United States Government Accountability Office

GAO

Report to Congressional Committees

October 2007

FINANCIAL REGULATION

Industry Trends Continue to Challenge the Federal Regulatory Structure

GAO

Accountability * Integrity * Reliability

GAO-08-32

GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-08-32, a report to congressional committees

FINANCIAL REGULATION

Industry Trends Continue to Challenge the Federal Regulatory Structure

Why GAO Did This Study

As the financial services industry has become increasingly concentrated in a number of large, internationally active firms offering an array of products and services, the adequacy of the U.S. financial regulatory system has been questioned. GAO has identified the need to modernize the financial regulatory system as a challenge to be addressed in the 21st century. This report, mandated by the Financial Services Regulatory Relief Act of 2006, discusses (1) measurements of regulatory costs and benefits and efforts to avoid excessive regulatory burden, (2) the challenges posed to financial regulators by trends in the industry, and (3) options to enhance the efficiency and effectiveness of the federal financial regulatory structure. GAO convened a Comptroller General's Forum (Forum) with supervisors and leading industry experts, reviewed regulatory agency policies, and summarized prior reports to meet these objectives.

What GAO Recommends

GAO does not make any new recommendations in this report, but observes that the recommendations and options presented in prior reports remain relevant today in considering how best to improve the federal financial regulatory structure. The Chairman of the Federal Reserve and the Chairman of the National Credit Union Administration provided formal comments generally agreeing with the thrust of our report.

To view the full product, including the scope and methodology, click on GAO-08-32. For more information, contact Yvonne Jones at (202) 512-8678 or jonesy@gao.gov.

What GAO Found

The inherent problems of measuring the costs and benefits of regulation make it difficult to assess the extent to which regulations may be unduly burdensome to U.S. financial services firms, particularly in comparison to firms in other countries. Additionally, it is difficult to separate the costs of complying with regulation from other costs and thus determine regulatory burden. Regulatory agencies, however, have undertaken several initiatives to reduce regulatory burden; these efforts contributed to the Financial Services Regulatory Relief Act of 2006. While noting that regulation contributes to confidence in financial institutions and markets, participants in the Forum agreed regulators have opportunities to further reduce regulatory burden and suggested regulators better measure the results of implemented regulations. GAO also recently recommended regulatory agencies consider whether and how to measure the performance of regulation during the process of promulgating the regulation and improving the communication of regulatory reviews to the public.

The current regulatory structure, with multiple agencies that oversee segments of the financial services industry, is challenged by a number of industry trends. The development of large, complex, internationally active firms whose product offerings span the jurisdiction of several agencies creates the potential for inconsistent regulatory treatment of similar products, gaps in consumer and investor protection, or duplication among regulators. Regulatory agencies have made efforts to collaborate in responding to these trends and avoid inconsistencies, gaps, and duplication. However, challenges remain; until recently, the Office of Thrift Supervision and the Securities and Exchange Commission, for instance, had not sought to resolve potentially duplicative and inconsistent regulation of several financial services conglomerates for which both agencies have jurisdiction. Finally, despite the challenges posed by the industry's dynamic environment, accountability for addressing issues that span agencies' jurisdiction is not clearly assigned. These issues have led GAO to suggest in prior work that the federal regulatory structure should be modernized.

GAO and others have recommended several options to accomplish modernization of the federal financial regulatory structure; these include consolidating certain regulatory functions as well as having a single regulator for large, complex firms. There also are potential lessons that can be learned from the experience of other nations that have restructured their financial regulators. Several Forum participants, for instance, suggested that one important lesson the United States could learn from the United Kingdom's Financial Services Authority was the value of setting principles or goals for regulators. The Department of the Treasury's recently announced plan to propose a restructured regulatory system provides an opportunity to take the first step toward modernization by providing clear and consistent goals for the regulatory agencies.

