state regulators; (3) better representing the industry in federal policy and international trade negotiations through a single federal regulator; and (4) allowing consumers to have more product choices and more uniform protections across states.

Opponents of an optional federal charter, including some smaller life insurers, property-casualty insurers specializing in local services such as auto and homeowners insurance, and consumer groups, have argued that creating a new federal regulator would (1) create competition over industry charters between the federal regulator and state regulators and hence cause deterioration in the state regulatory system and industry regulatory standards; (2) lead to the loss of regulatory innovation and the testing and emergence of better policies because the current state system allows for regulatory innovation; and (3) be more costly than supporting NAIC's current efforts to achieve uniformity in the state system; and (4) be less responsive to consumer needs.



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**Proposals Made Before and**  
**After GLBA Cut across**  
**Functional Areas**

Prior to the passage of GLBA, some proposals to restructure the U.S. regulatory system concerned regulators across the financial services sectors. For example, in the early 1990s the Chicago Mercantile Exchange proposed that all federal financial regulation, including that of OCC, OTS, FDIC, CFTC, SEC, and certain functions of the Federal Reserve, be consolidated into “a single cabinet level department within the executive branch” to, among other things, facilitate regulatory coordination and allow for equal regulation of similar products, services and markets. In 1997, a congressional proposal included a National Financial Services Oversight Committee with representatives from Treasury, each of the federal bank regulators, SEC, and CFTC that would, among other things, establish uniform examination and supervision standards for financial services providers and identify providers that require “special supervisory attention.” Following the passage in 1999 of GLBA, which did not change the regulatory structure, calls for regulatory restructuring across sectors continued, including a recommendation in 2002, by the Chairman of FDIC, for a single bank regulator, securities regulator, and insurance regulator at the federal level.

# Regulators Are Adapting Regulatory and Supervisory Approaches in Response to Industry Changes

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Although the U.S. regulatory structure has not changed in response to the industry changes we have identified—globalization, consolidation, conglomeration, and convergence—some U.S. regulators have adapted their regulatory and supervisory approaches to these changes. Some of these adaptations, especially those related to large, internationally active firms, have been made as part of or in response to efforts to achieve some degree of harmonization across the major industrial nations and within the EU. Some U.S. regulatory agencies have also made or considered other changes in response to the industry changes that we have identified.

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## New Basel II Structure and EU Requirements Will Likely Affect Oversight of U.S. Financial Institutions

As part of the evidence of continuing globalization and increased complexity of financial institutions, the Basel Committee adopted a new set of standards (Basel II) in June 2004 that member and nonmember countries may adopt.<sup>1</sup> These Basel II requirements are designed to address some of the shortcomings of the Basel I standards, and include supervision and market discipline requirements as well as standards for minimum capital levels. U.S. bank regulators are in the process of determining how to apply these standards for large, internationally active firms. Because the EU is requiring securities firms and other firms with significant insurance operations operating in the EU to adopt Basel standards as part of its Action Plan, international harmonization efforts are also having an impact on other U.S. regulators that oversee large, internationally active firms.

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## While U.S. Regulators Applied Basel I Standards to All Banks, They Propose to Require Only Large, Internationally Active Banks to Adopt Basel II Standards

In 1988, the Basel Committee adopted the Basel Accord for international convergence of capital standards (now referred to as Basel I) to provide uniform risk-based capital requirements with the objectives of strengthening the soundness and stability of the international banking system and diminishing a source of competitive inequality among international banks. These risk-based capital requirements, which were available for implementation in the Basel Committee members' countries between 1990 and 1992, focused on limiting credit risk by requiring certain firms to hold capital equal to at least 8 percent of the total value of their risk-weighted on-balance sheet assets and off-balance sheet items, after adjusting the value of the assets according to certain rules intended to

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<sup>1</sup>The Basel II framework includes several levels of approaches for determining capital requirements for banks. While the standard approaches will be available for implementation in 2006, the most advanced approaches, which are the only ones being proposed for some U.S. banks, will not be available for implementation until 2007.

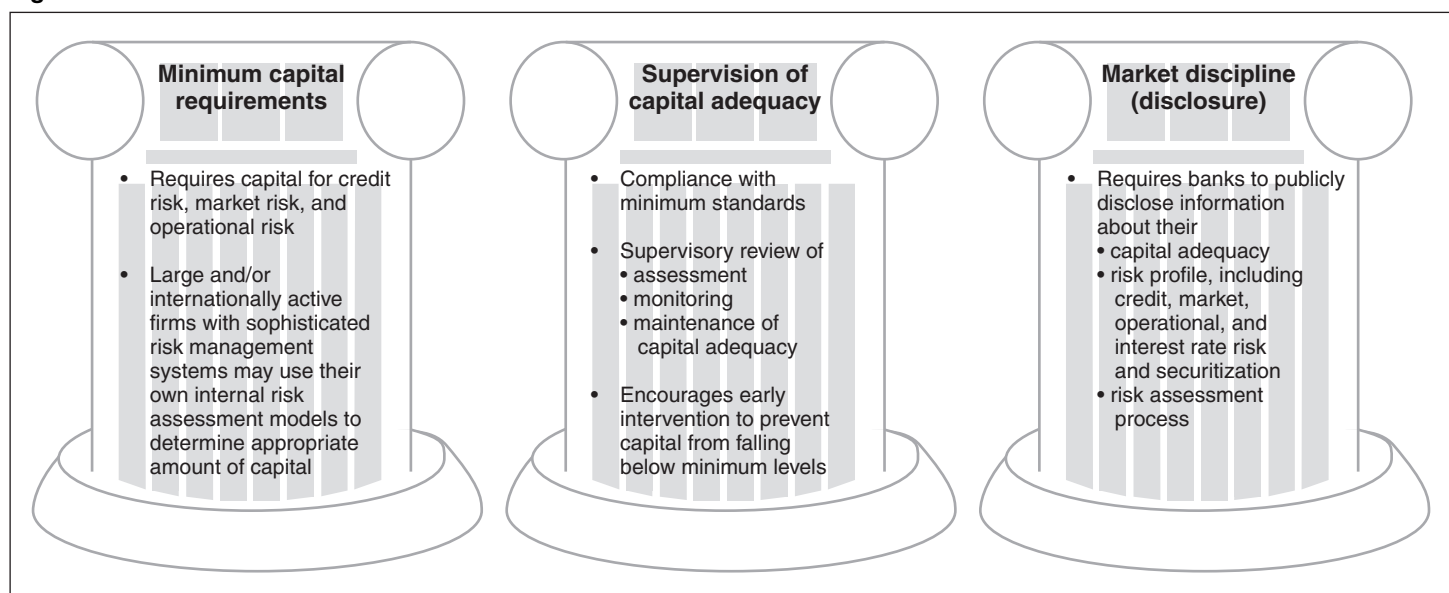
reflect their relative risk.<sup>2</sup> U.S. bank regulators applied these standards to banks and bank holding companies. Basel I was amended in 1996 to include capital requirements for market risks for those banks or bank holding companies with a certain amount of securities and derivatives trading activity or, if deemed necessary by the regulator for safety and soundness purposes. Although Basel I generally is credited with improving the regulatory capital levels of most banks and reducing competitive inequities among international banks, it did not fully address changes and risks arising from increasingly complex financial markets. For instance, Basel I did not account for the internal credit risk mitigation activities of large, internationally active banks. Also, the limited number of risk-weighted categories under Basel I meant that the standards had limited risk sensitivity. This has, among other outcomes, allowed banks to take on higher risk assets within each category without having to hold more capital for regulatory purposes. Moreover, Basel I did not explicitly account for operational risks, such as poor management or security and process failures.

Basel II, which is available for implementation in banking organizations in 2006 or 2007, is intended to address the shortcomings of Basel I. As illustrated in figure 7, Basel II has three pillars: (1) minimum capital requirements, (2) supervision of capital adequacy, and (3) market discipline in the form of increased disclosure.

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<sup>2</sup>Off-balance sheet items are financial contracts that can create credit losses for banks but are not reported on banks' balance sheets under standard accounting practices. An example of such an off-balance sheet position is a letter of credit or an unused line of credit committing the bank to making a loan in the future that would be on the balance sheet and thus creates a credit risk. To adjust for credit risks created by financial positions not reported on the balance sheet, U.S. regulations provide conversion factors to express off-balance sheet items as equivalent on-balance sheet items, as well as rules for incorporating the credit risk of off-balance sheet derivatives.

Figure 7: The Three Pillars of Basel II



Source: GAO.

Under the first pillar of Basel II—the definition of capital—the treatment of market risk and the minimum capital requirement of 8 percent of risk-weighted assets remain the same as that in Basel I. With regard to credit and operational risk, however, Basel II allows firms with sophisticated risk management systems—generally large or internationally active firms—to use their internal risk assessment models and techniques to determine the appropriate amount of regulatory capital, with certain restrictions. These advanced approaches will not be available for implementation until the end of 2007.

The second pillar of Basel II focuses on supervisory review of and action in response to banks' capital adequacy. Supervisory review is expected to capture potential risks, including those that are external to banks, that are not fully captured under Pillar I and to assess banks' compliance with minimum standards and disclosure requirements of the more advanced capital calculation options being used by some firms. Supervisors are to evaluate banks' assessment, monitoring, and maintenance of their capital adequacy relative to their risk profile, including compliance with regulatory capital ratios. Supervisory review can involve on-site examinations or inspections, off-site review, discussions with bank management, review of work done by external auditors, and periodic reporting. Basel II calls for

supervisors to intervene at an early stage to prevent capital from falling below minimum levels and to require remedial action if capital is not maintained or restored.

The third pillar of Basel II—market discipline—calls for banks to disclose information about their risk profile, risk assessment processes, and adequacy of their capital levels. The rationale is that a bank's borrowing and capital costs will rise if market participants perceive a bank to be risky, and banks will thus have an incentive to refrain from excessive risk taking. Members of the Basel Committee note that market discipline will become more important once banks are using their internal models and techniques to make capital decisions.

In recognition that large, internationally active banks pose different risks and use different risk management techniques than smaller, less internationally active banks, U.S. regulators are proposing to require that only a number of large, internationally active institutions comply with capital standards that are consistent with Basel II. Federal regulators expect that fewer than 10 large, internationally active banking organizations will be required to operate under rules consistent with Basel II by the end of 2007. Under current proposals, other U.S. banks that satisfy certain requirements will have the option of implementing the Basel II framework, and federal regulators expect roughly another 10 large banking organizations to adopt capital standards consistent with Basel II requirements.

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**EU Financial  
Conglomerates Directive Is  
Requiring Some Securities  
and Insurance Firms to  
Have Consolidated  
Supervision and Apply Basel  
Capital Standards**

Certain directives in the EU Action Plan, especially the Financial Conglomerates Directive, will impact some internationally active firms in the United States, especially those that have not been subject to bank or financial holding company oversight by the Federal Reserve because they do not own commercial banks. In recognition of the risks posed by financial conglomerates and other financial firms that do not have consolidated supervision, the directive specifies minimum requirements for consolidated supervision of such firms conducting business in the EU. The directive defines a financial conglomerate as a firm with insurance operations that also engages in banking or securities activities. In addition, the directive requires that non-European conglomerates, banks, and securities firms have adequate consolidated supervision, which would

generally include application of Basel standards.<sup>3</sup> Under the directive, which goes into effect at the beginning of 2005, a non-European financial conglomerate or group that has a banking presence in the EU that is not considered to be supervised on a consolidated basis by an equivalent home country supervisor would be subject to additional requirements by EU regulators, which could include additional direct supervision.

U.S. regulators that provide or might provide consolidated oversight—the Federal Reserve, OTS, and SEC, among others—responded to EU requests for information about their activities as holding company supervisors. This information was used to develop EU guidance for EU country regulators in determining whether U.S. firms doing business in EU countries have consolidated supervision that is equivalent to that required to be in place in EU host countries. According to EU officials, specific regulators in EU countries will use this guidance to determine whether a specific U.S. company operating in Europe has adequate consolidated supervision.

Officials at the Federal Reserve say that they do not expect to have to make any changes in the way they oversee bank or financial holding companies to be deemed an equivalent home country supervisor for affected companies under their supervision. However, because U.S. securities firms that are not owned by a bank or financial holding company are currently not supervised on a consolidated basis the way bank and financial holding companies are, to comply with the directive, these securities firms that conduct business in the EU will need to have a consolidated supervisor sometime in 2005.<sup>4</sup> Some of these firms requested that SEC develop a program to provide them with consolidated supervision, and SEC responded with its CSE proposal. Firms opting to become CSEs will be subject to capital requirements that are consistent with Basel standards,<sup>5</sup> which are described by the rules governing CSEs as an alternative to the

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<sup>3</sup>EU member states have been required to adopt capital adequacy rules that are generally consistent with Basel standards for credit institutions (banks and securities firms). Thus, to satisfy the EU requirements, U.S. banks and securities firms operating in EU member states would be subject to similar requirements. The EU is currently considering amendments to relevant directives partly in response to the adoption of Basel II.

<sup>4</sup>See SEC, Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Entities, 69 FR 34428 (June 21, 2004); and Supervised Investment Bank Holding Companies 69 FR 34472 (June 21, 2004).

<sup>5</sup>Because the EU Financial Conglomerate Directive is effective in January 2005 and the Basel II standards are not required until year-end 2006, there is some question as to whether CSEs will adopt Basel II standards at the time of their registration.

net capital requirements generally required for broker dealers.<sup>6</sup> Because the requirements of Basel II were not established with U.S. securities firms in mind, SEC staff notes that it is participating in a joint working group established by IOSCO and the Basel Committee to address issues relating to the treatment of positions held in the trading book. One issue of interest to holding companies with broker-dealer subsidiaries is the development of a more risk-based approach to capital requirements for securities activities. For example, since the Basel II standards were developed with the expectation of long-term credit exposures that are common for banks, securities firms believe that credit risk in their trading books that have much shorter exposures is overstated using Basel II requirements. IOSCO and the Basel Committee have had several meetings to discuss this and other issues.

With regard to required examination and disclosure requirements at the consolidated level, SEC says it expects to better monitor the financial condition, risk management, and activities of a broker-dealer's affiliates that could impair the financial and operational stability of the broker-dealer or CSE. SEC will examine regulated affiliates of CSE's that do not have a principal U.S. regulator, but will defer to the UK-FSA (or another EU regulator) to examine affiliates in EU countries. For the ultimate holding company, SEC will examine the holding company unless it determines that it is already subject to "comprehensive, consolidated supervision" by another principal regulator. Thus, bank or financial holding companies generally would be exempt from SEC examination. In the case of holding companies, SEC believes the disclosure requirements that are part of Basel II are not consistent with those required by SEC.<sup>7</sup> However, SEC staff said that they would apply Basel II disclosure standards while working to make them more consistent. SEC says that data being collected by the Basel Committee to measure the impact of Basel II will include data from the large securities firms that will register as CSEs, and this may allow the standards to better reflect the risks of these firms over time.

In response to the Financial Conglomerates Directive, U.S. and other firms with insurance and banking operations in the EU will need to choose a consolidated regulator and comply with Basel II. OTS is responsible for the

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<sup>6</sup>Some bank, financial, and thrift holding companies with significant broker-dealer affiliates may also register as CSEs. Their broker-dealers will have the option of complying with the capital standards consistent with Basel II rather than SEC's net capital rule.

<sup>7</sup>SEC staff notes that it raised this issue before completion of the final Basel II draft.

consolidated supervision of Thrift Holding Companies, including a number of firms that are conglomerates under the EU directive. Some of the largest such firms may choose OTS as their consolidated supervisor for purposes of the directive. These firms qualify as thrift holding companies because they own a thrift under the exemption provided before May 1999 or have obtained a thrift charter since then. Officials at OTS say that 40 companies with insurance operations are now thrift holding companies, but not all of these are operating in EU countries or would be deemed conglomerates. These companies may not qualify as financial holding companies because they do not own a commercial bank and the scope of their activities, which may include commercial enterprises, make doing so impractical. Furthermore, they may not qualify for SEC oversight because they do not have a broker-dealer affiliate with a substantial presence in the securities markets. OTS expects its level of supervisory coordination with foreign regulators to increase as a result of the EU directive.

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## **U.S. Regulators Have Made or Considered Some Other Changes to Their Regulatory and Supervisory Approaches in Response to Industry Changes**

Because of the increased size and complexity of some banks, U.S. bank regulators had adopted risk-focused examination procedures that tailor reviews to key characteristics of each bank, including its asset size, products offered, markets in which it competes, and its tolerance for risk. In recognition of the increased size of the largest banks and the possibility that shareholders and creditors believe that these banks are too big for regulators to allow them to fail, regulators have considered requiring banks to issue subordinated debt as a mechanism to enhance market discipline of banking institutions. However, regulators have not adopted this requirement, because evidence of its potential effectiveness is limited. Bank regulators also have adjusted their approaches in response to what appears to be heightened concern about reputational risk. SEC had made some changes related to the increased size and complexity of securities firms prior to adopting its consolidated supervision rules in response to the EU financial conglomerates directive. These changes affected the collection of information related to risk management from the parents and affiliates of broker-dealers. While CFTC and state insurance regulators will not adopt Basel II requirements, they have made other changes that acknowledge how the industry is changing. CFMA acknowledges the increasingly global nature of the futures industry and the increasing importance of new financial products. As a result of property-casualty failures in the 1980s and recognition of changes in the insurance industry, NAIC adopted a new Solvency Policy Agenda that included risk-based capital and the creation of a Financial Analysis Unit that analyzes the behavior of insurers that operate across state lines.



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U.S. Bank Regulators  
Adopted Risk-Focused  
Supervision for Large,  
Complex Firms and Made or  
Considered Other Changes

In response to the development of large, complex banking organizations with diverse and changing risks and sophisticated risk management systems, U.S. bank regulators have generally placed greater emphasis on examining an institution's internal control systems and on the way it manages and controls its risks, rather than on assessing a bank's condition at a specific point in time. The federal bank regulators generally apply risk-focused examinations. We reported in 2000 that since the mid-1990s, the Federal Reserve and OCC have developed and refined their on-site examination policies and procedures for large, complex banks to focus on risk assessments along business lines, which often cross bank charters within the banking organization.<sup>8</sup> Under the risk-focused approach, Federal Reserve and OCC examiners are to continually monitor and assess an institution's financial condition and risk management systems through the review of a variety of management reports and frequent meetings with key bank officials, documenting the areas they select for review, including their rationale for selecting those areas. Federal Reserve officials noted that detecting fraud remains a difficult task under the risk-focused approach, but that the approach was designed to detect the areas of a bank's (or bank holding company's) activities that posed the greatest risk to the safety and soundness of the institution.

