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Testimony  
Before the Committee on Banking,  
Housing, and Urban Affairs, U.S. Senate

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# FINANCIAL REGULATION

## Recent Crisis Reaffirms the Need to Overhaul the U.S. Regulatory System

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Financial Markets and Community Investment



**GAO**

Accountability \* Integrity \* Reliability

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss issues relating to efforts to reform the regulatory structure of the financial system. In the midst of the worst economic crisis affecting financial markets globally in more than 75 years, federal officials have taken unprecedented steps to stem the unraveling of the financial services sector. While these actions aimed to provide relief in the short term, the severity of the crisis has shown clearly that in the long term, the current U.S. financial regulatory system was in need of significant reform. Our January 2009 report presented a framework for evaluating proposals to modernize the U.S. financial regulatory system, and work we have conducted since that report further underscores the urgent need for changes in the system.<sup>1</sup> Given the importance of the U.S. financial sector to the domestic and international economies, in January 2009, we also added modernization of its outdated regulatory system as a new area to our list of high-risk areas of government operations because of the fragmented and outdated regulatory structure.<sup>2</sup> We noted that modernizing the U.S. financial regulatory system will be a critical step to ensuring that the challenges of the 21<sup>st</sup> century can be met. In my statement today, which is based on our reports and additional work we have completed, I will discuss (1) how regulation has evolved and recent work that further illustrates the significant limitations and gaps in the existing regulatory system, (2) the experiences of countries with other types of varying regulatory structures during the financial crisis, and (3) how certain aspects of proposals would reform the U.S. regulatory system.

To do this work, we synthesized existing GAO work and other studies on the financial crisis, such as those from the Department of Treasury, Group of Twenty (G20), Group of Thirty (G30), and the Committee on Capital Markets Regulation, among others. We also selected a judgmental sample of countries—Australia, Canada, The Netherlands, Sweden, and the United Kingdom—because they each had advanced financial markets and were illustrative of regulatory changes made internationally. We compiled information from publicly available sources on the individual countries' regulatory systems and the countries' experiences during the crisis. Finally, we used our framework of regulatory reform elements that was

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<sup>1</sup>GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009).

<sup>2</sup>GAO, *High Risk Series: An Update*, [GAO-09-271](#) (Washington, D.C.: Jan. 2009).

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developed for our January 2009 report to analyze the strengths and weaknesses of legislative proposals on regulatory reform. Our work was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between August 2009 and September 2009.

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## Summary

The current U.S. financial regulatory system is fragmented due to complex arrangements of federal and state regulation put into place over the past 150 years. It has not kept pace with major developments in financial markets and products in recent decades. Today, almost a dozen federal regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies share responsibility for overseeing the financial services industry. Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing U.S. regulatory system. For example, regulators have struggled, and often failed, both to identify the systemic risks posed by large and interconnected financial conglomerates and to ensure these entities adequately manage their risks. In addition, regulators have had to address problems in financial markets resulting from the activities of sometimes less-regulated and large market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today’s financial markets. Further, the increasing prevalence of new and more complex financial products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products.

Our recent work has also highlighted significant gaps in the regulatory system and the need for an entity responsible for identifying existing and emerging systemic risks. For example, our July 2009 report on oversight of banks’ fair lending practices revealed that the fragmented financial regulatory system limited the consistency and effectiveness of regulators’ oversight of these practices. In addition, our recent reports on regulators’ oversight of risk management systems found that regulators were not sufficiently focused on looking across institutions to identify factors that could affect the overall financial system was in part responsible for the failure to detect problems that significantly contributed to the crisis. Reports from a variety of international groups have identified similar

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weaknesses in regulatory systems globally and have called for a number of reforms.

