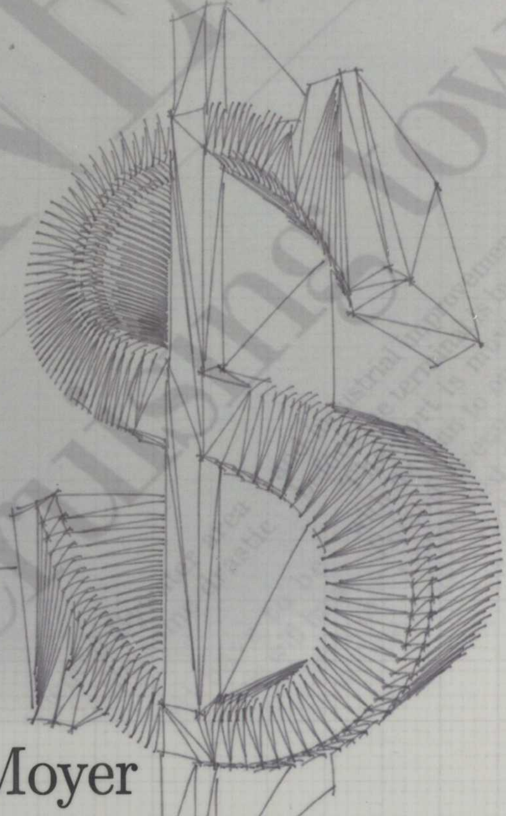
Global Recession

Causes, Impacts and Remedies Series

Financial Regulatory Reform



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Editor

NOVA

GLOBAL RECESSION – CAUSES, IMPACTS AND REMEDIES

FINANCIAL REGULATORY REFORM

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PREFACE

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators - put into place over the past 150 years - that has not kept pace with major developments in financial markets and products in recent decades. As the nation finds itself in the midst of one of the worst financial crisis ever, it has become apparent that the regulatory system is ill-suited to meet the nation's needs in the 21st century. This book examines several key changes in financial markets and products in recent decades and highlights significant limitations and gaps in the existing regulatory system. In addition, the authors of this book identify eight specific areas most urgently in need of reform and make recommendations for the future. This book consists of public documents which have been located, gathered, combined, reformatted, and enhanced with a subject index, selectively edited and bound to provide easy access.

Chapter 1 - This chapter is edited and excerpted testimony Gene L. Dodaro before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, dated February 4, 2009.

Chapter 2 - 1. Lessons from the Past - Financial crises are not new. As early as 1792, during the presidency of George Washington, the nation suffered a severe panic that froze credit and nearly brought the young economy to its knees. Over the next 140 years, financial crises struck on a regular basis—in 1797, 1819, 1837, 1857, 1873, 1893–96, 1907, and 1929–33—roughly every fifteen to twenty years.

But as the United States emerged from the Great Depression, something remarkable happened: the crises stopped. New financial regulation—including federal deposit insurance, securities regulation, and banking supervision—effectively protected the system from devastating outbreaks. Economic growth returned, but recurrent financial crises did not. In time, a financial crisis was seen as a ghost of the past.

After fifty years without a financial crisis—the longest such stretch in the nation's history— financial firms and policy makers began to see regulation as a barrier to efficient functioning of the capital markets rather than a necessary precondition for success.

This change in attitude had unfortunate consequences. As financial markets grew and globalized, often with breathtaking speed, the U.S. regulatory system could have benefited from smart changes. But deregulation and the growth of unregulated, parallel shadow markets were accompanied by the nearly unrestricted marketing of increasingly complex consumer financial products that multiplied risk at every stratum of the economy, from the family level to the global level. The result proved disastrous. The first warning followed deregulation of the thrifts, when the country suffered the savings and loan crisis in the 1980s. A second warning came in 1998 when a crisis was only narrowly averted following the failure of a large unregulated hedge fund. The near financial panic of 2002, brought on by corporate accounting and governance failures, sounded a third warning.

The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public.

2. Shortcomings of the Present - The current crisis should come as no surprise. The present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings.

Financial markets are inherently volatile and prone to extremes. The government has a critical role to play in helping to manage both public and private risk. Without clear and effective rules in place, productive financial activity can degenerate into unproductive gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to swindles and fraud.

A well-regulated financial system serves a key public purpose: if it has the power and if its leaders have the will to use that power, it channels savings and investment into productive economic activity and helps prevent financial contagion. Like the management of any complex hazard, financial regulation should not rely on a single magic bullet, but instead should employ an array of related measures for managing various elements of risk. The advent of the automobile brought enormous benefits but also considerable risks to drivers, passengers, and pedestrians. The solution was not to prohibit driving, but rather to manage the risks through reasonable speed limits, better road construction, safer sidewalks, required safety devices (seatbelts, airbags, children's car seats, antilock breaks), mandatory automobile insurance, and so on. The same holds true in the financial sector.