Contents

Abbreviations

AIM	Alternative Investment Market
BSA	Bank Secrecy Act
CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CRS	Congressional Research Service
CSE	consolidated supervised entity
EGRPRA	Economic Growth and Regulatory Paperwork Reduction Act of 1996
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FINRA	Financial Industry Regulatory Authority
Forum	Comptroller General's Forum
FSA	United Kingdom - Financial Services Authority
Group	President's Working Group
ILC	industrial loan company
IMF	International Monetary Fund
LTCM	Long-Term Capital Management
NCUA	National Credit Union Administration
NPR	Notice of Proposed Rulemaking
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
SRO	self-regulatory organization
Treasury	Department of the Treasury

United States Government Accountability Office
Washington, DC 20548

October 12, 2007

The Honorable Christopher Dodd
Chairman
The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The financial services industry—including the banking, securities, and futures sectors— has changed significantly over the last several decades.[1] Firms today are generally fewer and larger, provide more and varied services, offer similar products, and operate in increasingly global markets. These developments have both benefits and risks for the overall U.S. economy. Despite these changes, the U.S. financial regulatory structure has largely remained the same. It is a complex system of multiple federal and state regulators as well as self-regulatory organizations (SROs) that operate largely along functional lines, even as these lines have become increasingly blurred in the industry. Regulated financial institutions have learned to operate and thrive under the existing regulatory system. However, concerns about inefficient overlaps in responsibility, undue regulatory burden, and possible gaps in oversight raise questions about whether the current structure is best suited to meet the nation's needs.

[1]The scope of our work includes regulatory oversight of the banking, securities, and futures industry sectors by the federal government. The federal financial regulators in the scope of our work are: the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC). The scope of our work excludes government-sponsored enterprises such as Fannie Mae and Freddie Mac; state financial regulatory agencies, including those in the insurance sector; the securities and futures industry SROs, and the Public Company Accounting Oversight Board.

We identified a need to modernize the financial regulatory system as a challenge to be addressed in the 21st century, noting that although multiple specialized regulators bring critical skills to bear in their areas of expertise, they have difficulty identifying and responding to risks that cross industry lines.[2] We asked whether it is time to modernize the financial regulatory system to promote a more coherent and integrated structure and specify goals more clearly. Such concerns also have been recently raised by the International Monetary Fund (IMF).[3] In a statement regarding its review of U.S. economic developments, IMF concluded that rapid innovation in the U.S. financial industry had created new regulatory challenges for a system disadvantaged by its overlapping regulatory oversight. IMF stated that emphasis should be placed on strategies to improve regulatory effectiveness, such as implementing general regulatory principles or goals to ease interagency coordination and shorten reaction times to industry developments. Similarly, the Department of the Treasury has undertaken an initiative to examine the regulatory structure associated with financial institutions, partly in response to concerns that the current structure may make U.S. financial markets less competitive. Treasury expects to develop a plan by early 2008 to identify a regulatory structure with improved oversight, increased efficiency, reduced overlap, and the ability to adapt to financial market participants' constantly changing strategies and tools.

Debate about modernizing the current financial regulatory structure is not new. However, there is continuing value in reexamining the current regulatory system and structure and considering ways in which it could be more efficient and effective.

In response to a mandate in the Financial Services Regulatory Relief Act of 2006,[4] this report

- describes measurements of the costs and benefits of financial regulation in general and current efforts to avoid excessive regulatory burden;[5]

[2]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

[3]International Monetary Fund, *United States: 2007 Article IV Consultation—Staff Report: Staff Statement; and Public Information Notice on the Executive Board Discussion*, IMF Country Report No. 07/264 (Washington, D.C., August 2007).

[4]Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, § 1002, 120 Stat. 1966, 2009-2010 (Oct. 13, 2006).

- describes financial industry trends and the challenges that these pose to the federal financial regulatory structure; and
- discusses various options to enhance the efficiency and effectiveness of the federal financial regulatory structure.