Various countries have implemented changes in their regulatory systems in recent years, but the current crisis affected most countries regardless of their structure. All of the countries we reviewed have more concentrated regulatory structures than that of the United States. Some countries, such as the United Kingdom, have chosen an integrated approach to regulation that unites safety and soundness and business conduct issues under a single regulator. Others, such as Australia, have chosen a “twin peaks” approach, in which separate agencies are responsible for safety and soundness and business conduct regulation. However, regardless of regulatory structure, each country we reviewed was affected to some extent by the recent financial crisis. One regulatory approach was not necessarily more effective than another in preventing or mitigating a financial crisis. However, regulators in some countries had already taken some actions that may have reduced the impact on their institutions. These and other countries also have taken or are currently contemplating additional changes to their regulatory systems to address weaknesses identified during this crisis.

The Department of the Treasury’s recent proposal to reform the U.S. financial regulatory system includes some elements that would likely improve oversight of the financial markets and make the financial system more sound, stable, and safer for consumers and investors. For example, under this proposal a new governmental body would have responsibility for assessing threats that could pose systemic risk. This proposal would also create an entity responsible for business conduct, that is, ensuring that consumers of financial services were adequately protected. However, our analysis indicated that additional opportunities exist beyond the Treasury’s proposal for additional regulatory consolidation that could further decrease fragmentation in the regulatory system, reduce the potential for differing regulatory treatment, and improve regulatory independence.

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## U.S. Financial Regulatory System's Failure to Keep Pace with Market Developments Underscores the Need for Reforms

As a result of 150 years of changes to financial regulation in the United States, the regulatory system has become complex and fragmented. 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. For example:

- Insured depository institutions are overseen by five federal agencies—the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA)—and states supervise state-chartered depository and certain other institutions.
- Securities activities and markets are overseen by the Securities and Exchange Commission (SEC) and state government entities, and private sector organizations performing self-regulatory functions.
- Commodity futures markets and activities are overseen by the Commodity Futures Trading Commission (CFTC) and also by industry self-regulatory organizations.
- Insurance activities are primarily regulated at the state level with little federal involvement.

Other federal regulators also play important roles in the financial regulatory system, such as the Federal Trade Commission, which acts as the primary federal agency responsible for enforcing compliance with federal consumer protection laws for financial institutions such as finance companies that are not overseen by another financial regulator.

Much of this structure has developed as the result of statutory and regulatory measures taken in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve 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. Changes in the types of financial activities permitted for financial institutions and their affiliates have also shaped the financial regulatory system over time. For example, under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services, but with the passage of the Gramm-Leach-

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Bliley Act of 1999, Congress permitted financial institutions to fully engage in both types of activities, under certain conditions.

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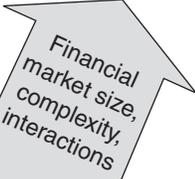
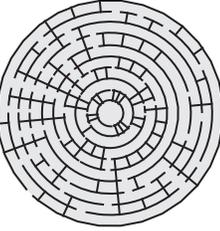
Various Market  
Developments Have  
Revealed Limitations in the  
Existing Regulatory  
Structure

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure.<sup>3</sup> (See fig. 1.)

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<sup>3</sup>[GAO-09-216](#).

**Figure 1: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System**

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

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

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Regulators have struggled, and often failed, to identify the systemic risks posed by large and interconnected financial conglomerates, as well as new and complex products, and to adequately manage these risks. These firms' operations increasingly cross financial sectors, but no single regulator is tasked with assessing the risks such an institution might pose across the entire financial system. In addition, regulators have had to address problems in financial markets resulting from the activities of sometimes less-regulated and large market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets. Further, the increasing prevalence of new and more complex financial products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Standard setters for accounting and financial regulators have also faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments. And 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.

Because of this hearing's focus on prudential regulation of the banking industry, I would like to reinforce that our prior work has repeatedly identified limitations of the fragmented banking regulatory structure. For example:

- In 1996, we reported that the division of responsibilities among the four federal bank oversight agencies in the United States was not based on specific areas of expertise, functions or activities, either of the regulator or the banks for which they are responsible, but based on institution type and whether the banks were members of the Federal Reserve System. Despite their efforts to coordinate, this multiplicity of regulators was cited as resulting in inconsistent treatment of banking institutions in examinations, enforcement actions, and regulatory decisions.<sup>4</sup>
- In a 2007 report we noted that having bank holding company affiliates supervised by multiple banking regulators increased the potential for conflicting information to be provided to the institution, such as when a large, complex banking organization initially received conflicting information from the Federal Reserve, its consolidated supervisor, and

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<sup>4</sup>GAO, *Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure*, [GAO/GGD-97-23](#) (Washington D.C.: Nov. 20, 1996).