In 2002, FDIC adopted an agreement with OTS, OCC, and the Federal Reserve that allows FDIC to examine insured depository institutions that pose a greater than normal risk to the deposit insurance funds. According to FDIC's annual report, under the agreement FDIC has assigned dedicated examiners to each of the eight largest insured banking institutions to monitor their financial condition and risk management processes and obtain timely information on the potential risks of these institutions. As FDIC is not the primary regulator of these institutions, it will rely on supervisory information provided by the primary regulators. In 2003, FDIC established a Risk Analysis Center to analyze information generated from the dedicated examiner program, among other tasks.

One change that has been discussed but not made in response to the growing size of banks is whether banks should be required to issue subordinated debt as a market discipline tool. The usual disclosure requirements for publicly traded companies may not be sufficient for large

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<sup>8</sup>GAO, *Risk-Focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*, GAO/GGD-00-48 (Washington, D.C.: Jan. 24, 2000).

banks because shareholders may believe that the banks are too big for regulators to allow them to fail. Because subordinated creditors are especially sensitive to risks that a bank may fail, mandatory issuance of subordinated debt has been proposed as a means of enhancing market discipline to inhibit risk-taking activities and limit losses to the insurance funds when excessive risk taking damages a bank. Requiring banks to issue subordinated debt has been discussed in relation to the market discipline pillar of Basel II, but no such requirement appears in the standards adopted in June 2004. Similar proposals have not been adopted in the United States. GLBA directed the Federal Reserve and Treasury to study the feasibility of requiring depository institutions that pose significant systemic risk and their holding companies to maintain some portion of their capital in the form of subordinated debt. The Federal Reserve and Treasury supported the use of subordinated debt as a way of enhancing market discipline but said that more evidence would be needed to make such a policy mandatory. According to the report, almost all of the largest banking organizations had voluntarily issued and had subordinated debt outstanding in excess of 1 percent of their assets, providing some degree of direct market discipline and transparency. The Federal Reserve, OCC, and OTS agreed to continue to use various data and supervision to evaluate the use of subordinated debt.

U.S. bank regulators are also charged with ensuring that banks comply with various consumer protection laws and laws concerning money laundering and corporate governance issues. In addition to safety and soundness examinations, banks are also subject to examinations that evaluate their performance in meeting the needs of their communities under the Community Reinvestment Act and their compliance with anti-money laundering rules under the Bank Secrecy Act and the USA PATRIOT Act. The regulatory agencies recently announced new examination procedures for banks' customer identification programs, for instance; this program was required under section 326 of the USA PATRIOT Act.<sup>9</sup> Regulators also note that failure to comply with consumer protection and anti-money laundering laws and regulations can endanger a bank's safety and soundness because they may affect the bank's reputation. For example, OCC asserts that predatory lending practices in national banks could damage the reputations

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<sup>9</sup>See joint press release issued by Federal Reserve, FDIC, NCUA, OCC, and OTS (Washington, D.C.; July 28, 2004), <http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040728/default.htm> (downloaded Sept. 10, 2004). See also 31 U.S.C. 5318(l) (2000 & Supp. 2004).

and thus the safety and soundness of those institutions. Furthermore, recent money laundering activities at some banks—which could affect the reputation of those banks—appear to have heightened regulatory efforts to prevent such activity.

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**SEC Had Made Changes**  
**Related to Size and**  
**Complexity of Firms Prior**  
**to Becoming a Consolidated**  
**Regulator**

With regard to adopting consolidated regulations for CSEs and SIBHCs, SEC officials said that what appear to be significant changes in their regulatory and supervisory approach are merely continuations of previously ongoing trends that recognized the increased size and complexity of many securities firms. Further, SEC officials recognize that because of the size of the parent firms, the sudden failure of a large securities firm that has broker-dealer affiliates could have a major impact on markets and investors.

SEC says that in setting capital requirements, it has been concerned with the safety and soundness of broker-dealers for some time. Since 1975, the net capital rule has required that broker-dealers maintain a minimum level of net capital sufficient to satisfy all obligations to customers and other market participants and to provide a cushion of liquid assets to cover potential credit, market, and other risks. SEC amended its net capital rule in early 1997 to allow broker-dealers to use statistical models to calculate required capital charges for exchange-traded financial instruments to better reflect market risk. In 1999, SEC adopted an optional regulatory framework that includes alternative net capital requirements for OTC derivatives dealers. Under this framework, OTC derivatives dealers may be permitted to use statistical models to calculate capital charges for market risk and to take alternative charges for credit risk. SEC rules also require firms to integrate their statistical models into their daily risk management processes and establish a system of internal controls to monitor and manage the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks. With regard to supervision of risk management of securities firms, SEC officials say that they have long sought more information on the parents and affiliates of broker-dealers. Since 1992, SEC has collected risk assessment information from securities firms that own large broker-dealers. And, beginning in 1999, SEC has held monthly discussions regarding these risk assessments.

Much of SEC's examination program is related to ensuring that SROs, broker-dealers, and investment advisers comply with federal securities laws and rules, including having adequate systems and procedures in place to ensure compliance. SEC's examination procedures have evolved over

time. In the mid-1990s, SEC's examination office began conducting fewer full scope examinations, which review all aspects of operations, and more frequent risk-focused examinations, which focus on specific areas or issues. We noted in a 2002 report<sup>10</sup> that although SEC officials said they had been able to maintain their examination schedules and workload with their existing staff levels, some officials were concerned that the cycle for certain types of reviews could stretch beyond the planned time frames. In that report, we noted SEC officials also said that newly implemented rules would add time and complexity to the reviews. Overall, SEC officials said their examination office had lost a lot of experienced staff at the junior level and that new staff requires constant training.

With the corporate governance and accounting scandals that came to light beginning in 2002 and with the 2003 revelation of market timing and late trading abuses in mutual funds, SEC has made additional changes in its compliance exams and developed rules to improve corporate governance. We have reported that SEC did not identify the abusive practices in mutual funds for several reasons, including the inherent difficulty of detecting fraud and the focus of examinations on operations of mutual funds rather than on trading in the funds themselves.<sup>11</sup> In response to late trading and other abuses in the mutual fund industry, SEC says that it is reassessing its supervision of investment companies.

We also reported that anticipating and identifying problems in a timely manner is a continuing problem for SEC:

One of the challenges SEC faces is being able to anticipate potential problems and identify the extent to which they exist. Historically, limited resources have forced the SEC to be largely reactive, focusing on the most critical events of the day. In this mode, the agency lacked the institutional structure and capability to systematically anticipate risks and align agencywide resources against those risks. In an environment like this, it is perhaps not surprising that SEC was not able to identify the widespread misconduct and trading abuses in the mutual fund industry. Increasing SEC's effectiveness would require it to become more proactive by thinking strategically, identifying and prioritizing emerging issues, and marshaling resources from across the organization to answer its most pressing needs.<sup>12</sup> SEC

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<sup>10</sup>GAO, *SEC Operations: Increased Workload Creates Challenges*, [GAO-02-302](#) (Washington, D.C.: Mar. 5, 2002).

<sup>11</sup>GAO, *SEC Operations: Oversight of Mutual Fund Industry Presents Management Challenges*, [GAO-04-584T](#) (Washington, D.C.: Apr. 20, 2004).

<sup>12</sup>[GAO-04-584T](#), 14.

is in the process of staffing a new risk assessment office that may lead to more proactive risk-based policies in the future.

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**Futures and Insurance  
Regulators Have Not  
Adopted Basel Standards,  
but Have Made Changes in  
Their Regulatory and  
Supervisory Approaches**

Many of the changes being made in CFTC's regulatory and supervisory approaches have come as a result of the passage of CFMA in 2000. The primary goal of that legislation was to address changes in market conditions such as the introduction of a wider variety of products, including contracts based on individual stocks. CFMA replaced "one-size-fits-all" regulation with broad, flexible core principles.<sup>13</sup> Generally, the new rules recognize the speed with which these markets change by laying out core principles for participants and markets, rather than by specifying prescriptive rules.<sup>14</sup> For example, a CFTC regulation requires that certain entities—derivatives transaction execution facilities and contract markets—provide authorities and the public with trading information such as trading practices and contract conditions and prices, and that they enforce rules to minimize conflicts of interest in the decision making process, but it does not require specific measures for carrying out the principles.<sup>15</sup>

CFTC has also changed its net capital rules for FCMs to better reflect changes in the commodity business. To modernize capital requirements for FCMs, CFTC adopted rules in August 2004 that replace the net capital requirement based on segregated customer funds with minimum risk-based capital requirements. The new rules attempt to reflect an FCM's complete exposure to commodity positions carried for both customers and noncustomers. According to CFTC's 2003 annual report, the rules are expected to ensure that a firm's capital requirement reflects the risks of the futures and options positions it carries.

In addition to the self-regulatory programs administered by the exchanges and NFA, CFTC oversees the compliance activities of SROs through audits and financial surveillance to ensure that SRO member firms are properly capitalized, maintain appropriate risk management capabilities, and

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<sup>13</sup>See 7 U.S.C. § 7a(d) (2000 & Supp. 2004).

<sup>14</sup>See Trading Facilities, Intermediaries and Clearing Organizations; New Regulatory Framework; Final Rule, 66 Fed. Reg. 42256-42289 (Aug. 10, 2001); see also Proposed Rules for Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9 69 Fed. Reg. 39880-39886 (July 1, 2004).

<sup>15</sup>17 C.F.R. § 37.6 (2004).

segregate customer funds. According to CFTC's 2003 annual report, to meet CFMA objectives, in the early 2000s CFTC modified its oversight process for SROs, moving from compliance-based examinations to risk-focused programs that respond to regulatory core principles. These exams were to focus on an institution's exposure to, and internal controls for, managing underlying risks. These programs were first implemented in 2003 in an SRO oversight examination of the Chicago Mercantile Exchange covering "financial capacity, customer protection, risk management, market move surveillance and stress testing, and operational capability." According to its 2003 annual report, CFTC is also developing a risk management tool that uses data received from firm financial filings and large trader reports to proactively monitor firm risk exposure and assess trader losses from risky positions that may cause firms to become undercapitalized.

According to an NAIC official, during the mid- to the late 1980s, a high number of failures among property-casualty insurers as well as a collective recognition on the part of the insurance regulatory community that the industry was becoming more complex, in part, because of technological advances, globalization, and capital market innovations, led NAIC to adopt its Solvency Policy Agenda. The agenda was composed of a number of initiatives, including risk-based capital and the Financial Analysis Unit.

According to NAIC, by 1990 a number of states were experimenting with risk-based capital formulas, and NAIC approved risk-based capital standards for life insurance companies in 1992 and for property-casualty insurers in 1993. NAIC developed and recommended that states adopt the Risk-Based Capital for Insurers Model Act, which gave state insurance regulators the authority to act on the results generated by the risk-based capital formulas. For life insurers, companies are required to hold minimum percentages of various assets and liabilities as capital, with these percentages based on the historical variability of the value of those assets and liabilities. Risk factors are to be applied, usually as multipliers, to selected assets, liabilities, or other specific company financial data to establish the minimum capital needed to bear the risk arising from that item (similar to risk-weights in banking). In addition, the risk-based capital formula requires the performance of sensitivity tests to indicate how sensitive the formula is to changes in certain risk factors.

NAIC's Solvency Policy Agenda also led to the setting up of the Financial Analysis Unit. This unit's mission is to assist insurance regulators in achieving their objective of identifying, at the earliest possible stage, insurance companies that may be financially troubled. In pursuit of this

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**Chapter 4**  
**Regulators Are Adapting Regulatory and**  
**Supervisory Approaches in Response to**  
**Industry Changes**

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mission, the Unit performs financial analysis of insurance companies under the direction of an NAIC working group. The working group was formed to identify nationally significant insurance companies—large firms or firms operating in a number of states—that are, or may become, financially troubled, and to determine whether appropriate regulatory action is being taken with regard to these firms.

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# Regulators Communicate and Coordinate in Multiple Ways, but Concerns Remain

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In a system with multiple financial services regulators, communication and coordination are essential to preventing duplication in agency oversight, while ensuring that all regulatory areas are effectively covered. U.S. federal financial services regulators communicate and coordinate with other federal, state, and foreign regulators within their sector, and state insurance regulators communicate and coordinate across states and with insurance regulators in other countries; however, in each sector concerns remain. To a lesser extent, financial services regulators communicate and coordinate across sectors with U.S., state, and foreign regulators, but coordinating regulatory activities and sharing information continue to be sources of concern. Agencies have had problems systematically sharing information across sectors, making it more difficult for regulators to identify potential crises, fraud, and abuse, and for consumers to identify the relevant regulators. In addition, regulators do not routinely assess risks that cross traditional regulatory and industry boundaries.

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## U.S. Financial Regulators Communicate and Coordinate with Other Regulators in Their Sectors, but Sometimes Find It Difficult to Cooperate

Within each of the four sectors, federal regulators have established interagency groups to facilitate coordination and also communicate informally on a variety of issues. Within sectors the federal regulators generally communicate with each other, with SROs, with relevant state regulators, and with their international counterparts. In insurance, NAIC is the primary vehicle for state regulators to communicate with each other and to coordinate with insurance regulators in other countries.

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## Federal Banking Regulators Coordinate Their Activities, but Bank Failures and International Negotiations Have Been Problematic

The Financial Institutions Regulatory and Interest Rate Control Act of 1978<sup>1</sup> established the Federal Financial Institutions Examination Council (FFIEC) in 1979 as a vehicle through which bank regulators could communicate formally. FFIEC is empowered to prescribe uniform standards and principles and to devise report forms for member agencies' examinations of financial institutions. FFIEC makes recommendations to promote uniformity in the supervision of financial institutions, conducts schools for examiners, and has also established interagency task forces on

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<sup>1</sup>Pub. Law No. 95-630, Title X. See <http://www.ffiec.gov/about.htm>.



consumer compliance, examiner education, information sharing, supervision, reports, and surveillance systems. Finally, it serves as a forum for dialogue between federal and state bank supervisory agencies.

A joint evaluation by the Offices of the Inspector General from three federal banking regulators found that FFIEC was accomplishing its legislative mission of prescribing uniform principles, standards, and report forms.<sup>2</sup> Some officials criticized it for not accomplishing its mission more effectively and taking too long to complete interagency projects, however. FFIEC is discussing improvements to its effectiveness by developing annual goals, objectives, and work priorities. In response to questions about whether FFIEC should have a broadened role in coordinating banking, insurance, and securities regulators as a result of GLBA, most officials interviewed were not in favor of broadening FFIEC to include regulatory representatives from the insurance and securities industries. Most officials also did not see the need for a separate coordinating entity under GLBA modeled after FFIEC. Officials indicated that coordination under GLBA was occurring as needed and on an ad hoc basis and through periodic cross-sector meetings hosted by the Federal Reserve. Banking industry and professional associations said that FFIEC could be more proactive in communicating with the banking industry, however.

The 1994 Riegle Community Development and Regulatory Improvement Act mandated improvements to the coordination of examinations and supervision of institutions that are subject to multiple bank regulators. A set of basic principles, issued by the regulators in 1993, said that the agencies place a high priority on working together to identify and reduce the regulatory burden and on coordinating supervisory activities with each other as well as with state supervisors, securities and insurance regulators, and foreign supervisors.<sup>3</sup> Their objective is to minimize disruption and avoid duplicative examination efforts and information requests by

- coordinating the planning, timing, and scope of examinations and inspections of federally insured depository institutions and their holding companies;

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<sup>2</sup>Offices of the Inspector General at Treasury, FDIC, and Federal Reserve, *Joint Evaluation of the Federal Financial Institutions Examination Council* (Washington, D.C.; June 21, 2002).

<sup>3</sup>See OCC, "Policy Statement on Examination Coordination and Implementation Guidelines," *Examination Planning and Control Handbook* (Washington, D.C., July 1997).

- conducting joint interagency examinations or inspections;
- coordinating and conducting joint meetings between bank or bank holding company management and regulators;
- coordinating information requests; and
- coordinating enforcement actions.

The Federal Reserve, FDIC, and OCC have additional mechanisms to communicate and coordinate. Under the Shared National Credit Program, for example, they jointly review large syndicated loans that involve several banks to ensure that loans are reviewed consistently and to reduce regulatory burden on financial institutions. Program reports also include information on the level of credit risk in banks overall and by type of bank as well as credit exposures to certain industries. Similarly, representatives from the agencies meet regularly as the Interagency Country Exposure Review Committee to jointly determine the level of risk for credit exposures to various countries.

U.S. bank regulators also communicate regularly with bank regulators in other countries, both bilaterally and through multicountry organizations that specialize in bank issues. U.S. bank regulators overseeing U.S. subsidiaries of foreign banks work with the host-country regulators in overseeing those institutions. U.S. bank regulators and UK-FSA explained how they coordinate examinations of U.K. institutions with U.S. operations such as HSBC and U.S. banks with U.K. subsidiaries such as MBNA. Similarly, some U.S. regulators coordinate with BaFin in overseeing Citigroup's activities in Germany and Deutsche-Bank Securities' activities in the United States. The Federal Reserve, FDIC, and OCC are members of the Basel Committee<sup>4</sup> and a Federal Reserve Official chaired that committee during much of the Basel II discussions.

Throughout our meetings with banking agencies, officials told us they communicate regularly on both a formal and informal basis. They explained that officials in different agencies, both at the federal and regional level, know each other well and have each other's personal cell phone numbers so they can easily contact each other in case of a crisis. At

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<sup>4</sup>OTS officials say that they participate in the Basel Committee as a temporary member pending acceptance of OTS's request for permanent membership.

the regional level, officials and staff from the Federal Reserve, OCC, FDIC, OTS, and state bank regulatory agencies regularly meet formally and talk often. Communication across these agencies, according to several officials, is facilitated by staff often moving between agencies and by long-standing working relationships.

