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## FINANCIAL REGULATION

# A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

Statement of Gene L. Dodaro  
Acting Comptroller General of the United States



**GAO**

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our January 8, 2009, report that provides a framework for modernizing the outdated U.S. financial regulatory system.<sup>1</sup> We prepared this work under the authority of the Comptroller General to help policymakers weigh various regulatory reform proposals and consider ways in which the current regulatory system could be made more effective and efficient. My statement today is based on our report, which (1) describes how regulation has evolved in banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets and other important areas; (2) describes several key changes in financial markets and products in recent decades that have highlighted significant limitations and gaps in the existing regulatory system; and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. On January 22, we released an update to our biennial High-Risk Series, which described high-risk areas in federal programs, including focusing on the need for broad-based transformations to address major economy, efficiency, or effectiveness challenges. Based on recent economic events and our past work on financial regulatory reform, we added the need to modernize the outdated U.S. financial regulatory system as a new high-risk area this year.<sup>2</sup>

To do this work, we synthesized existing GAO work and other studies and met with representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. The work upon which the report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008.

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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. 22, 2009).

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The report was enhanced by input from representatives of 29 agencies and other organizations, including federal and state financial regulatory agencies, consumer advocacy groups, and financial service industry trade associations, who reviewed and commented on a draft of the report prior to its release. A list of organizations that reviewed the draft report is included at the end of my statement. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

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## Summary

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. 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. As the nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the nation’s needs in the 21st century.

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.
- 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.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit

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standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.

- Finally, as financial markets have become increasingly global, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

These significant developments have outpaced a fragmented and outdated regulatory structure, and, as a result, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has significant weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. Our report offers a framework for crafting and evaluating regulatory reform proposals consisting of nine characteristics that should be reflected in any new regulatory system. By applying the elements of the 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.

**Table 1: Framework for Crafting and Evaluating Regulatory Reform Proposals**

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.

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the

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likelihood that the United States will experience another financial crisis similar to the current one.

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

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. 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. In particular, five federal agencies—including the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—and multiple state agencies oversee depository institutions. Securities activities are overseen by the Securities and Exchange Commission and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by the Commodity Futures Trading Commission 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 Public Company Accounting Oversight Board, which oversees the activities of public accounting firms, and 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, which are not overseen by another financial regulator.

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. Changes in the types of financial activities permitted for depository 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-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities.

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

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 1.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulators have struggled, and often failed, to mitigate the systemic risks posed by these conglomerates, and to ensure they adequately manage their risks. The portion of firms that conduct activities across the 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.

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

A third development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. In particular, 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



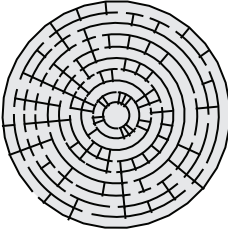

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addressing challenges arising from the global convergence of accounting and auditing standards.

Finally, with the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators. For example, the current system has complicated the ability of financial regulators to convey a single U.S. position in international discussions, such the Basel Accords process for developing international capital standards, and international officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making.



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

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, we identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products.<sup>3</sup> Since then, we have described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs.<sup>4</sup> Our 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.

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

A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of a dynamic financial services industry is to clearly define regulatory goals and objectives. In the background of our report, we identified four broad goals of financial regulation that regulators have generally sought to achieve. These include ensuring adequate consumer protections, ensuring the integrity and fairness of markets, monitoring the safety and soundness of institutions, and acting to ensure the stability of the overall financial system. However, these goals are not always explicitly set in the federal statutes and regulations that govern these regulators. Having specific goals clearly articulated in

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<sup>3</sup>GAO, *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133 (Washington, D.C.: May 18, 1994).

<sup>4</sup>GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004); and *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007).

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legislation could serve to better focus regulators on achieving their missions with greater certainty and purpose, and provide continuity over time.

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

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

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

Once these goals are agreed upon, policymakers will need to determine the extent to which goals need to be clarified and specified through rules

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

Key issues to be addressed:

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

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

A financial regulatory system should effectively meet the goals of financial regulation, as articulated as part of this process, in a way that is appropriately comprehensive. In doing so, policymakers may want to consider how to ensure that both the breadth and depth of regulation are

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

Key issues to be addressed:

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

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

A regulatory system should focus on risks to the financial system, not just institutions. As noted in our report, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. The collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly,

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once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

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

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

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

Key issues to be addressed:

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.