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OCC, its primary bank supervisor, about the firm's business continuity provisions.<sup>5</sup>

- In 2005, we reported that a difference in authority across the banking regulators could lead to problems in oversight. For example, FDIC's authority over the holding companies and affiliates of industrial loan corporations was not as extensive as the authority that the other supervisors have over the holding companies and affiliates of banks and thrifts. For example, FDIC's authority to examine an affiliate of an insured depository institution exists only to disclose the relationship between the depository institution and the affiliate and the effect of that relationship on the depository institution. Therefore, any reputation or other risk from an affiliate that has no relationship with the industrial loan corporation could go undetected.<sup>6</sup>
- In a 2004 report, we noted cases in which interagency cooperation between bank regulators has been hindered when two or more agencies share responsibility for supervising a bank. For example, in the failure of Superior Bank of West Virginia problems between OTS, Superior's primary supervisor, and FDIC hindered a coordinated supervisory approach, including OTS refusing to let FDIC participate in at least one examination. Similarly, disagreements between OCC and FDIC contributed to the 1999 failure of Keystone Bank.<sup>7</sup>
- In a 2007 report, we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.<sup>8</sup>

Our recent work has further revealed limitations in the current regulatory system, reinforcing the need for change and the need for an entity responsible for identifying existing and emerging systemic risks. In

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<sup>5</sup>GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, [GAO-07-154](#) (Washington, D.C.: Mar. 15, 2007).

<sup>6</sup>GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, [GAO-05-621](#) (Washington, D.C.: Sept. 15, 2005).

<sup>7</sup>GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, [GAO-05-61](#) (Washington, D.C.: Oct. 6, 2004).

<sup>8</sup>[GAO-07-154](#).

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January 2009, we designated modernizing the outdated U.S. financial regulatory system as a new high-risk area to bring focus to the need for a broad-based systemwide transformation to address major economy, efficiency, and effectiveness challenges.<sup>9</sup> We have found that:

- Having multiple regulators results in inconsistent oversight. Our February 2009 report on the Bank Secrecy Act found that multiple regulators are examining for compliance with the same laws across industries and, for some larger holding companies, within the same institution.<sup>10</sup> However, these regulators lack a mechanism for promoting greater consistency, reducing unnecessary regulatory burden, and identifying concerns across industries. In July 2009, we reported many violations by independent mortgage lenders of the fair lending laws intended to prevent lending discrimination could go undetected because of less comprehensive oversight provided by various regulators.<sup>11</sup>
- Lack of oversight exists for derivatives products. In March 2009, we reported that the lack of a regulator with authority over all participants in the market for credit default swaps (CDS) has made it difficult to monitor and manage the potential systemic risk that these products can create.<sup>12</sup>
- Gaps in the oversight of significant market participants. We reported in May 2009 on the issues and concerns related to hedge funds, which have grown into significant market participants with limited regulatory oversight.<sup>13</sup> For example, under the existing regulatory structure, SEC's ability to directly oversee hedge fund advisers is limited to those that are required to register or voluntarily register with the SEC as an investment advisor. Further, multiple regulators (SEC, CFTC, and federal banking regulators) each oversee certain hedge fund-related activities and advisers.

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<sup>9</sup>GAO-09-227.

<sup>10</sup>GAO, *Bank Secrecy Act: Federal Agencies Should Take Action to Further Improve Coordination and Information-Sharing Efforts*, GAO-09-227 (Washington, D.C.: Feb. 12, 2009).

<sup>11</sup>GAO, *Fair Lending: Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts*, GAO-09-704 (Washington, D.C.: Jul. 15, 2009).

<sup>12</sup>GAO, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T (Washington, D.C.: Mar. 5, 2009).

<sup>13</sup>GAO, *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges*, GAO-09-677T (Washington, D.C.: May 7, 2009).