In some cases, however, interagency cooperation between bank regulators has been hindered when two or more agencies share responsibility for supervising a bank. The Superior Bank and the First National Bank of Keystone (West Virginia) episodes illustrate this problem. Superior Bank, FSB, a federally chartered savings bank located outside Chicago failed in 2001. The failure was caused by Superior's strategy of originating and securitizing large volumes of high-risk loans and the failure of its management to properly value and account for the interest that Superior retained in pooled home mortgages. Shortly after the bank's closure, FDIC projected that the failure of Superior Bank would result in a substantial loss to the deposit insurance fund. We found that federal regulators had not identified and acted on the problems at Superior Bank early enough to prevent a material loss to the deposit insurance fund. Problems between OTS, Superior's primary supervisor, and FDIC hindered a coordinated supervisory approach; OTS refused to let FDIC participate in at least one examination.<sup>5</sup> Similarly, disagreements between OCC and FDIC contributed to the 1999 failure of Keystone Bank, which was caused by the bank's maintaining loans that it did not own on its balance sheet; these overstated assets were attributed to alleged fraud. FDIC subsequently announced that it had reached agreement with the other banking regulators to establish a better process for determining when FDIC will examine an insured institution where FDIC is not the primary federal regulator.

Over the last couple of years, bank regulators have expressed differing views concerning the complex Basel Committee negotiations over Basel II (see ch. 4). However, it is unclear whether the differing views of the regulators improved the process, as the regulators claim, or unnecessarily complicated the process and possibly disadvantaged U.S. companies, as others have claimed. Bank regulators who sit on the Basel Committee told us that the outcome of the Basel II negotiations is better than it would have been with a single U.S. representative because of the contributions of regulators who represent the perspectives and expertise of their varied

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<sup>5</sup>See GAO, *Bank Regulation: Analysis of the Failure of Superior Bank, FSB, Hinsdale, Illinois*, GAO-02-419T (Washington, D.C.: Feb. 7, 2002).

agencies. Regulators note that they have communicated regularly, but still have the responsibility of representing their agencies' differing objectives publicly. U.S. Basel Committee members said that this requirement to discuss differences in an open and transparent manner, rather than privately, is a strength of the system. The regulators also noted that some of the concerns raised by others about the timeliness of U.S. agencies' involvement in the negotiations might stem primarily from the long public comment period mandated in U.S. law, rather than the involvement of multiple agencies. This public comment period, they noted, would be a requirement even if fewer agencies were involved.

However, the lack of a single contact or negotiating position has raised questions about these negotiations. Since each of the agencies on the Basel Committee is charged with representing the objectives of its agency or the firms it oversees, the negotiations may not represent the interests of those who are not at the table. For example, OTS—which oversees some firms that will likely have to comply with Basel II, due, in part, to the EU Action Plan—does not have a permanent seat on the Basel Committee. Since the large firms overseen by OTS differ in some important ways from those overseen by the other agencies, their positions may not be adequately represented in these negotiations. However, OTS officials say that they have a temporary seat on the Basel Committee, while that body considers their request for membership. OTS also noted that they are active members of two Basel capital implementation groups. In addition, the sometimes-conflicting views being expressed by U.S. regulators made it difficult for other countries to understand our position. Finally, 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.<sup>6</sup> H.R. 2042 would establish a committee of financial regulators chaired by the Secretary of the Treasury to ensure that there is a unified U.S. position in Basel Committee negotiations.

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<sup>6</sup>Letter from Representative Michael Oxley et al. to Chairman Alan Greenspan et al., Nov. 3, 2003.

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Federal Securities  
Regulators Often  
Communicate and  
Coordinate Activities with  
State Regulators, Securities'  
SROs, and Foreign  
Securities Regulators, but  
Problems Persist

Federal securities regulators communicate and coordinate with SROs and state securities regulators. State securities regulators, including those in New York and Massachusetts, told us that for the most part they coordinate enforcement activities with SEC. One difficulty they pointed to was that privacy issues prevent them from discussing a case before they are ready to bring charges. However, they note that state regulators, SEC, and some SROs have jointly pursued securities law violators.

In addition to overseeing the securities SROs, SEC communicates regularly with them about various issues. For example, SEC and the SROs have taken steps to coordinate their examinations. In 2002, we reported that, according to SEC and SRO officials, representatives of SEC, all SROs, and the states attend annual summits to discuss examination coordination, review examination results from the prior year, and develop plans for coordinating examinations for the coming year. In addition, regional SEC staff and SRO compliance staff are to meet quarterly to discuss and plan examination coordination, and SRO examiners are to meet monthly to plan specific examinations of common members. At these latter meetings, examiners are expected, among other things, to collaborate on fieldwork dates, document requests, and broker-dealer entrance and closeout meetings. SROs also are to share their prior examination reports before beginning fieldwork. We noted, however, that SEC officials told us that some broker-dealers that have tried the coordinated examination program have concluded that it is more efficient for them to have two separate examinations.<sup>7</sup> Additionally, SEC met with NYSE to discuss registrations of private foreign issuers.

Securities SROs also communicate regularly with each other. Ten of them, the major U.S. securities exchanges, are full members of the Intermarket Surveillance Group (ISG), a group they created in 1983 to share information across jurisdictions. The purpose of ISG is to share information and to coordinate and develop procedures designed to assist in identifying possible fraudulent and manipulative acts and practices across markets, particularly, between markets that trade the same or related securities and between markets that trade equity securities and options on an index in which such securities are included.

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<sup>7</sup>GAO, *Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation*, GAO-02-362 (Washington, D.C.: May 3, 2002).

Internationally, SEC communicates and coordinates with international securities regulators through IOSCO and has worked with the EU's CESR to help harmonize activities between the EU and United States. SEC staff notes that it is participating in a joint working group established by IOSCO and the Basel Committee to address issues relating to the treatment of security positions held in the trading book, which includes securities held for dealing or proprietary trading. One issue is the development of a risk-based approach to capital requirements for securities activities, an issue of interest to holding companies with broker-dealer subsidiaries. And CESR officials told us that their communications with SEC have been fruitful in easing certain concerns, such as those associated with European companies' U.S. operations having to adopt Sarbanes-Oxley requirements. In May 2004, SEC and CESR announced their intentions to increase their cooperation and collaboration aimed at two primary objectives, namely to

- identify emerging risks in the U.S. and EU securities markets to address potential regulatory problems at an early stage; and
- engage in early discussion of potential regulatory projects in the interest of facilitating converged, or at least compatible, ways of addressing common issues.

For the rest of 2004 and 2005, SEC and CESR proposed considering issues related to market structure, mutual fund regulation, accounting convergence, and credit rating agencies.

Despite efforts of SEC and state securities regulators to communicate and coordinate their activities, some well-publicized disagreements developed following the corporate, accounting, and mutual fund scandals. After a settlement with one of the major U.S. securities firms concerning the use of research and during investigations of mutual fund irregularities, SEC and state regulators sometimes disagreed on what is an appropriate role for each, and on how effective each has been. For example, the Attorney General of New York, testifying before Congress concerning analyst conflicts of interest, said that while the issues had been widely reported in the press for years, SEC had issued no meaningful new regulations and had taken no serious enforcement actions prior to New York's investigation. Some securities industry officials told us that state officials should leave securities issues to federal officials and noted that unilateral actions by states have led to differing state securities laws. In addition, an official at one of the SROs told us that communication often takes place in a crisis situation, but that there is little or no time for strategic thinking.

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NAIC Is the Coordinating  
Body for State Insurance  
Commissioners, but States  
Often Pursue Their Own  
Course

NAIC is the long-standing structure for communication and coordination among state insurance commissioners. NAIC's meetings of all state regulators occur four times a year and interstate working groups meet regularly in various locations or by teleconference or videoconference to consider almost every aspect of insurance. Through its development of model laws such as those concerning risk-based capital standards and its accreditation program, NAIC has been a mechanism for achieving some harmonization in state securities regulation. In addition, NAIC officials and individual state insurance commissioners have coordinated with insurance regulators from other countries through IAIS and other forums. IAIS has developed core principles of insurance supervision and is working on developing a regulatory framework.

Because each state ultimately determines what actions it will take, NAIC cannot ensure uniform regulation. One tool NAIC has used to attempt to achieve a consistent state-based system of solvency regulation throughout the country is its accreditation program. However, we have reported that the accreditation program has weaknesses. In our review of the program in 2001, we noted that while the accreditation program had improved over the 10 years of its existence, and 47 state insurance departments had been accredited by NAIC, it still had weaknesses that raised questions about NAIC's accreditation reviews.<sup>8</sup> For example, Mississippi and Tennessee received accreditation during and after a \$200 million theft that involved four failed insurance companies in those states as well as two others. In addition, because New York will not adopt the risk-based capital model law, what is usually considered one of the strongest state regulatory bodies is not accredited. As a result of NAIC's inability to force states to adopt certain rules and regulations, some critics think the voluntary aspect of NAIC reduces its effectiveness. Other critics argue that because NAIC operates as a quasi-governmental entity, it exercises too much power over individual state regulators.

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<sup>8</sup>GAO, *Insurance Regulation: The NAIC Accreditation Program Can Be Improved*, GAO-01-948 (Washington, D.C.: Aug. 31, 2001).

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**CFTC Coordinates Activities  
with SROs and Futures  
Regulators in Other  
Countries**

According to CFTC, it coordinates with futures SROs and foreign financial services regulators. CFTC says it coordinates with exchanges in monitoring of daily trading activities, looking at the positions of large traders, and reviewing products listed by exchanges. CFTC's coordination with futures regulators in other countries—for example, UK-FSA and BaFin—takes place partially through CFTC's participation in the activities of IOSCO. CFTC participates in IOSCO working groups on secondary markets and market intermediaries, enforcement and information sharing, and investment management. CFTC also participates on IOSCO task forces covering issues such as implementation of IOSCO objectives and principles of securities regulation, and payment and settlement systems. While CFTC participates in working groups and task forces, it does not have the same status at IOSCO that SEC has; CFTC is an associate member of that organization, rather than a ordinary member.

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**Financial Services  
Regulators Also  
Communicate across  
Financial Sectors, but  
Do Not Effectively  
Identify Some Risks,  
Fraud, and Abuse That  
Cross Sectors**

Federal financial regulators also communicate and coordinate their activities across “functional” areas. Federal Reserve officials note that, as directed by GLBA, they rely on information that is shared by functional regulators, including SEC, in the Federal Reserve's supervision of bank and financial holding companies. Channels for communication and coordination have been set up by the regulators or at the direction of the President or Congress, often in response to a crisis. However, regulators do not always share information or monitor risks across sectors.

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**Federal Reserve Reports  
That It Relies on Functional  
Regulators in Supervision of  
Bank and Financial Holding  
Companies**

GLBA directed the Federal Reserve to rely on functional regulators in its supervision of nonbanking activities in bank and financial holding companies. For example, broker-dealer subsidiaries of bank or financial holding companies are subject to oversight by SEC, NASD, and, potentially, other SROs. In its 2001 strategic plan, the Federal Reserve reported that it is coordinating with other regulators to fulfill its role as the holding company supervisor. Federal Reserve officials told us that this coordination is a key component in their supervision of bank and financial holding companies, and that information has been readily provided by functional regulators as part of that process.



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Regulators and SROs Have  
Created Mechanisms for  
Communicating across  
Sectors

SEC and CFTC have jointly developed regulations implementing portions of CFMA that lifted the ban on certain types of securities-based futures, but the process was difficult. Before CFMA was enacted, SEC and CFTC competed over regulation of single-stock futures for nearly two decades. SEC claimed jurisdiction because single-stock futures behave like the underlying individual stocks and bonds; CFTC claimed jurisdiction because single-stock futures behave like futures. As a result of this stalemate, Congress banned the trading of single-stock futures. CFMA lifted the prohibition on trading single-stock futures and narrow-based stock index futures and allows these futures to be traded under a system of joint regulation by SEC and CFTC. However, according to CFTC and SEC officials, the market for single-stock futures has been slow to develop. In addition, a CFTC official told us that it had long had routine, if informal, contacts with SEC concerning financial integrity and on how certain firm assets and liabilities should be treated in calculating net capital. SEC staff told us that they agree with this statement. Similarly, CFTC coordinates its efforts with SEC on enforcement cases with jurisdiction in several different geographic areas.

Since its creation in 1983, ISG has expanded to include futures and foreign exchanges as affiliate members. According to CFTC, the purpose of ISG today is to provide a framework for the sharing of information and the coordination of regulatory efforts among exchanges trading securities and related products to address potential intermarket manipulation and trading abuses. ISG plays a crucial role in information sharing among markets that trade securities, options on securities, security futures products, and futures and options on broad-based security indexes. ISG also provides a forum for discussing common regulatory concerns, thus enhancing members' ability to fulfill efficiently their regulatory responsibilities.

Internationally, regulators from multiple sectors have established forums to facilitate multinational communication across sectors. The Joint Forum and FSF are two such forums. The Basel Committee, IOSCO, and IAIS established the Joint Forum in 1996 to examine cross-sectoral supervisory issues related to financial conglomerates such as risk assessment and disclosure. The Federal Reserve, Treasury, and SEC serve on FSF, which was initiated in 1999 in response to the Asian financial crisis. FSF brings together, on a regular basis, representatives of governments, international financial institutions, and others to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance.

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Congress and the President  
Have Directed Regulators to  
Communicate across  
Sectors, Especially after  
Crises

By executive order in March 1988, the President established the President's Working Group on Financial Markets, which is composed of the heads of the Federal Reserve, SEC, and CFTC and chaired by Treasury, to address issues related to the 1987 stock market crash. As we reported in 2000,<sup>9</sup> the President's Working Group was established in response to a crisis and, as the need had arisen, had continued to function as such. The President's Working Group was formally reactivated in 1994 and since then has considered several issues, including the 1997 market decline, hedge funds and excessive leverage, year 2000 preparedness issues, the rapid growth of the OTC derivatives market, and threats to critical infrastructure.<sup>10</sup> The group meets on a bimonthly basis at the staff level and has sent letters to Congress with common positions on issues such as energy derivatives legislation and mutual fund reform.

After the events of September 11, 2001, the President issued an executive order to create the Financial and Banking Information Infrastructure Committee (FBIIC), which is charged with coordinating federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system. Chaired by Treasury's Assistant Secretary for Financial Institutions, FBIIC includes representatives from federal and state financial regulatory agencies, including CFTC, the Conference of State Bank Supervisors, FDIC, the Federal Housing Finance Board, the Federal Reserve, NAIC, NCUA, OCC, the Office of Cyberspace Security, the Office of Federal Housing Enterprise Oversight, the Office of Homeland Security, OTS, and SEC.

In passing GLBA, Congress recognized the need for regulators engaged in supervising parts of holding companies to communicate and coordinate across "functional" areas. For example, the Federal Reserve and state insurance regulators must coordinate efforts to supervise companies that control both a bank and a company engaged in insurance activities; similarly, OTS and state insurance regulators have to coordinate activities as well. The Federal Reserve, FDIC, OCC, and OTS have signed regulatory cooperation agreements with almost all insurance jurisdictions; NAIC and the bank regulators say the remainder of the insurance jurisdictions have

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<sup>9</sup>GAO, *Financial Regulatory Coordination: The Role and Functioning of the President's Working Group*, GAO/GGD-00-46 (Washington, D.C.: Jan. 21, 2000).

<sup>10</sup>GAO, *Critical Infrastructure Protection: Efforts of the Financial Services Sector to Address Cyber Threats*, GAO-03-173 (Washington, D.C.: Jan. 30, 2003).

state laws that prohibit them from sharing information. GLBA also established the National Association of Registered Agents and Brokers, subject to NAIC's oversight, and stipulated that the association coordinate with NASD in order to ease the administrative burden on those who are members of both organizations—that is, agents and brokers that deal both in insurance and securities.



Other congressionally directed communication includes directing the Federal Reserve, OCC, and SEC to form an interagency group to draft guidance on complex structured finance transactions following the corporate and accounting scandals of the late 1990s. At the invitation of these agencies, FDIC and OTS joined the interagency group. On May 19, 2004, the agencies issued that guidance for comment. More recently, Congress has created the Financial Literacy and Education Commission to coordinate federal efforts and develop a national strategy to promote financial literacy.<sup>11</sup> The commission, which is chaired by the Secretary of the Treasury, consists of 20 federal agencies, including all of the federal financial regulators.

In light of the major changes being made in the EU as a result of the Action Plan as well as other factors, Treasury and EU officials agreed in early 2002 to establish an informal dialogue on financial market issues. As part of that dialogue, U.S. and EU financial services policymakers, including officials from the Federal Reserve and SEC, meet regularly (1) to foster a mutual understanding of each other's approach to the regulation of financial markets, (2) to identify any potential conflicts in approaches as early in the regulatory process as possible, and (3) to discuss regulatory issues of mutual interest. Some of the issues that have been considered in the dialogue are Sarbanes-Oxley, the Financial Conglomerates Directive, accounting standards, and allowing the placement of foreign electronic trading screens in the United States absent registration of either the exchange or its listed securities. As figure 8 shows, regulators and others are talking to their EU counterparts in a number of separate venues.

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<sup>11</sup>The commission was created in Title V of the Fair and Accurate Credit Transactions Act of 2003, known as the Financial Literacy and Education Improvement Act. See Pub. L. No. 108-159, Title V, 117 Stat. 2003 (codified at 20 U.S.C. §§ 9701–08). The act also mandated that GAO report on recommendations for improving financial literacy among consumers. On July 28, 2004, GAO hosted a forum entitled "Improving Financial Literacy: The Role of the Federal Government." The results of this forum will appear in a forthcoming GAO report.

**Figure 8: United States—EU Regulatory Dialogue**

Title	Participants		Objectives
	 United States	 European Union	
<b>Financial markets regulatory dialogue</b>	U.S. Treasury; Securities and Exchange Commission; Federal Reserve	European Commission (Internal Market Directorate)	Informal discussion of current regulatory problems
<b>Insurance dialogue</b>	National Association of Insurance Commissioners	European Commission	Information exchange on regulatory and supervisory practices
<b>Mixed Technical Group</b>	Securities and Exchange Commission and federal banking regulators	European Commission desk officers, member state experts	Financial Conglomerates Directive equivalence
<b>CESR-SEC Dialogue</b>	Securities and Exchange Commission	Committee of European Securities Regulators	Cross-border information sharing and early discussion of regulatory initiatives in the interest of facilitating convergence
<b>None</b>	Financial Accounting Standards Board	International Accounting Standards Board	Convergence between United States and international accounting standards

Source: GAO analysis of HM-Treasury information.