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- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.

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

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

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

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Key issues to be addressed:

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

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

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

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we note in our report, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part



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because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted in our report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

One first step to addressing such problems is to seriously consider the need to consolidate depository institution oversight among fewer agencies. Since 1996, we have been recommending that the number of federal agencies with primary responsibilities for bank oversight be reduced.<sup>5</sup> Such a move would result in a system that was more efficient and improve consistency in regulation, another important characteristic of an effective regulatory system. In addition, Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity. We have not studied the issue of an optional federal charter for insurers, but have through the years noted difficulties with efforts to harmonize insurance regulation across states through the NAIC-based structure. The establishment of a federal insurance charter and regulator could help alleviate some of these challenges, but such an approach could also have unintended consequences for state regulatory bodies and for insurance firms as well.

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

Organizing agencies around regulatory goals as opposed to the existing sector-based regulation may be one way to improve the effectiveness of the system, especially given some of the market developments discussed earlier. Whatever the approach, policymakers should seek to minimize conflict in regulatory goals across regulators, or provide for efficient mechanisms to coordinate in cases where goals inevitably overlap. For example, in some cases, the safety and soundness of an individual

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<sup>5</sup>See GAO, *Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure*, GAO/T-GGD-96-117 (Washington, D.C.: May 2, 1996).

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institution may have implications for systemic risk, or addressing an unfair or deceptive act or practice at a financial institution may have implications on the institution's safety and soundness by increasing reputational risk. If a regulatory system assigns these goals to different regulators, it will be important to establish mechanisms for them to coordinate.

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

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

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be less burdensome to institutions than others, such as ongoing supervision and examination.

Key issues to be addressed:

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

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

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

As discussed in our report, many consumers that received loans in the last few years did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate they had in recent years. In addition, increasing

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

Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer protections, including suitability requirements and disclosures across the financial services industry.
- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how they are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.

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

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**accountable for meeting regulatory goals.**

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

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

In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, 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>6</sup> It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct

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<sup>6</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).

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their work effectively. A regulatory system should also include adequate checks and balances to ensure the appropriate use of agency authorities. With respect to accountability, policymakers may also want to consider different governance structures at agencies—the current system includes a combination of agency heads and independent boards or commissions—and how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals.

Key issues to be addressed:

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

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

A regulatory system should ensure that similar institutions, products, and services posing similar risks are subject to consistent regulation, oversight, and transparency. Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.

Streamlining the regulation of similar products across sectors could also help prepare the United States for challenges that may result from increased globalization and potential harmonization in regulatory

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

As we noted in a 2004 report, different regulatory treatment of bank and financial holding companies, consolidated supervised entities, and other holding companies may not provide a basis for consistent oversight of their consolidated risk management strategies, guarantee competitive neutrality, or contribute to better oversight of systemic risk.<sup>7</sup> Recent events further underscore the limitations brought about when there is a lack of consistency in oversight of large financial institutions. As such, Congress and regulators will need to seriously consider how best to consolidate responsibilities for oversight of large financial conglomerates as part of any reform effort.

Key issues to be addressed:

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

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

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<sup>7</sup>GAO-05-61.

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

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

Key issues to be addressed:

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

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



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complete, the changes could be implemented in phases with specific target dates around which the affected entities could formulate plans. In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.<sup>8</sup> Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

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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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## Contacts

For further information on this testimony, please contact Orice M. Williams at (202) 512-8678 or [williamsso@gao.gov](mailto:williamsso@gao.gov), or Richard J. Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

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<sup>8</sup>See GAO, *Homeland Security: Critical Design and Implementation Issues*, [GAO-02-957T](#) (Washington, D.C.: July 17, 2002).

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# Appendix I: Agencies and Other Organizations That Reviewed the Draft Report

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

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# Related GAO Products

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*High-Risk Series: An Update.* [GAO-09-271](#). Washington, D.C.: January 22, 2009.

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

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

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

*Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved.* [GAO-06-1021](#). Washington, D.C.: September 19, 2006.

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

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

*Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending.* [GAO-04-280](#). Washington, D.C.: January 30, 2004.

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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.

*Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure.* [GAO/T-GGD-96-117](#). Washington, D.C.: May 2, 1996.

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

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