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We concluded that given the recent experience with the financial crisis, regulators should have the information to monitor the activities of market participants that play a prominent role in the financial system, such as hedge funds, to protect investors and manage systemic risk.

- Lack of appropriate resolution authorities for financial market institutions. We recently reported that one of the reasons that federal authorities provided financial assistance to at least one troubled institution—the insurance conglomerate AIG—in the crisis stemmed from concerns that a disorderly failure by this institution would have contributed to higher borrowing costs and additional failures, further destabilizing fragile financial markets. According to Federal Reserve officials, the lack of a centralized and orderly resolution mechanism presented the Federal Reserve and Treasury with few alternatives in this case. The lack of an appropriate resolution mechanism for non-banking institutions has resulted in the federal government providing assistance and having significant ongoing exposure to AIG.
- Lack of a focus on systemwide risk. In March 2009 we also reported on the results of work we conducted at some large, complex financial institutions that indicated that no existing U.S. financial regulator systematically looks across institutions to identify factors that could affect the overall financial system.<sup>14</sup> While regulators periodically conducted horizontal examinations on stress testing, credit risk practices, and risk management, they did not consistently use the results to identify potential systemic risks and have only a limited view of institutions' risk management or their responsibilities. Our July 2009 report on approaches regulators used to restrict the use of financial leveraging—the use of debt or other products to purchase assets or create other financial exposures—by financial institutions also found that regulatory capital measures did not always fully capture certain risks and that none of the multiple regulators responsible for individual markets or institutions had clear responsibility to assess the potential effects of the buildup of systemwide leverage.<sup>15</sup>

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<sup>14</sup>GAO, *Financial Regulation: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions*, [GAO-09-499T](#) (Washington, D.C.: Mar. 18, 2009).

<sup>15</sup>GAO, *Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System*, [GAO-09-739](#) (Washington, D.C.: Jul. 22, 2009).

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Recognition of the need for regulatory reform extends beyond U.S. borders. Various international organizations such as the G20, G30, Bank for International Settlements, and Committee on Capital Markets Regulation have all reported that weaknesses in regulation contributed to the financial crisis.<sup>16</sup> Specifically, among other things, these reports pointed to the fragmented regulatory system, the lack of a systemwide view of risks, and the lack of transparency or oversight of all market participants as contributing to the crisis. Further, the reports noted that sound regulation and a systemwide focus were needed to prevent instability in the financial system, and that recent events have clearly demonstrated that regulatory failures had contributed to the current crisis.

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## Other Countries Have Adopted Various Structures for Their Regulatory Systems, but the Recent Crisis Is Prompting Additional Changes

In response to consolidation in the financial services industry and past financial crises, other countries have previously made changes to their financial regulatory systems in the years before the most recent crisis. For the purposes of our study, we selected five countries—Australia, Canada, Sweden, the Netherlands, and the United Kingdom—that had sophisticated financial systems and different regulatory structures. Each of these countries restructured their regulatory systems within the last 20 years in response to market developments or financial crises (see table 1).

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<sup>16</sup>G-20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, March 25, 2009 and Bank for International Settlements, *79th Annual Report* (Basel, Switzerland, Jun. 12, 2009). The Group of 30, *Financial Reform: A Framework for Financial Stability* (Washington, D.C.: Jan. 15, 2009). Committee on Capital Markets Regulation, *The Global Financial Crisis, A Plan for Regulatory Reform* (May 2009).