To meet our objectives, we convened a Comptroller General's Forum (Forum) on June 11, 2007, that brought together leading experts from the financial services industry, the regulatory agencies, and academia to discuss issues relative to our objectives. The Forum agenda covered three broad topics: (1) balancing regulatory costs and benefits, (2) financial services regulation in a dynamic environment, and (3) assessing options for enhancing the financial regulatory system. Forum participants were selected to provide perspectives from different segments of the industry and different regulatory agencies. To encourage a free exchange of information and viewpoints, no specific statements or opinions expressed by Forum participants are attributed to any participant. To meet our objectives, we also met with federal regulators to discuss our objectives and reviewed regulatory agency documents and reports. We also reviewed and summarized relevant analysis, conclusions, and recommendations from our earlier reports on financial regulation. (These reports are referenced in footnotes or noted in Related GAO Products at the end of this report.) We conducted our work between January 2007 and October 2007 in Chicago, Illinois, and Washington, D.C., in accordance with generally accepted government auditing standards. Appendix I provides a list of Forum participants.

Results in Brief

Regulators and the financial services industry face challenges measuring regulatory costs and benefits, making it difficult to assess the extent to which regulations may be unduly burdensome to U.S. firms—particularly in comparison to the amount of regulation that firms face in other countries. Most notably, it is hard to separate the costs of complying with regulation from other costs. As a result, it is difficult for regulators to determine the extent that costs to implement rules impose regulatory burden and for the industry to substantiate claims about burdensome regulation. Measuring regulatory benefits remains an even greater challenge largely because of the difficulty in quantifying benefits such as improved consumer protection or financial stability, though regulators and

[5]By "costs and benefits of financial regulation in general," we mean to include the measurement of the costs and benefits of financial regulation to firms, regulators, and the overall economy.

other groups acknowledge that financial regulation provides such benefits as an increased confidence in our financial markets and an enhanced level of consumer protection. Nevertheless, regulators have responded to concerns about specific regulatory burdens, and many provisions of the Financial Services Regulatory Relief Act of 2006 are based on regulators' identification of regulations that are outdated or unnecessarily burdensome. However, some groups still assert that regulatory burden has increased significantly over time and that regulators should do more to address such burdens. Forum participants agreed with these assertions, suggesting that regulators improve measurements of implemented regulations' results as a way to promote their own regulatory accountability. Continued efforts such as those that the bank regulatory agencies undertook in response to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) could be important steps in identifying and eliminating outdated, unnecessary, and unduly burdensome regulations. We recently recommended several steps agencies should take to ensure they conduct effective and transparent reviews of regulations, including consideration of whether and how to measure the performance of a regulation during the process of promulgating the regulation and steps to improve the communication of regulatory reviews to the public. Further consideration of steps such as these could help ensure financial regulations are cost-effective.

The current regulatory structure—characterized by specialization and competition among regulators as well as charter choice—has contributed to broad and deep U.S. financial markets, but the agencies that share responsibility for financial regulation face continued challenges from financial trends including increased globalization, consolidation, and product convergence. In particular, the offering of similar financial products and services by firms subject to different regulatory regimes creates the potential for regulatory inconsistencies and regulatory gaps, among other issues. For example, in our prior work, we reported that holding companies of industrial loan companies (ILC) are overseen by regulators with different authority than holding companies of other depository institutions. As a result of differences in supervision, ILCs in a holding company structure may pose more risk of loss to the Deposit Insurance Fund than other types of insured depository institutions in a holding company structure. The Federal Deposit Insurance Corporation (FDIC), the regulator of ILCs, has placed a moratorium on applications for the ILC charter by commercial firms to allow it and Congress to further evaluate ILC ownership and its related issues. Similarly, we previously have reported that both the Office of Thrift Supervision (OTS) and the Securities and Exchange Commission (SEC) have jurisdiction over the holding companies of several large financial services firms, but had not resolved how to clarify accountability for the supervision of these firms, creating the potential for duplicative or inconsistent regulation. Regulators have made efforts to collaborate to respond to changes in the industry to avoid inconsistencies, gaps, and duplicative activities. OTS and SEC, for instance, have begun meeting to resolve the potential for duplicative or inconsistent regulation for the holding companies where they share jurisdiction. Also, the President's Working Group (Group) provides a framework for coordinating policies and actions that cross jurisdictional lines. However, we have reported that the Group is not well suited to orchestrate a consistent set of goals or objectives that would direct the work of the different agencies because it lacks the authority to bind members to its decisions or positions. While the regulatory agencies have taken actions to work collaboratively in response to the industry's trends, continued progress in these areas would help to make our existing regulatory structure more effective.