**Cross-Sector  
 Communication Has Not  
 Facilitated Sharing of  
 Important Information or  
 Monitoring of Risks**

In evaluating some of the means by which U.S. regulators communicate across sectors, we have found that these generally do not provide for the systematic sharing of information, making it more difficult for regulators to identify potential fraud and abuse, and for consumers to identify the relevant regulator. In addition, these means do not allow for a satisfactory assessment of risks that cross traditional regulatory and industry boundaries and therefore may inhibit the ability to detect and contain certain financial crises, as can be seen in the following.

- With regard to the President’s Working Group, we reported in 2000 that although it has served as a mechanism to share information during unfolding crises, its activities generally have not included such matters as routine surveillance of risks that cross markets or of sharing information that is specific enough to help identify potential crises.<sup>12</sup>
- In reviewing the near collapse of LTCM—one of the largest U.S. hedge funds—in 1998, we reported that regulators continued to focus on individual firms and markets but failed to address interrelationships across industries. Thus, federal financial regulators did not identify the extent of weaknesses in bank, securities, and futures firm risk management practices until after LTCM’s near collapse and had not sufficiently considered the systemic threats that can arise from unregulated entities.<sup>13</sup>
- Our reviews of financial crises showed that almost never did a single federal financial services regulator have the necessary authority, jurisdiction, or resources to contain the crisis. Several officials told us that this dispersion had sometimes limited the federal government’s ability to identify incipient financial crises or to monitor a crisis once it had occurred.<sup>14</sup>
- In reviewing responses to the events of September 11, 2001, we reported that the multiorganization nature of U.S. financial services regulation has slowed the development of a strategy that would ensure continuity of business for financial markets in the event of a terrorist attack.<sup>15</sup>
- In a recent review of interagency communication regarding enforcement actions taken by the regulatory agencies against individuals and firms, we reported that while information sharing among financial regulators is a key defense against fraud and market abuses, the regulators do not have ready access to all relevant data related to

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<sup>12</sup>GAO/GGD-00-46.

<sup>13</sup>GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999).

<sup>14</sup>GAO, *Financial Crisis Management: Four Financial Crises in the 1980s*, GAO/GGD-97-96 (Washington D.C.: May 1, 1997).

<sup>15</sup>GAO, *Potential Terrorist Attacks: Additional Actions Needed to Better Prepare Critical Financial Market Participants*, GAO-03-251 (Washington, D.C.: Feb. 12, 2003).

regulatory enforcement actions taken against individuals or firms. We also reported that many financial regulators do not share relevant consumer complaint data among themselves on certain hybrid products such as variable annuities (products that contain characteristics of both securities and insurance products) in a routine, systematic fashion, compounding the problem that consumers may have in identifying the relevant regulator.<sup>16</sup> Determining the relevant regulator for variable annuities has been a source of regulatory disagreement for some time. After years of court battles, it was determined that variable annuities would be regulated as securities by the federal government but also fall under the authority of state insurance and securities regulators. At the federal level, SEC regulates the registration of variable annuity products. Under federal law, variable annuity products registered with SEC are generally exempt from registration with state securities regulators. As with other securities products, NASD regulates the sale of variable annuity products through broker-dealers. At the state level, the insurance companies that offer variable annuities generally fall under the jurisdiction of insurance regulators, though sales of such products can also fall under the jurisdiction of state securities regulators, or some combination of both regulators, depending on the state. Some state securities regulators told us they are making an effort to amend the Uniform Securities Act to place the oversight of variable annuities sales under the jurisdiction of state securities departments.

While financial regulators generally supported better sharing of regulatory information, they cited some barriers to sharing. Those barriers generally centered on the need for individual agencies to meet their statutory objectives, including protecting confidential regulatory information from public disclosure. Officials at one banking agency, additionally, noted that they are sometimes reluctant to discuss some issues with SEC because of concern that the discussion would immediately trigger an investigation, while the banking officials are working to resolve the issue in a manner that does not compromise safety and soundness. However, officials at that agency also note that if the agency becomes aware of a securities law violation, they make an immediate referral to SEC.

Officials at several of these regulatory agencies noted that their responsibilities are outlined in law. For example, with regard to airing

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<sup>16</sup>GAO, *Better Information Sharing among Financial Services Regulators Could Improve Protections for Consumers*, [GAO-04-882R](#) (Washington, D.C.: June 29, 2004).

differences on Basel II, bank regulators noted that they are required to put documents out for public comment and respond to those comments. In other cases, agencies note that they were created as independent agencies rather than as components of executive agencies and departments to avoid interfering with these responsibilities. Officials at one agency, for instance, noted that while Treasury would have a role in coordinating the efforts of executive agencies prior to or during international negotiations, their agency would have to ensure that any such coordinating role did not interfere with their statutory responsibilities. We have also reported that banking and securities regulators have said that NAIC's status as a nonregulatory entity was a barrier to information sharing, even when NAIC was acting on behalf of its member agencies. In some cases, current state statutes may also hinder information sharing.

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# The U.S. Regulatory System Has Strengths, but Its Structure May Hinder Effective Regulation

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While structure is not the determining factor in the success of efforts to provide efficient and effective regulation, it can facilitate or hinder regulators' efforts. Some U.S. regulators and financial market participants we spoke with cited the contribution of the current regulatory structure to the development of U.S. capital markets, and the U.S. economy overall—for example, for encouraging competition and promoting stability. However, the regulatory system does not facilitate the monitoring of risks across firms and markets and does not provide for a proactive, strategic approach to systemwide issues. In addition, some outside the U.S. regulatory system, including foreign regulators, have criticized the U.S. regulatory system for hindering effective oversight of large, complex firms. We also found that dividing supervision of large, complex firms among U.S. regulators can result in inconsistent supervision. In addition, the U.S. regulatory system is not well structured for dealing with issues in a world where financial firms and markets operate globally.

While the demarcations between the “functional” areas have blurred and large firms have diversified across sectors, differences among the sectors are still important. Thus, the system benefits from having regulators that specialize in the “functional” areas. However, “functional” specialization has drawbacks as well, including the inability to take advantage of economies of scale and scope, the danger of becoming a voice for certain interests, and the possibility that firms may seek supervision from the least intrusive regulators.

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## U.S. Financial Services Regulatory System Has Generally Been Successful but Lacks Overall Direction

The U.S regulatory system has allowed financial intermediaries and markets to contribute broadly to the U.S. economy. Corporations have a range of financing options to choose from—including bank lending and securities issuance—that have generally allowed the economy to grow and consumers have a range of options to choose from that allow them to make purchases and save for retirement. In addition, new products have been developed that allow financial institutions to manage risk. Some of the people we spoke with wondered why anyone would want to change a regulatory system that has generally supported these aspects of our economy. Officials at one trade association told us that because our system is so successful, some other countries are trying to replicate aspects of it. In addition, at least one academic researcher has commented that European countries tried to create SEC-type regulatory agencies where the focus, in part, is on protecting consumers.



U.S. financial institutions are generally characterized as dynamic and innovative and some aspects of the regulatory system have these characteristics as well. In chapter 4 of this report, we showed how some regulatory approaches have evolved over time to better address changes in the industry. The U.S. financial system is dynamic and innovative because it is populated by a large number of firms and different industries that compete with each other in an environment where no one sector or firm has gained the market power that would stifle innovation. Similarly, the regulatory system is characterized by a large number of regulators that must often compete with each other to provide more innovative or vigilant regulation. Competition among the banking regulators, especially the Federal Reserve and OCC, is given credit for changes in regulation including the modernization that removed prohibitions against securities firms, banks, and insurance companies operating in a single holding company structure, and increased regulatory attention to the provision of loans in certain minority areas. Similarly actions by some state attorneys general and other securities officials helped prod the Justice Department and SEC to take more aggressive action and may have helped to highlight a need for increased resources at SEC.

Having multiple regulators also allows for regulatory experimentation. An insurance regulator in Illinois can allow the market to set insurance rates, while insurance regulators in Massachusetts must approve rate increases. Similarly, for depository institutions, Utah offers certain advantages to ILCs that obtain charters in that state. The movement of CFTC to a principles-based approach while SEC stays with a rules-based approach to regulation is another example of how regulators can be innovative in experimenting with different approaches to regulation.

One of the international criteria for a successful regulatory system is to have adequate resources, and the success of the U.S. regulatory system is often attributed to the overall quality of U.S. regulators. Many of the industry officials we talked with felt that their regulators had the needed skills to provide effective supervision. Whether the U.S. regulatory structure facilitates the hiring of a sufficient number of quality staff across all of the regulatory agencies is an open question. Officials at UK-FSA said they felt they were better able to attract good staff in a consolidated regulatory structure because they had better visibility in the marketplace, could offer better career paths, and in some cases, were able to pay higher salaries than the agencies that existed before consolidation. However, that organization still has only about 2,300 staff members. Because several of the U.S. regulators are this large, have visibility in the marketplace, and are

able to offer competitive salaries, they are well positioned to hire good staff. However, some of the federal regulators and state insurance regulatory agencies are relatively small and could face difficulties in attracting qualified staff due to the substantial demand by other government agencies and the private sector for the best personnel.

The regulatory system is also credited with helping to foster financial stability and maintain continuity. The system has allowed for creative solutions to potentially destabilizing events. For example, between January and September 1998, LTCM lost almost 90 percent of its capital. In September 1998, the Federal Reserve determined that rapid deterioration of LTCM's trading positions and the related positions of some other market participants might pose a significant threat to global financial markets that were already unsettled with Russia's default on its debt. As a result, the Federal Reserve facilitated a privately funded recapitalization to prevent LTCM's total collapse.<sup>1</sup> While some experts believe that the market would have handled this crisis, the Federal Reserve Bank of New York is credited by many with facilitating the resolution of a major liquidity crisis with potential systemic repercussions. Again, when the events of September 11, 2001, led to unsettled government securities trades and other financial market disruptions, the Federal Reserve provided needed liquidity to financial markets. Federal bank regulators also provided guidance to banks on maintaining business relations with their customers that had been affected by the attacks and issued a joint statement advising banks that any temporary drops in bank capital would be evaluated in light of a bank's overall financial condition. SEC took similar actions to facilitate the successful reopening of stock markets, including providing temporary relief from some regulatory requirements.<sup>2</sup>

Through its supervision of bank and financial holding companies, the Federal Reserve does have oversight responsibility for a substantial share of the financial services industry. The scope of its oversight, however, is limited to bank and financial holding companies. However, no government agency is charged with looking at the financial system as a whole, and the ability of regulators to meet their objectives on an ongoing basis. We have repeatedly noted that regulators do not share information or monitor risks

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<sup>1</sup>See [GAO/GGD-00-3](#); and GAO, *Responses to Questions Concerning Long-Term Capital Management and Related Events*, [GAO/GGD-00-67R](#) (Washington, D.C.: Feb. 23, 2000).

<sup>2</sup>See [GAO-03-251](#).

across markets or “functional” areas preventing them from identifying potential systemic crises and limiting opportunities for fraud and abuse (see ch. 5). In addition, we noted limitations on effectively planning strategies that cut across regulatory agencies.

In addition, there is no mechanism for the regulatory agencies to perform this task cooperatively. From an overall perspective the system is not proactive, but instead reacts in a piecemeal, ad hoc fashion—often when there is a crisis. No one has the authority, and there is no cooperative mechanism to conduct risk analyses, prioritize tasks, or allocate resources across agencies, although the Office of Management and Budget may perform some of these tasks for agencies that are funded by federal appropriations. Similarly, no one has the responsibility, and there is no cooperative mechanism, for putting together a long run strategic plan that develops a clearly defined set of objectives for the financial regulatory system and lays out a plan for achieving those goals over time.

Each agency does develop its own strategic plan. The Federal Reserve, for instance, published its most recent plan in December 2001, providing three primary goals—including promoting “a safe, sound, competitive, and accessible banking system and stable financial markets.” The plan provided specific objectives and performance measures, and discussed the external factors that would affect the Federal Reserve. For instance, it noted the following:

Continued integration of U.S. financial market sectors, accompanied by the introduction of new financial products and means for their delivery, is further blurring lines between banks and nonbanks. Securities firms, insurance companies, financial companies, and even many prominent industrial companies—as well as commercial banks—are exploiting technological and financial innovations to seek to capture larger shares of the financial services market. Industry consolidation will affect the way the Federal Reserve operates to ensure safety and soundness and limit systemic risk.

However, no entity is charged with developing a strategic plan like this that would address how industry changes affect the ability of the financial regulatory system, as a whole, to meet its many missions.

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## Structure of U.S. Financial Services Regulatory System May Not Facilitate Oversight of Large, Complex Firms

Legal experts and some regulators in EU and Joint Forum countries believe that large, complex, internationally active firms need to be supervised on a consolidated level. In response, the EU is requiring consolidated supervision for certain financial institutions on the assumption that these firms are so large and so complex that a failure at anyone of them could pose systemic threats within and across countries. In addition, many of the countries we studied said that one of the primary reasons they consolidated their regulatory structure was to better supervise conglomerates. Historically, in the U.S., holding company supervision—a form of consolidated supervision—has been required for companies owning commercial banks and thrifts. These bank and thrift holding companies were expected to be sources of financial and managerial strength to their subsidiary banks. They were supervised to ensure this, and to enforce laws intended to protect the insured bank even if the parent failed. The goal is to protect the banking system and, by extension, the deposit insurance fund. Another goal of this supervision has been to wall off the bank, so that other parts of the holding company do not benefit from any subsidy inherent in the provision of deposit insurance or other safety net provision. Holding company supervision in the United States has evolved to include broader concerns about the potential systemic risk posed by large financial services firms.

GLBA continued the U.S. tradition of requiring holding company supervision when such a company owns a commercial bank or thrift, and provided for supervision of investment bank holding companies. However, the structure set up in GLBA has led to concerns about (1) the scope and effectiveness of the Federal Reserve's authority to examine functionally regulated entities within a financial holding company, and (2) the possibility of competitive imbalances among holding company supervisors. Officials at the Federal Reserve say that because firms file consolidated financial statements and the Federal Reserve has the authority to conduct examinations of the holding companies, including verifying information in the consolidated financial statements, it generally has the information it needs to oversee bank and financial holding companies. The officials also said that when the Federal Reserve has needed information from other regulators, they have been able to obtain it.

However, some large financial services firms offer insured deposits and provide a range of banking services without incurring bank holding company supervision from the Federal Reserve. By owning or obtaining thrift charters, for instance, some have opted to be thrift holding

companies under OTS supervision. Given the complexity of some of these parent companies, OTS officials told us they have had to hire staff and develop expertise needed to understand these companies. We have neither evaluated OTS's efforts nor compared the depth and coverage of OTS examinations of large, complex thrift holding companies with that of Federal Reserve examinations of similarly large, complex bank and financial holding companies. Other companies have obtained or control firms with ILC charters, and are not, by virtue of that affiliation, subject to federal holding company supervision unless the holding company elects to be a CSE subject to SEC consolidated oversight.

The differential oversight of holding companies in the different sectors has the potential to create competitive imbalances. In discussions with some of these companies, we were told they offer similar services and see themselves as competing more with other large, internationally active firms in other sectors than with smaller entities in their own sector. They also raise funds in the same markets and often participate in the same transactions. Thus, they are taking on similar risk profiles. However, they may not be subject to the same supervision and regulation. Bank and financial holding companies are supervised by the Federal Reserve. Other companies may opt to organize themselves as thrift holding companies under OTS supervision, and with SEC's recent CSE and SIBHC rules, some may opt for SEC oversight. While these differences stem from differences among the supervisory agencies and their regulatory goals, the differences potentially could have competitive implications as well. There is no mechanism to ensure that differences in these regulatory approaches do not create competitive differences among the different types of holding companies. Further, under the new CSE rules some firms could be subject to both SEC and OTS holding company oversight and, as OTS pointed out in its response to the CSE proposal, perhaps subject to conflicting regulatory requirements. Finally, there is no mechanism to ensure that any systemic risk that these large firms might pose would be treated in a consistent manner.