**Table 1: Examples of Regulatory Changes**

Country & Regulatory Structure	Response to the Crisis	Examples of Actions Taken or Contemplated
<p><b>Australia</b> - Separate regulator for prudential oversight and a separate consumer protection agency that oversees conduct of business. Responsibility for systemic stability, the payment system, and monetary policy is with the central bank.</p>	<p>The government expressed willingness to purchase residential mortgage backed securities. Retail deposits up to AUD \$1 million were guaranteed—previously the limit was AUD \$20,000.</p>	<ul style="list-style-type: none"> <li>Reviewing liquidity standards and risk management approaches for banks.</li> </ul>
<p><b>Canada</b> - Single prudential supervisor for banks insurance companies, and pension plans. A separate agency oversees consumer protection for banking. Securities regulation is conducted at the provincial level. The central bank is the lender of last resort.</p>	<p>Banks have accessed liquidity facilities provided by the central bank. Government agency has purchased residential mortgages from banks.</p>	<ul style="list-style-type: none"> <li>Reexamining the quality of bank capital, the effect of relying on wholesale funding, the risks posed by off balance sheet exposures, the role of credit rating agencies, and the need for improved international solvency resolution.</li> </ul>
<p><b>The Netherlands</b> - The prudential and systemic risk supervisor of all financial services is the central bank. A separate conduct of business regulator also is responsible for consumer protection.</p>	<p>The government took over the Dutch operations of an internationally active bank. Other banks were given solvency assistance and the government also took on the high risk mortgage portfolios of other banks.</p>	<ul style="list-style-type: none"> <li>Will strengthen capital requirements.</li> <li>Will strengthen supervisory authorities.</li> <li>Will address systemic risk nationally.</li> </ul>
<p><b>Sweden</b> - A single regulator covers banking, securities, and insurance. Sweden's central bank conducts monetary policy and is entrusted with promoting safe and efficient payment systems.</p>	<p>The government approved a debt guarantee scheme for the medium term borrowing of banks and mortgage institutions. Bank deposit insurance limits were increased. One domestic bank failed and was resolved.</p>	<ul style="list-style-type: none"> <li>The government enacted legislation giving it the power to grant credit guarantees if there is a serious systemic risk and bank capital falls below a regulatory threshold.</li> <li>Changes are being contemplated in the prompt corrective action framework, the deposit insurance scheme, cross border crisis resolution.</li> </ul>
<p><b>United Kingdom</b> - A single agency deals with banking, insurance, asset management and market supervision and regulation. The central bank exercised informal oversight over the banking sector.</p>	<p>The government created a bank recapitalization fund, a credit guarantee scheme, and special liquidity scheme, and an asset protection scheme.</p>	<p>Reform of the regulatory and legislative framework will:</p> <ul style="list-style-type: none"> <li>reform the corporate governance of banking institutions,</li> <li>change the amount of capital firms will need,</li> <li>reduce their leverage,</li> <li>more intensive regulation of financial firms, and</li> <li>new powers for authorities to deal with failing banks.</li> </ul>

Source: GAO analysis.

The countries we reviewed chose one of two models—with some implementing an integrated approach, in which responsibilities for overseeing safety and soundness issues and business conduct issues are centralized and unified in usually a single regulator, and with others implementing what is commonly referred to as a “twin peaks” model, in which separate regulatory organizations are responsible for safety and

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soundness and business conduct regulation.<sup>17</sup> A single regulator is viewed by some as advantageous because, with financial firms not being as specialized as they used to be, a single regulator presents economies of scale and efficiency advantages, can quickly resolve conflicts that arise between regulatory objectives, and the regulatory model increases accountability. For example, the United Kingdom moved to a more integrated model of financial services regulation because it recognized that major financial firms had developed into more integrated full services businesses. As a result, this country created one agency (Financial Services Authority) to deal with banking, insurance, asset management and market supervision and regulation. Similarly, Canada and Sweden integrated their regulatory systems prior to the current global financial crisis.

In contrast, other countries chose to follow a twin peaks model. The twin peaks model is viewed by some as advantageous because they view the two principal objectives of financial regulation—systemic protection and consumer protection—as being in conflict. Putting these objectives in different agencies institutionalizes the distinction and ensures that each agency focuses on one objective. For example, in order to better regulate financial conglomerates and minimize regulatory arbitrage, Australia created one agency responsible for prudential soundness of all deposit taking, general and life insurance, and retirement pension funds (Australian Prudential Regulatory Authority) and another for business conduct regulation across the financial system including all financial institutions, markets, and market participants (Australian Securities and Investment Commission). In the Netherlands, regulators were divided along the lines of banking, insurance, and securities until the twin peaks approach was adopted. Under the revised structure, the prudential and systemic risk supervisor of all financial services including banking, insurance, pension funds, and securities is the central bank (DNB). Another agency (Netherlands Authority for Financial Markets) is responsible for conduct of business supervision and promoting transparent markets and processes to protect consumers.

