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

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FINANCIAL REGULATION

A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

Why GAO Did This Study

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

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

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

What GAO Found

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

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

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

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

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

Source: GAO.