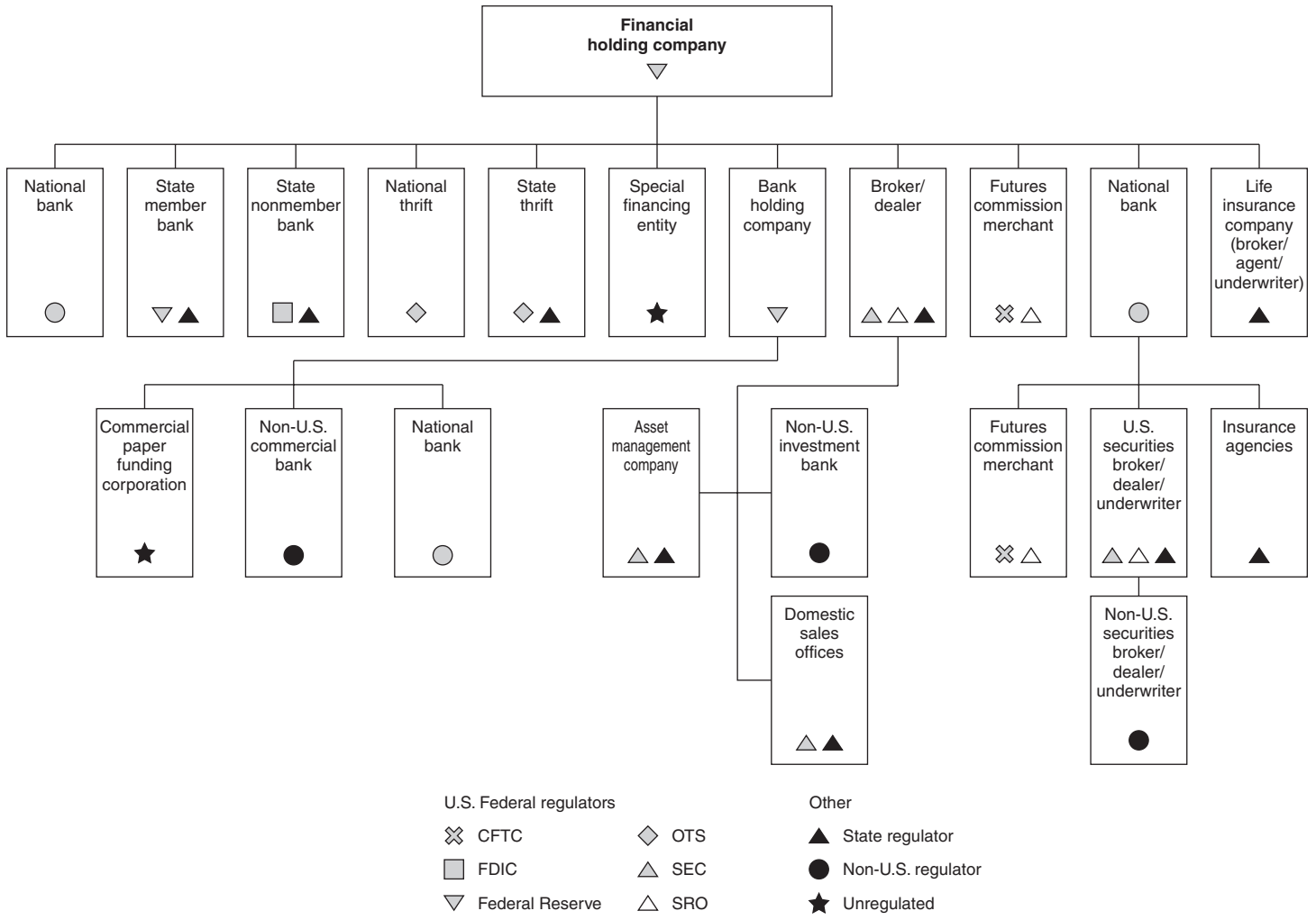
The regulatory system for consolidated supervision set up under GLBA rests on the "functional" regulatory system envisioned there—a system in which "functional" regulators oversee specific activities or products. Some industry experts believe that this system conflicts with reality in that it rests, in part, on preserving distinctions between financial firms based on their lines of business, even though the differences between financial products and services are blurring and management of affiliated firms is more efficient and effective when it is performed centrally, rather than on a

firm-by-firm basis. Businesses say that to benefit from conglomeration, they integrate certain functions such as risk management and capital allocation. In addition, new corporate governance standards require that the board and senior management of a consolidated corporation be responsible for a variety of conduct-of-business issues throughout the organization. Moreover, using a brand name or symbol across these legal entities further links subsidiaries and affiliates in these large, complex firms. Some legal experts and regulators note that because conglomerates are managed centrally, regulators that specialize in understanding risks specific to their “functional” sector may not appreciate complex risks that span financial sectors and may not understand the risk aggregation methodologies employed by these firms. Moreover, they note that the existence of a range of supervisory authorities poses the risk that financial firms will engage in a form of regulatory arbitrage that involves the placement of particular financial services or products in that part of the financial conglomerate in which supervisory oversight is the least intrusive.

GLBA considers linkages among affiliated firms and contains several provisions under which regulators are to coordinate and cooperate with each other to achieve effective and efficient regulation. However, as we have seen, cooperation among regulators in different sectors is difficult within a system that values regulatory competition—a feature of our system that is often credited with making the regulatory system dynamic and innovative but that may be inefficient as well. As figure 9 shows, the agency overseeing a holding company might have to rely on a large number of other regulators for information about subsidiaries engaged in many different functions.

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**Figure 9: Regulators for a Hypothetical Financial Holding Company**



Source: GAO.

Consolidated regulators in the United States also rely on consolidated financial statements that may include descriptions of risk management techniques as well. However, these same firms have to create reports and risk analyses to meet the specific demands of individual “functional” regulators, particularly when the focus of the regulators differs from the firm’s focus on its consolidated position and risk management techniques.

These reports may have little connection to the overall risk position of the larger entity.

Regulators say that in certain cases they are not concerned about the holding company because the entity they supervise is walled off from the larger entity. For example, several state insurance regulators noted that the entities they regulate are incorporated and do business only within their states, although the companies are subsidiaries of parent companies in other states. Similarly, FDIC notes that the safety net provided in the form of deposit insurance is only extended to banks as legal entities. However, it is difficult to imagine that problems in a significant subsidiary of a conglomerate would not impact the rest of the organization. Especially when the parts of an organization are being managed centrally and a company brand name is used across sectors, the reputation of any part of an organization is likely to impact the other parts. The problems of its junk bond operations led to the wider collapse of Drexel Burnham Lambert Group, for instance. Some observers have noted that when an organization is interconnected in these ways, it is less likely that a healthy organization would let any one of its significant parts fail. In addition, Federal Reserve regulations say that bank holding companies are to be a source of strength for their bank subsidiaries. Regulators also note that unlike other countries, the United States still has a large number of small and medium-sized firms in all of the financial sectors who engage in activities that are primarily within one sector; however, a research study issued in 2000 by IMF staff shows that based on a sample of the top 500 financial services firms in assets worldwide, 73 percent of the financial assets held by U.S. firms in the sample were held by firms that engaged in some significant degree in at least two financial services sectors.<sup>3</sup>

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<sup>3</sup>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).



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## Structure of U.S. Financial Services Regulatory System May Not Facilitate Response to Increased Globalization

For multinational financial services firms to have effective oversight, regulators from various countries must coordinate, if not harmonize, regulation/supervision of financial services across national borders and must communicate regularly. Many of the companies we spoke with told us that international harmonization of regulatory requirements would be good for their businesses. In addition, the degree to which financial services are integrated across countries makes it essential for regulators in different countries to communicate regularly. (See ch. 5.) However, as we have seen in the Basel II discussions and with the U.S.-EU dialogue, the current U.S. regulatory structure is not conducive to communicating a single U.S. position in these discussions. Negotiations related to harmonizing financial regulation across international borders differ from negotiations related to international trade, such as those involving the General Agreement on Tariffs and Trade or the allocation of radio-frequency spectrum.<sup>4</sup> In those negotiations, a structure is in place to develop a unified negotiating position. And while the outcome of negotiations may not depend on the number of regulators involved—the relative importance of U.S. financial institutions, especially in overseas capital markets, and many other factors are also important—speaking with a single voice would ensure that the U.S. position is effectively heard.

One area where the mismatch between globalization and the U.S. regulatory structure is marked is in the area of insurance regulation. Companies in the insurance industry increasingly operate on a national and international basis and many companies are foreign-owned, but the industry is regulated by 55 independent jurisdictions. While insurance regulators in the United States responded through NAIC to a solvency crisis in that industry during the early 1990s, the NAIC process remains cumbersome in a multinational world. Some of the kinds of problems that can develop as a result of an international industry being overseen at the state level are evident in the case of Executive Life. In 1998, issues surrounding the sale of Executive Life, a life insurer that became insolvent in the early 1990s after investing heavily in junk bonds, came to light. The issue essentially pitted the insurance regulator of California against the national government of France. While this problem was handled within the current structure, the structure did not facilitate the solution. Not surprisingly, officials at the EU, UK-FSA, and BaFin told us that having a

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<sup>4</sup>See GAO, *Telecommunications: Better Coordination and Enhanced Accountability Needed to Improve Spectrum Management*, [GAO-02-906](#) (Washington, D.C.: Sept. 30, 2002).

single point of contact on insurance issues within the United States would facilitate international decision making. EU officials noted that international negotiations with NAIC led to the creation of IAIS; however, the effectiveness of this organization may be limited by its inability to speak for the actual insurance regulators in the U.S. In addition, NAIC's supervisory stance embodied in its model laws differs from the Solvency II model being created in the EU, especially with regard to the oversight of insurance groups. NAIC says that IAIS is developing a model for insurance supervision that conforms to the U.S. position. Finally, some foreign-based financial services firms that want to sell insurance products in the United States have characterized the fragmented U.S. regulatory system as an unfair trade barrier.

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**Regulators Provide  
Some Other Benefits  
by Specializing in  
Particular Industry  
Segments or  
Geographic Units, but  
Specialization Has  
Costs As Well**

Since there are still significant differences in many areas of the banking, securities, insurance, and futures businesses, specialized expertise with knowledge of those businesses is still deemed important. In addition, state regulators often argue that they have better knowledge of the needs of consumers in their respective states. Officials at OTS felt that even though all of the banking regulators are in the banking sector, OTS is able to focus its skills on the needs of institutions whose primary asset is mortgages. According to officials in the futures industry and at CFTC, creating a specialized regulator for the futures industry has permitted that industry to be innovative in ways that would not have been possible under either an SEC or bank regulatory environment. Many of the people we talked with were concerned about what might happen to these specialized skills and knowledge if regulators were combined into fewer agencies. In addition, a few industry representatives in the United Kingdom mentioned the lack of industry specific skills and knowledge as a concern in the United Kingdom once the regulator was unified across sectors.

Specialization in a particular industry segment ensures that the issues of that segment will get considered in larger forums, before Congress, or in international negotiations. This is particularly evident in the Basel II negotiations, where FDIC and OTS have expressed the concerns facing smaller banks—including the possibility that lower capital requirements for larger banks could place smaller banks at a competitive disadvantage. The Federal Reserve says that it is conducting a series of studies looking at the likely impact of Basel II. After two such studies, they have found no potential negative effects on smaller banks; however, one study did suggest that larger banks that do not adopt Basel II could face some competitive

disadvantage. Similarly, OCC expressed the concerns of trust banks over the capital charges they will have for operational risk.

Of course, specialization can be a double-edged sword that requires vigilance on the part of the regulator. First, a regulator's specialization can lead to an inability to track risks that cross sectors. This inability can be the result of statutory limitations on the regulator, as well as the regulator's policies and procedures that reflect its focus on particular risks. Second, if the regulator becomes too responsive to the needs of the industry, its independence can be in jeopardy. Again, the Basel II negotiations illustrate the trade-offs. It is unclear whether regulators who presented the views of particular segments of the industry were exhibiting their specialized knowledge or lobbying for the segment of the industry they oversee. One regulator told us they did not present certain issues earlier in the process because the regulator had not yet heard from the industry. The chance for regulators to lose their independence is stronger for agencies that oversee relatively few entities. An agency is at greater risk of being "captured" by the industry as consolidation in industry segments reduces the number of firms being overseen by that regulator. Alternatively, combining regulators could reduce the impact of any one segment in decisions, but runs the risk of swallowing up particular industry segments.

Although having knowledge of a particular industry segment is important for regulators, other specialized skills and knowledge cut across regulatory agencies, and these skills and knowledge may not be efficiently allocated across some of the smaller agencies. All regulators write rules, conduct off-site monitoring, and examine firms to determine whether firms are managing their risks effectively and complying with rules and regulations. In Massachusetts, we found former Federal Reserve examiners on the staff of OCC and at the Massachusetts Department of Insurance. In addition, CFTC told us that part of their implementation of new risk-focused examination procedures includes some training by Federal Reserve examiners. However, having some relatively small agencies limits the ability of these agencies to take advantage of economies of scope and scale relative to these skills. This is especially true with regard to the specialized skills related to understanding the complex statistical models that firms are using to manage risks and the structured products they provide. These skills are needed in varying degrees by all financial regulatory agencies. Finding people with the requisite skills is complicated because they are scarce and in demand by the industry, where the pay is often considerably higher than at a regulatory agency. Regulators say that consolidating regulatory agencies would not alleviate this shortage because even if they

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added together all of the staff of all of the regulatory agencies involved in these complex tasks, there would still not be enough staff with the requisite skills. However, the current system does not provide a mechanism to ensure that the staff is allocated optimally.

# Congress May Want to Consider Changes to the U.S. Regulatory Structure

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As we have seen, over the last several decades the financial services industry has changed in many significant ways. These changes have blurred the clear-cut boundaries between the “functional” areas underlying our regulatory structure, so that large firms and products increasingly compete across or otherwise ignore these boundaries. Very large firms are increasingly competing in more than one of the four sectors of the industry and across national boundaries. In addition, these firms take on similar risks and manage these risks at the consolidated level. Policies and procedures related to market conduct and corporate governance also tend to be set centrally in these organizations. Moreover, hybrid products are blurring the lines between “functional” activities, and even firms that specialize in a specific functional area are competing to provide similar services to the same consumers and businesses.

The financial services industry is critical to the health and vitality of the U.S. economy. While the industry itself bears primary responsibility to effectively manage its risks, the importance of the industry and the nature of those risks have created a need for government regulation as well. While the specifics of a regulatory structure, including the number of regulatory agencies and the roles assigned to each, may not be the critical determinant in whether a regulatory system is successful, the structure can facilitate or hinder the attainment of regulatory goals. The skills of the people working in the regulatory system, the clarity of its objectives, its independence, and its management systems are critical to the success of financial regulation.

The U.S. regulatory structure facilitates regulators having detailed knowledge about banking, insurance, securities, and futures activities, and these regulators report that they do exchange information relevant to the supervision of institutions that operate in more than one of these areas. However, the regulatory structure hinders comprehensively understanding and, when appropriate, containing the risk-taking activities of large, complex, internationally active institutions; promoting the global competitiveness of the U.S. financial services industry; maintaining to the greatest extent possible competitive neutrality; and handling possible systemic repercussions. The U.S. regulatory structure also does not have an ability to develop a strategic focus that would guide the priorities and activities of each agency and does not have the ability to allocate resources across agencies.

Because our regulatory structure relies on having clear-cut boundaries between the “functional” areas, industry changes that have caused those boundaries to blur have challenged the regulatory framework. While

diversification across activities and locations may have lowered the risks being faced by some large, complex, internationally active firms, understanding and overseeing them has also become a much more complex undertaking, requiring staff that can evaluate the risk portfolio of these institutions and their management systems and performance. Regulators must be able to ensure effective risk management without needlessly restraining risk taking, which would hinder economic growth. Similarly, because firms are taking on similar risks across “functional” areas, to understand the risks of a given institution or of the system as a whole, regulators need a more complete picture of the risk portfolio of the financial services industry both in the United States and abroad. For example, in our report on LTCM and its rescue, we said the following:

Because of the blurring in recent years of traditional lines that separate the businesses of banks and securities and futures firms, it is more important than ever for regulators to assess information that cuts across these lines. Regulators for each industry have generally continued to focus on individual firms and markets, the risks they face, and the soundness of their practices, but they have failed to address interrelationships across each industry. The risks posed by LTCM crossed traditional regulatory and industry boundaries, and the regulators would have needed to coordinate their activities to have had a chance of identifying these risks. Although regulators have recommended improvements to information reporting requirements, they have not recommended ways to better identify risks across markets and industries.<sup>1</sup>

The regulatory framework envisioned in GLBA recognizes some of the linkages within institutions and contains a framework for consolidated oversight of some types of firms. Activities at the Basel Committee and requirements that take affect in early 2005 for firms conducting business in EU countries have led regulators to adopt some new policies and rules in this area. However, different regulatory treatment of bank and financial holding companies, consolidated supervised entities, supervised investment bank holding companies, and thrift 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.

Recognizing that regulators could potentially overcome the impediments of a fragmented regulatory structure through better communication and coordination across agencies, Congress has created mechanisms for coordination and on a number of specific issues directed agencies to

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<sup>1</sup>GAO/GGD-00-3, 3.

coordinate their activities. In addition, we have repeatedly recommended that federal regulators improve communication and coordination. For example, in our report on LTCM, we recommended that federal financial regulators develop ways to better coordinate oversight activities that cut across traditional regulatory and industry boundaries. While we continue to support these recommendations, we recognize that the sheer number of regulatory bodies, their underlying competitive nature, and differences in their regulatory philosophies will continue to make the sharing of information difficult and true coordination and cooperation in the most important or most visible areas problematic as well. Therefore, Congress might want to consider some changes to the U.S. financial services regulatory structure that address weaknesses and potential vulnerabilities in our current system, while maintaining its strengths.

However, structural changes themselves will not ensure the attainment of various regulatory goals. That will require a structure with the right people and skills, clear regulatory objectives, effective tools, and appropriate policies and procedures. A different organizational structure will not necessarily make the inherently difficult task of detecting fraud in a financial institution easier, and it also would not ensure more accurate and comprehensive detection. In addition, any major change in the regulatory structure poses the risk of unintended consequences and transition costs. Organizational changes may take place over several years, and regulators might lose sight of their objectives while management jockeys for control of the agenda of a new or reformulated regulatory body, staff worry about having jobs in the new system, or employees become accustomed to their new roles in the new organization.

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## Matter for Congressional Consideration

While maintaining sector expertise and ensuring that financial institutions comply with the law, Congress may want to consider some consolidation or modification of the existing regulatory structure to (1) better address the risks posed by large, complex, internationally active firms and their consolidated risk management approaches; (2) promote competition domestically and internationally; and (3) contain systemic risk. If so, our work has identified several options that Congress may wish to consider:

- consolidating the regulatory structure within the “functional” areas;
- moving to a regulatory structure based on a regulation by objective or twin peaks model;

- combining all financial regulators into a single entity; or
- creating or authorizing a single entity to oversee all large, complex, internationally active firms, while leaving the rest of the structure in place.

If Congress does wish to consider these or other options, it may want to ensure that legislative goals are clearly set out for any changed regulatory structure and that the agencies affected by any change are given clear direction on the priorities that should be set for achieving these goals. In addition, any change in the regulatory structure would entail changing laws that currently govern financial services oversight to conform to the new structure.