However, regardless of the regulatory system structure, these and many other countries were affected to some extent by the recent financial crisis. For example, the United Kingdom experienced bank failures, and the

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<sup>17</sup>While we chose countries that use the integrated and twin peaks approaches, other approaches to financial regulation exist.

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government provided financial support to financial institutions. Further, in the Netherlands, where the twin peaks approach is used, the government took over the operations of one bank, provided assistance to financial institutions to reinforce their solvency positions, and took on the risk of a high-risk mortgage portfolio held by another bank, among other actions.

However, regulators or financial institutions in some of these countries took steps that may have reduced the impact of the crisis on their institutions. For example, according to a testimony that we reviewed, the impact on Australian institutions was mitigated by the country's relatively stricter prudential standards compared to other countries. The Australian prudential regulator had also conducted a series of stress tests on its five largest banks that assessed the potential impact of asset price changes on institutions. According to Canadian authorities, the positive performance of Canadian banks relative to banks in other countries in the recent crisis was the result of a more conservative risk appetite that limited their activities in subprime mortgages, and exotic financial instruments. However, both countries still experienced some turbulence, requiring among other actions, some government purchases of mortgage-backed securities by the Australian government and some Canadian banks taking advantage of liquidity facilities provided by the Bank of Canada.

Authorities in these five countries have taken actions or are contemplating additional changes to their financial regulatory systems based on weaknesses identified during the current financial crisis. These changes included strengthening bank capitalization requirements, enhancing corporate governance standards, and providing better mechanisms for resolving failed financial institutions. For example, in the United Kingdom, in response to its experience dealing with one large bank failure (Northern Rock) the government has called for strengthening the role of the central bank. The Banking Act of 2009 formalized a leading role for the Bank of England in resolving financial institution and provided it statutory authority in the oversight of systemically important payment and settlement systems.

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## Reform Proposals Would Enhance U.S. Regulatory System, but Additional Opportunities to Improve System Appear to Exist

With a clear need to improve regulatory oversight, our January 2009 report offered a framework for crafting and evaluating regulatory reform proposals.<sup>18</sup> This framework includes nine characteristics that should be reflected in any new regulatory system, including:

- goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.
- appropriately comprehensive coverage to ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met;
- a mechanism for identifying, monitoring, and managing risks on a systemwide basis, regardless of the source of the risk or the institution in which it is created;
- an adaptable and forward-looking approach allows regulators to readily adapt to market innovations and changes and evaluate potential new risks;
- efficient oversight of financial services by, for example, eliminating overlapping federal regulatory missions, while effectively achieving the goals of regulation;
- consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practices standards, and suitability requirements;
- assurance that regulators have independence from inappropriate influence; have sufficient resources and authority, and are clearly accountable for meeting regulatory goals;
- assurance that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency; and
- adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

Various organizations have made proposals to reform the U.S. regulatory system, and several proposals have been introduced to the Congress. Among these proposals are the administration's proposal, which is specified in its white paper and draft legislation, and another proposal that

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<sup>18</sup> [GAO-09-216](#).

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has been introduced as legislation in the House of Representatives (H.R. 3310).<sup>19</sup>

The administration's proposal includes various elements that could potentially improve federal oversight of the financial markets and better protect consumers and investors. For example, it establishes a council consisting of federal financial regulators that would, among other things, advise Congress on financial regulation and monitor the financial services market to identify the potential risks systemwide. Under H.R. 3310, a board consisting of federal financial regulators and private members, would also monitor the financial system for exposure to systemic risk and advise Congress. The creation of such a body under either proposal would fill an important need in the current U.S. regulatory system by establishing an entity responsible for helping Congress and regulators identify potential systemic problems and making recommendations in response to existing and emerging risks. However, such an entity would also need adequate authority to ensure that actions were taken in response to its recommendations. As discussed, the inability of regulators to take appropriate action to mitigate problems that posed systemic risk contributed to the current crisis.