In recent years, however, the regulatory system not only failed to manage risk, it also failed to require disclosure of risk through sufficient transparency. American financial markets are profoundly dependent upon transparency. After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk.

Markets have become opaque in multiple ways. Some markets, such as hedge funds and credit default swaps, provide virtually no information. Even so, disclosure alone does not always provide genuine transparency. Market participants must have useful, relevant information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner. Mortgage documentation suffers from a similar problem, with reams of paper thrust at borrowers at closing, far too late for any borrower to make a well-informed decision. Just as markets and financial products evolve, so too must efforts to provide understanding through genuine transparency.

To compound the problem associated with uncontained and opaque risks, the current regulatory framework has failed to ensure fair dealings. Unfair dealing can be blatant, such as outright deception or fraud, but unfairness can also be much more subtle, as when parties are unfairly matched. Individuals have limited time and expertise to master complex financial dealings. If one party to a transaction has significantly more resources, time, sophistication or experience, other parties are at a fundamental disadvantage. The regulatory system should take appropriate steps to level the playing field.

Unfair dealings affect not only the specific transaction participants, but extend across entire markets, neighborhoods, socioeconomic groups, and whole industries. Even when only a limited number of families in one neighborhood have been the direct victims of a predatory lender, the entire neighborhood and even the larger community will suffer very real consequences from the resulting foreclosures. As those consequences spread, the entire financial system can be affected as well. More importantly, unfairness, or even the perception of unfairness, causes a loss of confidence in the marketplace. It becomes all the more critical for regulators to ensure fairness through meaningful disclosure, consumer protection measures, stronger enforcement, and other measures. Fair dealings provide credibility to businesses and satisfaction to consumers.

In tailoring regulatory responses to these and other problems, the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats—especially the threats to other citizens—are greatest, and it should be more moderate elsewhere.

3. Recommendations for the Future - Modern financial regulation can provide consumers and investors with adequate information for making sound financial decisions and can protect them from being misled or defrauded, especially in complex financial transactions. Better regulation can reduce conflicts of interest and help manage moral hazard, particularly by limiting incentives for excessive risk taking stemming from often implicit government guaranties. By limiting risk taking in key parts of the financial sector, regulation can reduce systemic threats to the broader financial system and the economy as a whole. Ultimately, financial regulation embodies good risk management, transparency, and fairness.

Had regulators given adequate attention to even one of the three key areas of risk management, transparency and fairness, we might have averted the worst aspects of the current crisis.

1. Risk management should have been addressed through better oversight of systemic risks. If companies that are now deemed "too big to fail" had been better regulated, either to diminish their systemic impact or to curtail the risks they took, then these companies could have been allowed to fail or to reorganize without taxpayer bailouts. The creation of any new implicit government guarantee of high-risk business activities could have been avoided.
2. Transparency should have been addressed though better, more accurate credit ratings. If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.
3. Fairness should have been addressed though better regulation of consumer financial products. If the excesses in mortgage lending had been curbed by even the most minimal consumer protection laws, the loans that were fed into the mortgage backed securities would have been

choked off at the source, and there would have been no "toxic assets" to threaten the global economy.

While the current crisis had many causes, it was not unforeseeable. Correcting the mistakes that fueled this crisis is within reach. The challenge now is to develop a new set of rules for a new financial system.

The Panel has identified eight specific areas most urgently in need of reform:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Increase supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.

While these are the most pressing reform recommendations, many other issues merit further study, the results of which the Panel will present in future reports. Despite the magnitude of the task, the central message is clear: through modernized regulation, we can dramatically reduce the risk of crises and swindles while preserving the key benefits of a vibrant financial system

Americans have paid dearly for this latest crisis. Lost jobs, failed businesses, foreclosed homes, and sharply cut retirement savings have touched people all across the county. Now every citizen—even the most prudent—is called on to assume trillions of dollars in liabilities spent to try to repair a broken system. The costs of regulatory failure and the urgency of regulatory reform could not be clearer.

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Chapter 1

FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM

Government Accountability Office

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.[1] 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.[2]

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.

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.

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 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 tradeoffs 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..

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the likelihood that the United States will experience another financial crisis similar to the current one.

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 reexamining 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.

Table 1. (Continued)

Characteristic	Description
• 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.

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.

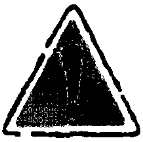
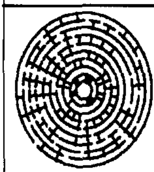
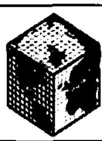
Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics 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.

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 Figure 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.

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

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

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