The first option would be to consolidate the regulatory structure within “functional” areas—banking, securities, insurance, and futures—so that at the federal level there would be a primary point of contact for each. The two major changes to accomplish this at the federal level would be consolidation of the bank regulators and, if Congress wishes to provide a federal charter option for insurance, the creation of an insurance regulatory entity. The bank regulatory consolidation could be achieved within an existing banking agency or with the creation of a new agency. In 1996, we recommended that the number of federal agencies with primary responsibilities for bank oversight be reduced. However, we noted that in the new structure, FDIC should have the necessary authority to protect the deposit insurance fund and that the Federal Reserve and Treasury should continue to be involved in bank oversight, with access to supervisory information, so that they could carry out their responsibilities for promoting financial stability. We have not studied the issue of an optional federal charter for insurers, but have through the years noted difficulties with efforts to normalize insurance regulation across states through the NAIC-based structure. Having a primary federal entity for each of the functional sectors would likely improve communications and coordination across sectors because it would reduce the number of entities that would need to be consulted on any issue. Similarly, it would provide a central point of communication for issues within a sector. Fewer bank regulators might reduce the cost of regulation and the opportunities for regulatory arbitrage, choosing charters so that transactions have the least amount of oversight. In addition, issues related to the independence of a regulator from the firms they oversee with a given kind of charter would be alleviated. However, consolidating the banking regulators and establishing a federal insurance regulator would raise concerns as well. While improved



communication and cooperation within sectors would help to achieve the other objectives outlined above, it would not directly address many of them. In addition, some constituencies, such as thrifts, might feel they were not getting proper attention for their concerns; and opportunities for regulatory experimentation and the other positive aspects of competition in banking could be reduced. Further, while this option represents a more evolutionary change than some of the others, it might still entail some costs associated with change, including unintended consequences that would undoubtedly erupt as various banking agencies and their staff jockeyed for position within the new banking regulator. Similarly, the establishment of a federal insurance regulator might have unintended consequences for state regulatory bodies and for insurance firms as well.

Another option would be consolidating the regulatory structure using a regulation by objective, or twin peaks model. The twin peaks model would involve setting up one safety and soundness regulatory entity and one conduct-of-business regulatory entity. The former would oversee safety and soundness issues for insurers, banks, securities, and futures activities, while the latter would ensure compliance with the full range of conduct-of-business issues, including consumer and investor protection, disclosure, money laundering, and some governance issues. This could be accomplished by changing the tasks assigned to existing agencies or by restructuring the agencies or creating new ones. On the positive side, this option would directly address many of the regulatory objectives related to larger, more complex institutions, such as allowing for consolidated supervision, competitive neutrality, understanding of the linkages within the safety and soundness and conduct-of-business spheres, and regulatory independence. In addition, conduct-of-business issues would not become subservient to safety and soundness issues, as some fear. On the negative side, in addition to the issues raised by any change in the structure, this structure would not allow regulators to oversee the linkages between safety and soundness and conduct-of-business. As reputational risk has become more important, the linkages between these activities have become more evident. In addition, if the controls and processes for conduct-of-business issues and safety and soundness issues are coming from the top of the organization, they are probably closely related. Finally, combining regulators into multifunctional units might not allow the regulatory system to maintain some of the advantages it now has, including specialized expertise and the benefits of regulatory competition and experimentation.

The most radical option would combine all financial regulators into a single entity, similar to UK-FSA. The benefits of the single regulator are that one body is accountable for all regulatory endeavors. It can more easily evaluate the linkages within and across firms, including those between conduct-of-business and safety and soundness considerations, plan strategically across sectors, and facilitate the allocation of resources to their highest priority use. However, achieving these goals would depend on having the right people and skills, clear regulatory objectives, effective tools, and appropriate policies and procedures. While the UK-FSA model is intriguing, this option raises some concerns for the United States. First, because of the size of the U.S. economy and the number of financial institutions this entity would have to be very large and, thus, could be unwieldy and costly. UK-FSA has about 2,300 employees, while estimates of the number of regulators currently in the United States range from about 30,000 to 40,000. In addition, officials at UK-FSA have commented about the difficulty of setting priorities when a large number of issues have to be dealt with. Prioritizing these issues for the United States would be particularly difficult. Further, an entity with this scope and size might have difficulty responding to smaller players and might therefore damage the diversity that has enriched the U.S. financial industry. Also, staff at such an entity might lose or not develop the specialized skills needed to understand both large and small companies and risks that are specific to the different “functional” sectors. And without careful oversight, such a large and all-powerful entity might not be accountable to consumers or the industry.

A more evolutionary change would be to have a single entity with responsibility for the oversight of all large, complex, or internationally active financial services firms that manage risk centrally, compete with each other within and across sectors, and, by their size and presence in a wide range of markets, pose systemic risks. Having a single regulatory entity for large, complex, or internationally active firms could be accomplished by giving this responsibility to an existing regulator or by creating a new entity. A new entity might consist of a small staff that would rely on the expertise of staff at existing regulatory agencies to accomplish supervisory tasks.

Having a single regulatory entity for large, complex, or internationally active firms would have the advantage of addressing industry changes, while leaving much of the U.S. regulatory structure unchanged. A single regulatory entity for large, complex holding companies would have responsibilities that more closely align with the businesses’ approach to risk than the current regulatory structure. In addition, this entity could

promote competition between these firms by ensuring, to the greatest extent possible, that oversight is competitively neutral. A single regulatory entity for internationally active firms would also be better positioned to help coordinate the views of the United States in international forums, so that the U.S. firms are not competitively disadvantaged during negotiations. Finally, this entity would be better able to appraise the linkages across large, complex, internationally active firms and, thus, with the aid of the Federal Reserve and Treasury, could contribute to promoting financial stability. These potential improvements could be obtained without losing the advantages afforded by our current specialized regulators, who would continue to supervise the activities of regulated firms such as broker-dealers or banks. However, this option also has drawbacks. While the transition costs might be less than in some of the other options, the creation of a new entity or changing the role of an existing regulatory entity would still entail costs and likely some unintended consequences. It might also be difficult to maintain the appropriate balance between the interests of the large or internationally active firms and smaller, more-specialized entities. It also could involve creating one more regulatory agency in a system that already has many agencies.

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## Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and the Director of SEC's Division of Market Regulation. These letters are reprinted in appendixes I-V of this report.

In his comments, the Chairman of the Federal Reserve's Board of Governors said that GLBA provided for a regulatory framework that struck a balance between the need for regulation and the need for adaptability. Congress at that time chose to retain and build upon the functional regulation approach, one that has worked well for the United States and, as the report notes, has helped promote the competition and innovation that is a "hallmark" of the U.S. financial system. He further wrote that, in GLBA, "Congress also reaffirmed its determination that functional regulation needed to be supplemented by consolidated supervision of holding companies only in the case of affiliations involving banks and other insured depository institutions" because of risks associated with the access that banks and other insured depository institutions have to the federal safety net. These risks include the subsidy implicit in the federal safety net being extended to nonbank affiliates and ownership of an insured bank reducing

market discipline. In addition, he cautioned that if Congress were to consider restructuring the federal financial regulatory agencies, it should carefully consider the benefits and costs, including the effect on the industry's competition and innovation and that any agency "strategic plan" would be unable to anticipate the effects of this innovation.

The Chairman of the Federal Deposit Insurance Corporation wrote that the draft report paid insufficient attention to the fact that deposit insurance is limited to insured depository institutions, and the danger that focusing on consolidated supervision would blur the distinction between the insured depository institution and any uninsured affiliates. He noted that this distinction would become more important if the marketplace drives greater mixing of commerce and finance than currently occurs. He also warned that, if federal financial regulators were to be consolidated, the value of differing perspectives within the regulatory system would be lost and independence of the deposit insurer could be diminished.

The Comptroller of the Currency also warned that any change in the federal financial regulatory structure "should be approached judiciously and cautiously." Like the Chairman of the Federal Reserve's Board of Governors, the Comptroller cautioned that changes in the federal regulatory structure could diminish the value of the dual banking system, with both state and federal charters for banks and thrifts. He noted that, while some foreign regulators may have preferred the "convenience" of having only one U.S. negotiator in the Basel II negotiations, this might have been less important than their desire to reach an agreement without the formal rule-making process that U.S. regulators must follow.

We agree with many of these comments, and believe the report accurately reflects the challenges that Congress would face if it were to choose to consider some consolidation or modification of the current federal financial regulatory structure. Achieving a balance between market forces and regulation is an inherently difficult task. We have made several changes to our report to ensure that it reflects this difficulty. In particular, we expanded our discussion of the statutory goals for the federal financial regulators. We also changed phrasing in the report to make clear that federal deposit insurance does not extend beyond FDIC-insured depository institutions. It is a valid concern that deposit insurance not be extended beyond the insured depository under any circumstances. We have also noted that the federal rule-making process could contribute to the statements made to us by foreign financial regulators about U.S. participation in the Basel II negotiations. In addition, we expanded our

discussion of agency strategic plans to make clear that their purpose is better preparing agencies to meet the challenges posed by the industry's innovations. During our study, we were impressed by the strategic focus that appears to permeate UK-FSA and believe that, in this regard, it is a useful model for U.S. agencies to study. We agree with the Chairman of the Federal Reserve's Board of Governors that a single regulator could "prohibit or restrain" innovation, and believe that the report does recognize this risk. In addition, while we recognize that Congress referred to the importance of deposit insurance and of not extending the safety net in its discussion of the Federal Reserve's role as a consolidated supervisor, it did not limit its discussion of consolidated supervision to this purpose and did not ensure that all insured depositories owned by other entities would be subject to consolidated supervision. For example, GLBA gave SEC the authority to oversee SIBHCs—investment bank holding companies that do not own certain types of insured depositories (at the option of the investment bank.) In addition, because GLBA exempts some insured depositories, either directly or as a result of grandfathering some pre-existing conditions, some of the most complex institutions in the United States that own insured depositories are not required to have consolidated supervision. Instead, these institutions are seeking consolidated supervision because of changes in EU law.

In his comments, the Director of the Office of Thrift Supervision wrote that the report inadequately recognized OTS's authority over thrift holding companies, including the top-tier parent company; that the report inaccurately portrayed OTS's international activities; and presented an "unbalanced" view in referring to the failure of Superior Bank, FSB, without referring to other bank failures.

We do not agree. Our report recognizes OTS's authority, noting that, under the Home Owners' Loan Act and other legislation, "companies that own or control a savings association are subject to supervision by OTS." Further, the report includes a section in chapter 1 devoted to a discussion of OTS's authority to oversee thrift holding companies; again in chapter 4, we discuss OTS's authority as a consolidated supervisor. In the report, we acknowledge that because OTS oversees some of the largest, most complex U.S. financial services firms, it may serve as the consolidated supervisor for some of these firms under the Conglomerates Directive of the EU Action Plan. As noted, however, we have neither evaluated OTS's thrift holding company examinations nor compared them with Federal Reserve examinations of bank or financial holding companies of similar size and complexity. Our report also discusses OTS's role in international

forums—specifically its participation in the Basel II negotiations—and at OTS’s suggestion, we have modified the report to make clear that OTS has applied to be a permanent member of the Basel Committee. However, we note that they continue to be the only federal regulator of depository institutions, other than NCUA, that does not have a permanent seat on this important committee.

Finally, while Superior Bank failed because of its own actions, the failure also provided lessons on the need for federal regulators to work together better. The then-Director of OTS acknowledged this need in testimony before the Senate Committee on Banking, Housing, and Urban Affairs.<sup>2</sup> In our assessments of that failure, both the FDIC Inspector General and we found that effective coordination was lacking.<sup>3</sup> We did revise this report to make explicit that the primary reason for Superior’s failure was actions by its owners and management. We also added a reference to the failure of the First National Bank of Keystone (West Virginia) that, according to a report by the Treasury Inspector General, also showed the need for better communication between FDIC and a primary federal regulator. (In the Keystone instance, OCC was the primary federal regulator.) Our report does discuss an agreement among federal bank regulators establishing a better process to determine when FDIC will join in the examination of an insured bank. In the comments, OTS also noted that, as a percentage of assets, the cost to the insurance fund of resolving Superior Bank was the lowest of the group of failures it cited (including Keystone). However, the Keystone and Superior failures did incur the largest costs to the insurance funds (\$635 million and \$436 million, respectively) of the failures that OTS cited.

In SEC’s comments on the draft report, the Director of the Division of Market Regulation noted that “supervision and regulation can always be improved, but the costs of change must always be weighed against its benefits.” As noted above, we concur.

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<sup>2</sup>Statement of Ellen Seidman, Director of the Office of Thrift Supervision, in U.S. Senate, Committee on Banking, Finance, and Urban Affairs, “The Failure of Superior Bank, FSB, Hinsdale, Illinois,” September 11, 2001, and October 16, 2001, S. Hrg. 107-698, p. 13.

<sup>3</sup>Office of the Inspector General, FDIC, *Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois*, Audit Report 02-005 (Washington, D.C.: Feb. 6, 2002); and GAO, *Bank Regulation: Analysis of the Failure of Superior Bank, FSB, Hinsdale, Illinois*, [GAO-02-419T](#) (Washington, D.C.: Feb. 7, 2002).

In addition to the written comments, we also received technical comments and corrections from the staffs at these agencies, or in the case of OTS as part of their written comments. We have incorporated these into the report, as appropriate.

We also provided the Department of the Treasury and CFTC with a draft of the report, so that they could provide written comments, if they wished. Neither agency chose to provide such comments. Because the report discusses proposals for an optional federal insurance charter, we also provided a draft to NAIC, representing the state insurance regulatory agencies, for them to provide comments; NAIC did not provide comments. We did receive technical comments and corrections from Treasury, CFTC, and NAIC staff that we have incorporated into the report, as appropriate.

# Comments from the Board of Governors of the Federal Reserve System



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

September 16, 2004

ALAN GREENSPAN  
CHAIRMAN

Mr. Thomas J. McCool  
Managing Director  
Financial Markets and Community Investment  
U.S. Government Accountability Office  
441 G Street, N.W., Room 2A32  
Washington, D.C. 20548

Dear Mr. McCool:

The Federal Reserve appreciates the opportunity to provide comments on a draft of the GAO's report on the regulatory structure of the U.S. financial services industry (GAO-04-0889). The report reviews the existing regulatory structure for the U.S. financial services industry, as well as the financial services regulatory structure implemented by a few other countries, and offers some broad alternatives that the Congress might wish to consider for consolidating the U.S. structure. These alternatives include vesting a single agency with regulatory responsibility for the entire financial services industry; establishing two overarching agencies, with one having responsibility for safety and soundness regulation and the other for market conduct across all financial services sectors; vesting a single agency with responsibility to oversee all large or internationally active financial services firms; or consolidating the regulatory agencies within individual sectors.

The report takes on a challenging task, especially given the breadth and diversity of the financial services industry in the United States and the fact that, by all indications, our regulatory framework has worked well and helped promote innovation, competition and stability in the financial markets. The Congress serves as the "strategic planner" of the U.S. financial system and in this capacity shapes the overall structure of our financial regulatory system and balances the costs and benefits of modifications to that system. Less than five years ago, the Congress considered the issues of financial modernization, globalization, concentration and competition across sectors of the financial services market along with the implication of these forces for the U.S. regulatory framework in connection with its passage of the Gramm-Leach-Bliley Act (GLBA). The resulting historic legislation eliminated outdated restrictions that previously limited the ability of financial services firms to affiliate and compete with one another and enhanced the ability of U.S. financial services firms to respond to technological changes and compete internationally.



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**Appendix I**  
**Comments from the Board of Governors of**  
**the Federal Reserve System**

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Mr. Thomas J. McCool  
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GLBA also provided for a regulatory framework that struck a balance between the need for regulation and the need for adaptability. The Congress at that time chose to retain and build upon the functional regulation approach, one which has worked well for the United States and, as the report notes, has helped promote the competition and innovation that is a hallmark of the U.S. financial system. Functional regulation helps ensure that regulatory oversight is imposed in each sector only to the extent necessary to address perceived market failings in that sector, such as to provide appropriate protection of investors (in securities markets) and consumers (in banking markets) and to ensure the safety and soundness of insured depository institutions where counterparty discipline is undermined by the effects of the government subsidy provided to depository institutions through deposit insurance and access to the discount window and payments system. Given the variety of goals associated with the regulation of different components of the financial system, the Congress determined that supervision was best accomplished by individual functional regulators who implement statutory mandates tailored to their individual sectors.

The Congress also reaffirmed its determination that functional regulation needed to be supplemented by consolidated supervision of holding companies only in the case of affiliations involving banks and other insured depository institutions. Notably the Congressional decision to require consolidated supervision of such financial services firms was not driven by size, but by the unique risks that occur when these firms are affiliated with depository institutions that have access to the federal safety net (that is, the risk that the subsidy arising from the federal safety net may spread to non-bank affiliates, as well as the reduced market discipline that may result from the company's ownership of an insured bank). In retaining the Federal Reserve's role as the consolidated or umbrella supervisor for bank and financial holding companies, the Congress reaffirmed the need for the central bank to maintain a significant role in the supervision of banking entities. The Federal Reserve, through consolidated capital requirements, examinations and reporting requirements (supplemented, where appropriate, by enforcement authority) seeks to ensure that the risks from the consolidated operations of a bank or financial holding company—including large and internationally active organizations—do not pose a risk to its subsidiary depository institutions. Moreover, in its role as umbrella supervisor, the Federal Reserve works to coordinate its supervisory functions and share information as appropriate with the functional regulators of the subsidiaries of a financial or bank holding company.

On balance, while our present regulatory structure is admittedly complex, the dynamism of our financial system also owes much to the opportunities, checks and balances that it provides. This no doubt helps explain why, less than five years ago, the Congress decided to build on the existing system of functional regulation when it reviewed the regulatory system for financial services in connection with the GLBA. Certainly, if the Congress should decide at some point in the future to revisit the issue of

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significant regulatory consolidation, it should conduct a careful and in-depth analysis of the potential costs and benefits associated with any proposed changes, including the impact of any changes on competition and innovation in the financial services industry.

In particular, the Congress should recognize that it may be difficult to consolidate the regulators for different sectors without altering the extent and nature of regulation for at least some sectors of the industry. Historically, our regulatory system has been guided by the principle that the best means to promote competition among financial institutions and to maintain a resilient financial system is to provide regulation only as needed to address demonstrated market deficiencies. The long and remarkable history of product innovation in U.S. financial markets speaks eloquently to the power of this prescription. The Congress has found functional regulation to be the most desirable approach to achieve this goal, since it allows the type of regulation to be tailored to the market shortcomings in each sector and allows individual regulators to focus on the goals mandated by the Congress. One danger of consolidating the regulatory agencies for different sectors is that it may lead to the extension of *regulation* beyond the individual segments where it currently is focused or to the expansion of the federal safety net. Spreading the ambit of supervision and regulation might well increase risk by reducing private market surveillance and discipline.