The administration's proposal also contains measures to improve the consistency of consumer and investor protection. First, the administration proposes to create a new agency, the Consumer Financial Protection Agency (CFPA). Among other things, this agency would assume the consumer protection authorities of the current banking regulators and would have broad jurisdiction and responsibility for protecting consumers of credit, savings, payment and other consumer financial products and services. Its supervisory and enforcement authority generally would cover all persons subject to the financial consumer protection statutes it would be charged with administering. However, the SEC and CFTC would retain their consumer protection role in securities and derivatives markets. As our January report described, consumers have struggled with understanding complex products and the multiple regulators responsible for overseeing such issues have not always performed effectively. We urged that a new regulatory system be designed to provide high-quality,

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<sup>19</sup>A NEW FOUNDATION: *Rebuilding Financial Supervision and Regulation* provides outlines the Administration's proposal and draft legislation provides additional specific information. Mr. Spencer Bachus and others introduced H.R. 3310, the Consumer Protection and Regulatory Enhancement Act of 2009—a proposal on behalf of House Republicans—on July 23, 2009.

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effective, and consistent protection for consumers and investors in similar situations. The administration's proposal addresses this need by charging a single financial regulatory agency with broad consumer protection responsibilities. This approach could improve the oversight of this important issue and better protect U.S. consumers. However, separating the conduct of consumer protection and prudential regulation can also create challenges. Therefore, having clear requirements to coordinate efforts across regulators responsible for these different missions would be needed.

Although the Administration's proposal would make various improvements in the U.S. regulatory system, our analysis indicated that additional opportunities exist to further improve the system exist. Unlike H.R. 3310, which would combine all five federal depository institution regulators, the Administration's proposal would only combine the current regulators for national banks and thrifts into one agency, leaving the three other depository institution regulators—the Federal Reserve, the FDIC, and NCUA—to remain separate. As we reported in our January 2009 report, having multiple regulators performing similar functions presents challenges.<sup>20</sup> For example, we found that some regulators lacked sufficient resources and expertise, that the need to coordinate among multiple regulators slowed responses to market events, and that institutions could take advantage of regulatory arbitrage by seeking regulation from an agency more likely to offer less scrutiny. Regulators that are funded by assessments on their regulated entities can also become overly dependent on individual institutions for funding, which could potentially compromise their independence because such firms have the ability to choose to be overseen by another regulator.

Finally, regardless of any regulatory reforms that are adopted, we urge Congress to continue to actively monitor the progress of such implementation and to be prepared to make legislative adjustments to ensure that any changes to the U.S. financial regulatory system are as effective as possible. In addition, we believe that it is important that Congress provides for appropriate GAO oversight of any regulatory reforms to ensure accountability and transparency in any new regulatory system. GAO stands ready to assist the Congress in its oversight capacity and evaluate the progress agencies are making in implementing any changes.

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<sup>20</sup>[GAO-09-216](#).

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Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss these critically important issues and would be happy to answer any questions that you may have. Thank you.

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## Staff Contributions and Acknowledgments

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# Appendix I: Framework for Crafting and Evaluating Regulatory Reform

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 following framework consists of nine elements that should be reflected in any new regulatory system. This 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.

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<b>Characteristic</b>	<b>Description</b>
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.

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Source: GAO

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*Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges.* [GAO-09-677T](#). Washington, D.C.: May 7, 2009.

*Financial Regulation: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions.* [GAO-09-499T](#). Washington, D.C.: Mar. 18, 2009.

*Federal Financial Assistance: Preliminary Observations on Assistance Provided to AIG.* [GAO-09-490T](#). Washington, D.C.: Mar. 18, 2009.

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

*Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency.* [GAO-09-161](#). Washington, D.C.: December 2, 2008.

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

*Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments.* [GAO-08-78R](#). Washington, D.C.: October 16, 2007.

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*Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure.* [GAO-08-32](#). Washington, D.C.: October 12, 2007.

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

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

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