Consolidating regulatory responsibility for the entire financial services industry within a single agency also involves special risks. No matter how wise the particular regulatory agency, no “strategic plan” by that agency can adequately foresee innovations in the industry. Indeed, a single financial regulator with oversight responsibilities for all sectors of the financial services industry may well have prohibited or restrained the kinds of innovations and advances that have contributed so much to the growth and vitality of the U.S. economy.

If the Congress considers consolidation of the regulatory agencies in the banking sector, it also should be careful to preserve the “dual” banking system, which has contributed greatly to competition and innovation in banking markets.

The Federal Reserve staff has given GAO detailed comments on a draft of its report to the Congress on regulatory structure. We hope that these comments have been addressed in the final report.

Sincerely,  


# Comments from the Federal Deposit Insurance Corporation



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONALD E. POWELL  
CHAIRMAN

September 14, 2004

Mr. Thomas J. McCool  
Managing Director  
Financial Markets and Community Investment  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to comment on your draft report on the U.S. financial regulatory structure. Your report recommends that Congress consider ways to improve the current regulatory structure and proposes several options as a starting point for those discussions.

The U.S. financial services system is the most vibrant and innovative in the world. As we explore options for regulatory reform, we should take care to preserve the strengths that presently underpin our financial services industry. But the industry is dynamic and what has served us well in the past may not be sufficient for the many and profound changes that have occurred in recent history. I have spoken on several occasions about the need to consider changes to the current regulatory structure in order to reflect the changes in the industry, to improve operating efficiencies, and to deliver policy in a timelier and more consistent manner. In 2003, the Federal Deposit Insurance Corporation held a symposium on the future of financial regulation, where some of the questions and issues raised in your report were explored.

The report is an important contribution to an extensive literature addressing options for restructuring the U.S. financial regulatory system. We are concerned, however, that the report did not address certain significant issues that need to be considered in any discussion of regulatory structure.

One major concern we have is that the report's treatment of consolidated supervision does not address the importance of legal-entity distinctions. In the U.S., significant federal safety net protections are extended to FDIC-insured depository institutions. Banks' parents and affiliated organizations do not enjoy similar protections. Choosing the scope of the federal financial institutions safety net is one of the most important choices in the financial arena that Congress can make. Once that choice is made, certain consequences follow, for with the safety-net protection comes a critical need to protect against the danger that market discipline will erode, risks undertaken by the protected entities will increase, and the taxpayers will be forced to underwrite the cost.

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**Appendix II**  
**Comments from the Federal Deposit**  
**Insurance Corporation**

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The danger in focusing on consolidated supervision is that the line delimiting the scope of the federal safety net may become blurred. Strong supervision and regulation of FDIC-insured depository institutions at the entity level is necessary to contain the cost of administering the deposit insurance guarantee. From this perspective it is imperative that the regulatory structure be designed so that any additional layers of consolidated or parent company supervision do not interfere with the ability to regulate and supervise insured institutions. The more a bank becomes inextricably linked with its affiliates, the greater the likelihood that problems elsewhere in the organization will lead to that bank's failure, and the greater the costs the FDIC will incur in the receivership.

The issue of consolidated versus entity-level supervision will become increasingly important if, as we expect, the marketplace continues to evolve toward greater mixing of banking and commerce. The report is essentially silent on this matter. Will commercial firms that choose to enter the banking business be subject to consolidated supervision, thus bringing more and more economic activity into a regulatory framework designed to administer the financial safety net? Or will we limit our regulatory attention to the bank itself, the entity that has the direct connection to the federal safety net, and let the discipline of the market oversee the nonbank activity?

The tone of the report is generally supportive of some regulatory consolidation. The FDIC agrees that some degree of regulatory consolidation would lead to regulatory efficiencies. The current system, with four federal banking regulators, is complex and inefficient and occasionally burdensome to the regulated entities. Indeed, having multiple regulators can too often lead to gridlock on important policy issues, resource allocation challenges in the presence of a shifting workload, and operational coordination difficulties.

While correctly noting a number of potential benefits of regulatory consolidation, the report does not sufficiently address a risk that could exist under a single regulator model — the loss of effective independent voices in the regulatory process. A beneficial aspect of our current regulatory structure is the checks-and-balances that are built into it. We should consider the experience of countries whose largest banks dominate their domestic banking markets to a much greater extent than in the U.S., and where the bank regulatory framework is more monolithic than in the U.S. In such countries, capital requirements and capital levels are substantially lower than in the U.S., and some of those banking systems are experiencing weakness. U.S. banks are relatively stronger than banks around the world for a number of reasons, but perhaps especially because bankers, regulators and Congress learned important lessons in the 1980s and early 1990s. The lessons were in part embodied in the Federal Deposit Insurance Corporation Improvement Act and its Prompt Corrective Action framework, enacted in substantial measure to contain the costs of deposit insurance. In this regard, we must not lose sight of the importance of minimum capital requirements for institutions, such as FDIC-insured banks and thrifts, that enjoy explicit safety-net support.

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**Appendix II**  
**Comments from the Federal Deposit**  
**Insurance Corporation**

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The need to contain the costs of deposit insurance, and the tools the FDIC needs to do this, are straightforward and, we believe, necessary components of any regulatory reform package. First, to fulfill its role effectively, the deposit insurer needs continued independence and back-up supervisory authority over the institutions it insures. Along with that independence, the power to approve or deny applications for deposit insurance, examine any insured institution or its affiliate, take enforcement actions, and participate on an ongoing basis in on-site supervision are vital. While a perfect regulatory framework may never be attained, a strong and independent deposit insurer can, as history has shown, serve as an important line of defense against systemic problems in the industry and, ultimately, losses to the insurance fund. History also has proven that when an insurer has no supervisory authority and no input into who receives access to the federal safety net, the outcome can be costly and even disastrous. Although your report does not specifically address the importance of a strong independent insurer with the appropriate authority, the GAO's historical support for a strong independent insurer indicates that you share this view.

Finally, we applaud the report for noting the importance of people. The report mentions how regulatory agencies can essentially rise above a regulatory framework that is less than ideal, appropriately noting that "having an adequate number of people with the right skills, clear objectives, appropriate policies and procedures, and independence are probably more important" than the regulatory structure. To that end, the FDIC introduced a legislative proposal on September 1, 2004, that will, if enacted, enhance the agency's responsiveness to rapidly changing business and regulatory demands through changes in the size and composition of the Corporation's employment levels and skill sets.

Thank you again for your efforts. The FDIC looks forward to continued involvement in discussions of the U.S. regulatory framework.

Sincerely,



Donald E. Powell

cc: Honorable Wayne Abernathy  
Honorable Thomas J. Curry  
Honorable James E. Gilleran  
Honorable Alan Greenspan  
Honorable John D. Hawke  
Honorable John Reich

# Comments from the Office of the Comptroller of the Currency



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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

September 17, 2004

Mr. Thomas J. McCool  
Managing Director, Financial Markets and Community Investment  
United States Government Accountability Office  
Washington, DC 20548

Dear Mr. McCool:

We have received and reviewed your draft report entitled Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure. The report was prepared at the request of Congress to describe the current state of the U.S. financial services regulatory structure in light of the passage of the 1999 Gramm-Leach-Bliley Act and increased competition within the financial services industry at home and abroad. The draft report concludes that (1) the financial services industry has undergone dramatic changes; (2) some countries and states have consolidated their regulatory structures, but the United States has not adopted consolidation proposals; (3) some regulators are adapting regulatory and supervisory approaches to industry changes; (4) regulators communicate and coordinate through multiple venues, but concerns remain; and (5) the U.S. regulatory system has strengths, but its structure may hinder effective regulation.

The report offers options for Congress to consider for changing the regulatory structure to (1) better address the risks posed by large, complex firms and their consolidated risk management approaches, (2) promote competition domestically and internationally, and (3) contain systemic risk. Options for consolidation could take place within functional areas, by regulatory objective, by combining all regulators into a single entity, or by creating a single regulator with responsibility for the oversight of large and/or internationally active financial services firms that manage risk centrally.

The report will provide a useful reference for continued discussions and deliberations on this important issue. In particular, the report underscores two important points with which we agree and that should be prominent in any dialog on regulatory restructuring. First, no one regulatory structure or framework is ideal. Each framework has its strengths and weaknesses and different jurisdictions have adopted different approaches – most of which remain untested in terms of a large scale, systemic problem or issue. Second, while any given regulatory structure may facilitate or hinder the attainment of regulatory goals, ultimately it is, as your report points out, the “skills of the people

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**Appendix III  
Comments from the Office of the Comptroller  
of the Currency**

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working in the regulatory system, the clarity of its objectives, its independence, and its management systems that are critical to the success of financial regulation.”

I publicly observed in a speech before the Exchequer Club in April 2003 that the current bank regulatory structure offends many of our aesthetic and logical instincts. It’s complicated; it probably has inefficiencies; and it takes a great deal of explaining. But, I concluded that the system works – perhaps not in theory but in practice. Indeed, it works well. Coordination occurs among the agencies on a routine basis, with regard to both the supervision of individual firms and broader supervisory policies and procedures. While there are examples of inconsistency, such as the recent CRA rulemaking, regulatory cooperation is the norm, not the exception. On the whole the agencies have recognized the need to work together to avoid inconsistencies and to respect one another’s jurisdictions and responsibilities. The exemplary manner in which the agencies cooperated to prepare for the Year 2000 date conversion and to cope with the aftermath of the September 11 emergency demonstrate the effectiveness of the existing relationships.

Another important consideration in deliberating the regulatory structure is the roles of the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve maintains that it must have a major presence in bank supervision as an adjunct to its monetary policy and payments system responsibilities. Similarly, the FDIC opines that it must have a role in bank supervision to minimize risks and losses to the deposit insurance fund. Adopting the foreign models described in GAO’s report would suggest that bank supervisory roles be extracted from these entities. Whether such a dramatic change in a system that is working well overall is warranted, is debatable.

For example, the GAO’s draft report provides the perspective of some foreign regulators and other parties about the efficacy of the U.S. in recent Basel II negotiations. While some European regulators may have preferred the convenience of having only one U.S. regulator at the “negotiating table,” their preference may be more indicative of a desire to finalize a Basel Accord without regard to the U.S. deliberative rulemaking process than of a judgment of the value that all of the U.S. regulators have contributed to the Basel II efforts. The U.S. agencies have been very clear in the Basel II discussions that the U.S. will have a rigorous and open rulemaking process. And it is precisely because of our insistence on this point that important changes have been made to the Basel II framework so as to not disadvantage U.S. firms even though this may have resulted in delays to the Basel Committee’s initial timetable.

Finally, it is especially important to weigh the effect of any change in the regulatory structure at the federal level on the dual banking system. If the federal bank supervisory agencies were consolidated into a single independent agency that supervised both federally and state chartered institutions, then charter choice could become meaningless and result in pressure for uniformity of powers between state and federal institutions.

For these reasons, any decision to change or overhaul the U.S. financial regulatory structure should be approached judiciously and cautiously.

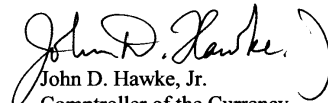
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**Appendix III**  
**Comments from the Office of the Comptroller**  
**of the Currency**

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Thank you for providing us the opportunity to review and comment on the draft report. Technical suggestions were provided to the analysts separately.

Sincerely,

  
John D. Hawke, Jr.  
Comptroller of the Currency



# Comments from the Office of Thrift Supervision



**Office of Thrift Supervision**  
Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6590

*James E. Gilleran*  
*Director*

September 9, 2004

Thomas J. McCool  
Managing Director, Financial Markets and  
Community Investment  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. McCool:

This letter provides comments with regard to United States Government Accountability Office's (GAO) study entitled Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure. We have carefully considered the findings and recommendations contained therein, and feel that inferences made throughout the report will mislead the reader into drawing inaccurate conclusions, not only about Office of Thrift Supervision's (OTS) regulatory role in supervising thrift institutions and their holding companies, but the regulatory framework in the United States (U.S.) and abroad in general. We ask that you change your report to accommodate our concerns. The following discussion summarizes particular areas of concern.

## **I. OTS's Authority as a Consolidated Regulator**

The highlights page that accompanied the draft report asserts that in the U.S. regulatory structure today, "no one regulator has a complete picture of complex institutions engaged in more than one functional area." This statement is not accurate with respect to the thrift industry. Unique among U.S. Federal banking agencies, OTS has supervisory authority over the entire thrift holding company structure up through the top-tier parent company. The origin of OTS's current authority to supervise thrift holding companies dates to the Savings and Loan Holding Company Amendments of 1967. Thrift institutions and their affiliates (including thrift holding companies and their subsidiaries) are subject to OTS-prescribed regulations and examinations and are required to give OTS complete access to all books, records and personnel. Under this authority, we may require reports on the condition and operations of the thrift institution, its holding company(ies) and other related entities. OTS may also regulate and examine

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independent entities that provide services to thrift institutions, subsidiaries or affiliates pursuant to 12 U.S.C. 1464(d)(7). OTS can take enforcement action against the service provider just as it can against the thrift, subsidiary or affiliate itself.

OTS supervises thrift holding companies that engage in more than one functional area. More than 100 thrift holding company structures are engaged in significant lines of business other than banking. These include insurance, asset management, financial services, retailing and manufacturing. The following list is representative of the diverse holding companies OTS supervises and is not all-inclusive. Some companies are mixed conglomerates with financial and non-financial operations while others are financial conglomerates. All have an OTS-licensed thrift, cross-sector and cross-border operations, and are supervised on a consolidated basis by OTS:

<b>Thrift Holding Company</b>	<b>Consolidated Assets (as of June 2004)</b>
American International Group	\$736.0 billion
General Electric	\$697.1 billion
General Motors	\$454.2 billion
Lehman Brothers Holdings	\$346.5 billion
American Express Company	\$179.2 billion
The Allstate Insurance Company	\$139.8 billion
Massachusetts Mutual Life Insurance Co.	\$ 89.9 billion
Capital One Financial	\$ 50.1 billion
E*Trade Group;	\$ 30.2 billion
John Deere	\$ 26.0 billion
Federated Department Stores	\$ 14.6 billion
Auto Club Insurance Association	\$ 3.1 billion
T Rowe Price Group	\$ 1.7 billion

OTS is in a unique position of having comprehensive supervisory and enforcement powers over the entire corporate structure. The Home Owners' Loan Act clearly enables OTS to obtain a complete picture of the interrelationships and risks present, regardless of the complexity of the structure or whether it crosses more than one functional area. Figures 7 and 10 in the draft report fail to recognize that thrift holding companies have this level of complexity. Furthermore, the chart portrayed in Figures 7 and 10 is replete with errors. (For example, the chart refers to thrifts as "National" as opposed to "Federal." Furthermore, as crafted, the chart could be construed to imply that a financial holding company must always control a thrift holding company; and, most importantly, a holding company structure that controls both a thrift and a bank is subject to supervision

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by the Federal Reserve. OTS would not be involved in holding company supervision in this example.)

In order to facilitate group-wide supervision, and consistent with the functional regulation provisions of the Gramm-Leach-Bliley Act (GLBA), we have entered into regulatory cooperation agreements with supervisors in the U.S. and abroad. These cooperation agreements generally outline the type of information to share, procedures for sharing information, and expectations regarding handling of confidential information. Each agreement is adapted to address unique circumstances resulting from different state laws. To date, OTS has executed agreements with 48 state insurance regulators, as well as state banking agencies, state thrift regulators, the Federal Home Loan Banks, and the National Association of Securities Dealers (NASD).

OTS also engages in a host of collaborative activities to further communications and enhance understanding of issues in all financial sectors. OTS staff has conducted meetings with Securities and Exchange Commission staff, NASD staff, and state securities regulators to understand their examination programs and practices so that we may address any gaps between functional regulators as we conduct our consolidated review. OTS staff also attends quarterly meetings sponsored by the National Association of Insurance Commissioners, as well as cross sector meetings hosted by the Board of Governors of the Federal Reserve. We have participated in training programs conducted by the insurance industry, as well as developed training for insurance supervisors to better understand the banking industry. Furthermore, OTS staff has been instrumental in bridging the gap between regulators to understand differences in cross-sector and cross-border banking, insurance and securities industry practices.

## **II. OTS International Initiatives**

OTS is extremely concerned with the GAO's inaccurate portrayal of OTS's international activities. These concerns are two-fold. First, we believe the report understates OTS's role in international initiatives on the Basel II Capital Framework and the European Union's Financial Conglomerates Directive. Recognizing that drafts of the Basel II capital framework and bifurcated capital requirements in the U.S. failed to address issues unique to mortgage-focused lenders and small institutions, OTS aggressively started attending and participating in meetings in Basel. Previously, OTS had informally participated by providing comments to other U.S. banking agencies that are permanent members of the Basel Committee. Furthermore, the changes to the Basel II framework, that some may have perceived as late, substantially improved the final product. Working together, the U.S. regulators, including OTS, were successful in negotiating improvements to include:

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- The bifurcation of risk into two components -- the long-run average losses (expected losses) and the variability around those losses (unexpected losses). The U.S. banking agencies took the lead in developing the appropriate capital treatment for these different types of losses. This separation of risk into component parts has made the framework more risk sensitive, especially for such assets as mortgages and credit cards, which are significant areas of concern to the U.S.
- The appropriate recognition of recovery risk. Periods of high default rates are often accompanied by low recovery rates on defaulted assets. The Basel II framework now incorporates recovery risk into the minimum capital requirement calculation.
- U.S. banks and thrifts make heavy use of securitization structures to redistribute risk. The U.S. banking agencies have been instrumental in incorporating the various aspects of securitization into the new framework.

Without these improvements, the new Basel framework would have been less risk sensitive and potentially detrimental to certain U.S. banking interests.

OTS has also been a leader in working with European Union representatives to implement the Financial Conglomerates Directive issued in December 2002. In fact, OTS had already implemented a comprehensive, more formalized supervisory planning process for high risk or other complex holding companies. For the most part, the majority of OTS-regulated holding companies that are considered complex, are identified as such because they either engage in a variety of financial services or other diverse activities such as commercial, retail or manufacturing. OTS responded to the convergence of banking, securities, and/or insurance activities in the thrift industry significantly before the enactment of GLBA expanded options for banks and their holding companies.

Our familiarity with these complex structures allowed us to share experiences not only as a consolidated regulator, but also as a regulator of structures with a variety of financial and commercial activities. Preliminary information provided by OTS to colleagues in the European Union was used as the cornerstone in developing a questionnaire for determining equivalency status. The legal authority that OTS has, combined with its' supervisory philosophy and strong tradition of cooperating with functional regulators across financial industries, were quickly identified as critical factors in consolidated supervision. OTS actively employs this tradition with a broader base of foreign regulators as they become more sensitive to consolidated supervision. OTS has actively engaged in extensive dialogue with a variety of foreign regulators, facilitated examination participation, coordinated numerous meetings, and had countless other

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communications on specific cases to deal with issues that arise in internationally active complex holding companies.

On July 7, 2004, the Banking Advisory Committee for the European Union issued general guidance on the extent to which the supervisory regime in the U.S. is likely to meet the objectives of consolidated supervision. The guidance concluded that there is broad equivalence in the U.S. supervisory approaches, including that employed by OTS.<sup>1</sup>

**III. Superior Bank, FSB and Interagency Cooperation**

Throughout the report, the GAO asserts that the failure of Superior Bank, FSB of Hinsdale, Illinois (Superior), is attributed to poor interagency cooperation between the Federal Deposit Insurance Corporation (FDIC) and OTS. The singular focus on Superior's failure in 2001 is unbalanced in light of the fact that there were several other bank failures around the same time with similar fact patterns. It is misleading, at best, to elaborate on only one of several similar failures and conclude without a comparative analysis that if regulatory cooperation were greater, the failure might not have occurred. In fact, the FDIC incurred significant losses in the resolution of three other depository institutions, two of which were regulated at the Federal level exclusively by the FDIC itself:

<b>Institution</b>	<b>Approximate Cost to Insurance Fund<sup>2</sup></b>	<b>Approximate Cost as a Percentage of Assets</b>
First National Bank of Keystone in Keystone, West Virginia	\$635 million	57%
BestBank, Boulder, Colorado	\$172 million	55%
Pacific Thrift and Loan Company in Woodland Hills, California	\$52 million	44%

While Superior is the only one in this group discussed in the report, it did not represent the largest loss to the insurance fund. The cost to the insurance fund to resolve Superior (\$436 million) amounted to 22 percent; the lowest cost of this group as a percentage of assets.

<sup>1</sup> The guidance did note certain caveats with many of the U.S. financial regulators. In the case of OTS, the only caveat noted was that because of the diverse population of holding companies we regulate, we do not employ a rigid, consolidated minimum capital requirement. The Banking Advisory Committee clearly understood our thinking behind our case-by-case approach. No other comments were noted with respect to OTS.

<sup>2</sup> Data from several FDIC Office of Inspector General reports (see Report Nos. 04-004 and 02-024) and from FDIC update of September 8, 2004.

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In each of these cases, the FDIC identified characteristics similar to Superior contributing to the failure of the institutions, including subprime lending and/or high loan-to-value lending without adequate prudential standards, apparent fraud, and/or large holdings of retained interests (or residuals) with questionable value.<sup>3</sup> In two of these failures, there was not another primary Federal regulator to communicate and coordinate with; yet, the failure still occurred. These failures occurred not because of an isolated incidence that could be interpreted as a lack of interagency cooperation, but because these institutions poorly managed a significant level of asset securitizations while retaining residual interests that were overvalued. This is not recognized in the GAO study and, thus, the references to Superior should be deleted.

**IV. Other Corrections**

In addition to the concerns noted above, we note the following corrections to the report.

<b>PAGE</b>	<b>CLARIFICATION/CORRECTION</b>
Multiple pages	The report uses the term "bank" both generically as a depository institution and specifically as a commercial bank (as opposed to thrift). The dual usage is problematic to the reader.
3	Line 3, after "For banks" add "and state savings banks." OTS regulates all federal savings associations and federal savings banks, state savings associations, but not state savings banks. Similar to state bank charters, the primary regulator is the state banking department, with FDIC or FRB also providing direct supervision.
6	The first paragraph implies that Basel II and consolidated supervision apply beginning January 1, 2005. Consolidated supervision is effective on that date, but Basel II is not effective until December 31, 2006, and can be postponed until the end of 2007 to allow for transition.
6	The sentence "These activities may change the regulation of some . . ." does not make sense.

<sup>3</sup> See Testimony of Donna Tanoue, then Chairman of the Federal Deposit Insurance Corporation, on recent bank failures and regulatory initiatives before the Committee on Banking and Financial Services on February 8, 2000.

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6	The reference on this page, and all other references to the “Basel Committee on Bank Supervision” should be changed to “Basel Committee on <b>Banking</b> Supervision.”
7	Text on this page is based purely on conjectures (i.e., may hinder, has the potential to create, may limit). There is not enough emphasis devoted to the current regulatory structure’s contributions to development of U.S. capital markets and overall economic growth.
12	Revise the sentence mid-paragraph that starts “The Financial Conglomerates Directive requires that non-European <b>financial conglomerates</b> ” (not just banks and security firms).
12	On this page, and elsewhere in the document the term “inappropriately supervised” firm has negative connotations. Such terminology is not used in the Financial Conglomerates Directive. The sentence should read as follows: “Under the directive, which goes into effect at the beginning of 2005, a non-European financial conglomerate, securities firm, or bank or financial holding company that is <b>not</b> supervised (delete “considered inappropriately) on a consolidated basis <b>by an equivalent</b> (delete “in its”) home country supervisor would be subject to additional . . .”
12	Same paragraph, the sentence that starts “As a result many major U.S. companies . . .” change “illustrate” to “demonstrate” and delete “acceptable” before consolidated supervision.
12	Same paragraph, next sentence “Those companies that own thrift institutions may meet the requirement because OTS oversees thrift holding companies (insert <b>on a consolidated comprehensive basis</b> ).”
13	First line, insert the word “investment” before holding companies.

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13	Line 13, sentence that begins "Securities regulators have repeatedly revised . . ." change "had" to "have."
14	Line 1, statement that "coordinated responses are not reached on some major issues." At end of sentence, add, "however, when there is a divergence, it reflects the need to address specific issues associated with a particular regulator's licensees (for example, thrift institutions that are primarily mortgage lenders, or small institutions)."
14	First paragraph, line 7, what does "On the international front" refer to? Basel II negotiations? Other negotiations? Clarification is needed.
15	Paragraph 2, line 2, "some cases" is an overstatement.
15	Paragraph 2, line 9, change "stat" to "state."
18	Line 2, change "communicate" to "communication."
18	Third line from the bottom. It is fallacious for the GAO to suggest that a "small agency" could be created to supervise the largest and most complex firms. Extensive resources are needed to accomplish a mission this expansive.
19	Line 8 references footnote 2, there is no accompanying footnote.
20	Line 1 refers to "International Stability Forum" whereas page 35 refers to "Financial Stability Forum."
20	Capitalize "Financial" in footnote 4.
21	Footnote 5 runs across three pages, also reference to percent of domestic deposits held by ILCs is inconsistent between text (line 8) and footnote 5 (page 22).
26	Paragraph 1, line 1, delete extra "be."
26	Middle paragraph, line 3. Add "and thrifts" after "Banks," and add "or Federal thrifts" after "national banks" later in the same sentence.
26	Second line from bottom, change "thrifts" to "state savings banks."



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27	In addition to federally chartered thrifts, OTS supervises state chartered savings associations.
27	Line 6, change "bank regulator" to "federal regulator."
27	Line 13, change to "... regulators oversee and enforce compliance with consumer ..."
27	Third and fourth lines from the bottom, delete "was first housed at" and delete the second "Farm Credit Administration."
27	Footnote 9, correct legal cite to read "Enforcement" not "Enhancement" regarding FIRREA.
28	Line 3, change "position's" to "agencies'."
28	Footnote 11 ends abruptly. Should "security" or another word be added after "underlying?"
29	Footnote 12, thrifts, as well as national banks, may engage in the certain types of insurance activities noted.
30	Third to last line, reference should be to a thrift or bank.
30	Last line, delete hanging "s" in middle of line.
31	Line 4, change "Bank" to "bank."
32	Line 1, change "Owner's" to "Owners'."
32	Line 8, change "an" thrift holding company to "a" thrift holding company.
34	First bullet, line 2, insert "as members" after "participate." At the end of the sentence after the footnote, insert "OTS participates as a temporary member pending acceptance of its request for permanent membership by the Basel Committee." Same bullet, line 9, delete "foreign" before "bank."
34	Footnote 18 is misplaced. It belongs on page 33.
37	Footnote 24 missing a period.
45	Footnote 26, change "consolidatiob" to "consolidation."
49	Line 3, change "that" to "whether."
53	Line 2, change "reduce risk and securitized" to "reduce risk while securitized."
53	Line 5, change "geographic lines and" to "geographic lines along with."

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53	Middle paragraph, last line, insert "credit" before "risks."
54	Line 2, change "ole" to "old."
54	Line 14, delete "or" at the end of the line.
57	Line 6, change "industry" to "entity."
82	Line 11, change "The Federal Reserve expects" to "The Federal regulators expect . . ." same change later in the paragraph.
83	Line 3, should read ". . . that is <b>not</b> considered supervised . . ." (delete "inappropriately").
83	Paragraph 3, lines 4 and 5, delete "approved as the consolidated supervisor" and add "deemed an equivalent supervisor for affected companies under their supervision." There is also an extra space before "changes."
85	Line 2. The reference to unitary thrift holding company is not technically accurate. Multiple thrift holding companies that acquired all, or all but one of their institutions in a supervisory transaction may also qualify for the activity exemption. Therefore, we recommend deleting the word "unitary."
85	Line 7. Reword the sentence that starts "These companies may not qualify . . ." as follows: "These companies may not qualify as Financial Holding Companies because they do not own a commercial bank and the scope of their activities make doing so impractical. Furthermore, they do not qualify for SEC oversight because they own a thrift and may not have a broker-dealer affiliate with a substantial presence in the securities markets."
86	Line 30, add OTS to the sentence to read "Since the mid 1990s, the Federal Reserve, OCC and <b>OTS</b> . . ."
91	Second line from bottom, what does "may be financially troubled" mean? States? Insurance companies? The statement is ambiguous. As drafted, it appears to apply to states.
92	Line 7, change to read ". . . sector and across sectors. State . . ." Same paragraph, second line from the end, change to "In addition, <b>all</b>

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	regulators do not routinely assess risks. . .” [OTS does assess risk.]
94	Middle paragraph, line 1, change to include OTS as follows “The Federal Reserve, FDIC, OCC and <b>OTS</b> . . .”
94	Footnote 55 is misplaced. It belongs on page 93.
95	Line 5, add “OTS participates as a temporary member on the Basel Committee while its permanent membership request is considered by the Committee.”
95	Footnote 56 is misplaced. It belongs on page 94.
96	Line 11, the sentences “For example, OTS” and “Since the large firms” are not factually correct. Although OTS does not have a permanent seat as a member of the Basel Committee, we have a temporary seat on the committee while our membership request is considered. Also, OTS supervised firms were represented in the negotiations on Basel II; not only do we attend Basel Committee meetings, we are also active members on two Basel capital implementation subgroups.
96	Footnote 57 is misplaced. It belongs on page 95.
98	Footnote 59 is misplaced. It belongs on page 97.
104	Footnote 63 is misplaced. It belongs on page 103.
106	Footnote 67 is misplaced. It belongs on page 105.
108	Line 14, add “system” after “regulatory.” We also disagree with the sentence “The U.S. regulatory system is also not well structured for dealing with issues in a world where financial firms and markets operate globally.” U.S. supervisors have had no significant problems in dealing with supervisors around the world, in banking or other sectors, regarding issues of mutual interest.

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111	Footnote 68 is misplaced. It belongs on page 110.
123	Line 11, change “communicate” to “communications.”

**V. Conclusion**

Financial regulators in the U.S. have continually adapted to industry change with innovative and flexible regulatory and supervisory strategies. This level of flexibility and responsiveness cannot be guaranteed in an alternate structure. A healthy tension between the federal banking regulators has developed as we each bring the unique perspectives of the industry we supervise and regulate. This has significantly benefited the U.S. banking system, making it the healthiest, most innovative and robust in the world. Further, we note that the regulatory systems of other countries addressed in this report were restructured in response to significant problems or failing banking systems. The report’s conclusions fail to recognize that this is not the case in the U.S., and, in fact, as noted by the GAO in the highlights cover page, the “strength and vitality of the U.S. financial services industry demonstrates that the regulatory structure has not failed.” The countries studied did not take on change for the sake of change, nor have their new regulatory structures been tested by a crisis to determine if they perform as hoped. In fact, in one country systemic problems have continued to exist, even after the regulatory system was restructured.

The regulatory consolidation undertaken by the United Kingdom, Germany, Japan, the Netherlands, and Australia, individually, cannot realistically be compared due to the much greater size of the U.S. financial markets and corresponding number of regulators required. To adjust the scale, the entire European market (not individual countries) should be compared to the United States market as a whole. One regulator supervising the entire U.S. financial services industry would be unresponsive to the complexities of our dynamic and large financial marketplace. We also do not agree with statements in the draft report that U.S. firms are competitively disadvantaged by the presence of multiple regulators during international negotiations. Instead, we firmly believe that they are more ably represented by regulators that are attuned to their specific issues.

Finally, we note that one of the matters you highlight for Congressional consideration is that fewer bank regulators might reduce the cost of regulation and the opportunities for regulatory arbitrage. Regardless of how many Federal regulators exist, as long as financial institutions have the option of a state charter or license, the opportunity for regulatory arbitrage will continue to exist. We believe in the dual regulation of financial institutions by state and federal regulators, and we do not recommend it be abolished.

The caliber of U.S. banking regulation is unparalleled in the world today and U.S. financial institutions have been operating in recent years at historically unprecedented levels of

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profitability and capitalization; therefore, any major change to the regulatory structure would be ill-advised. If you have any questions or need additional follow-up information, please contact Scott M. Albinson at (202) 906-7984.

Sincerely,



James E. Gilleran  
Director

cc: Wayne A. Abernathy, Assistant Secretary for Financial Institutions, DOT  
Susan Schmidt Bies, Governor, FRB  
Roger W. Ferguson, Jr., Vice Chairman, FRB  
Cynthia A. Glassman, Commissioner, SEC  
John D. Hawke, Comptroller, OCC  
James E. Newsome, Chairman, CFTC  
Donald E. Powell, Chairman, FDIC

# Comments from the Securities and Exchange Commission



DIVISION OF  
MARKET REGULATION

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

September 15, 2004

Mr. Thomas J. McCool  
Managing Director  
Government Accountability Office  
Financial Markets and Community Investment Issues  
441 G Street, N.W.  
Washington DC 20548

Re: Draft Report GAO-04-889

Dear Mr. McCool:

Thank you for the opportunity to comment on the Government Accountability Office's draft report GAO-04-889, entitled "Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure." The draft report discusses the current U.S. financial regulatory structure and suggests potential alternatives. The draft report also notes that U.S. regulators and financial market participants generally expressed the view that the current regulatory structure has contributed to the development of U.S. capital markets and the overall growth and stability in the U.S. economy.

The GAO acknowledges the existence of factors, apart from structure, that make for good and effective regulation. For example, the draft report notes that the regulatory system benefits from the specialized knowledge regulators acquire within their specialized agencies. In addition, the draft report acknowledges that some regulators are adapting their regulatory and supervisory approaches to industry changes. The draft report includes as one example the SEC's voluntary oversight of holding companies as Consolidated Supervised Entities.

The SEC takes the goal of good and effective regulation seriously.<sup>1</sup> We also share the conclusion in the draft report that cooperation and coordination among financial

<sup>1</sup> For example, the SEC's Strategic Plan states:

The SEC will strengthen the integrity and soundness of U.S. securities markets for the benefit of investors and other market participants, and will conduct its work in a manner that is as sophisticated, flexible, and dynamic as the securities markets it regulates.

\*\*\*

The mission of the Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

Securities and Exchange Commission, FY 2004 – 2009 Strategic Plan, July 2004.

Mr. Thomas J. McCool  
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services regulators are important, especially in light of the consolidation of the financial services industry and the existence of large, multifaceted, global enterprises. Notably, however, while the financial services industry has been changing over the past several years, Congress reaffirmed the functional regulation of financial services conglomerates through the enactment of the Gramm-Leach-Bliley Act of 1999.

The draft report acknowledges that there are a number of permanent groups and regular meetings that bring together the agency heads and staff from the financial institution regulators, as well as international regulators. Some of these groups and regular meetings have existed for a number of years and others have been established since the passage of the Gramm-Leach-Bliley Act. The regular meetings of interagency and international working groups promote communication and the creation of working relationships among regulators at the staff level. The existence of working relationships among staff permits the agencies to work together more quickly and effectively both during crisis situations and in exercising their ongoing regulatory and supervisory functions.

Of course, supervision and regulation can always be improved, but the costs of change must always be weighed against its benefits. As a general matter, the U.S. financial services regulators focus their resources on integrity, safety, soundness, investor protection, and responding to the changing needs of the financial industry for more flexible and constructive regulation. These efforts have resulted in financial markets that are globally competitive and provide a broad array of services nationally.

Thank you again for the opportunity to comment on the draft report. We request that the GAO include a copy of this letter in the final report.

Sincerely,



Annette L. Nazareth  
Director

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Thomas J. McCool, (202) 512-8678  
James M. McDermott, (202) 512-5373

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## Staff Acknowledgments

In addition to the individuals named above, Nancy S. Barry, Emily Chalmers, Patrick Dynes, James Kim, Marc W. Molino, Suen-Yi Meng, Kaya Leigh Taylor, Paul Thompson, John Treanor, and Cecile Trop also made key contributions to this report.



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# Related GAO Products

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*SEC Operations: Oversight of Mutual Fund Industry Presents Management Challenges.* [GAO-04-584T](#). Washington, D.C.: April 20, 2004.

*Securities Markets: Opportunities Exist to Enhance Investor Confidence and Improve Listing Program Oversight.* [GAO-04-75](#). Washington, D.C.: April 8, 2004.

*Mutual Funds: Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds.* [GAO-04-533T](#). Washington, D.C.: March 10, 2004.

*Government-Sponsored Enterprises: A Framework for Strengthening GSE Governance and Oversight.* [GAO-04-269T](#). Washington, D.C.: February 10, 2004.

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