In our prior work, we have recommended that Congress consider changes to the regulatory system to meet the challenges posed by the industry's trends and identified a number of options to accomplish this. Financial regulators today are increasingly dealing with large, complex firms that cross formerly distinct industry boundaries; however, the effects of the incremental development of our regulatory structure and the challenges that agencies face in responding to the dynamic industry environment are now more evident. The present federal financial regulatory structure, which has evolved largely as a result of periodic ad hoc responses to crises, continues to be challenged by the industry's trends of increased consolidation, conglomeration, convergence, and globalization. Today, financial services firms offering similar products may be subject to different regulatory regimes, creating the potential for inconsistent regulation. Many firms are subject to multiple regulators, creating the potential for regulatory duplication. At the same time, as our prior work has noted, no single agency has the responsibility and authority to identify and address risks that cross markets and industries. Thus, we and others previously have identified several options for consideration that, despite costs and risks, offer opportunities to enhance the efficiency and effectiveness of the regulatory system. We believe these options remain relevant today in considering how best to modernize the federal financial regulatory structure. Others also have proposed options for restructuring the federal financial regulatory system. Other nations have reorganized their regulatory systems; some have consolidated regulators into a single agency, while others have created specialized regulatory agencies that focus solely on ensuring the safety and soundness of institutions or on consumer protection. Lessons may be learned in this regard from the principles-based approach modeled by the United Kingdom, which consolidated several agencies into a single financial regulator, the Financial Services Authority (FSA). Some Forum participants noted that an important lesson from FSA's experience could be its development of clearly stated principles defining the regulator's priorities. Given the continued challenges faced by the current regulatory structure, establishing clear, consistent regulatory goals may be an important first step to improving its effectiveness.

We are not making new recommendations in this report, but believe that our prior recommendations to enhance the effectiveness of the current regulatory process remain relevant. We also continue to believe that the options we presented in prior work for modifying the existing regulatory structure to better meet today's financial environment remain relevant. Finally, we and others also have stressed the importance of establishing clearer, more consistent goals for financial regulation. A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of the dynamic financial services industry includes clearly defining regulatory agencies' goals and objectives. Such goals and objectives could help establish agency priorities as well as define responsibility and accountability for identifying risks, including those that cross markets and industries. No single financial regulator is currently in a position to set these goals, and current interagency groups have not proven themselves appropriate vehicles for goal setting. As Treasury considers how best to rationalize the U.S. financial regulatory structure, it has the opportunity to work with other agencies to define clear and consistent goals and objectives. Defining these goals could provide the impetus for making progress on the design of the financial regulatory system, and thus could be an important first step in the Secretary's plan to develop a more modern, efficient oversight structure that is better able to adapt to the industry's changes.

We provided the Secretary of the Treasury and the heads of CFTC, the Federal Reserve, FDIC, NCUA, OCC, OTS, and SEC with drafts of this report for their comment. We received written comments from the Chairman of the Board of Governors of the Federal Reserve System and the Chairman of NCUA who generally agreed with the thrust of our report; these are reprinted in appendixes II and III. We also received technical comments from the staffs at the Treasury, the Federal Reserve, CFTC, FDIC, NCUA, OCC, OTS, and SEC that we have incorporated in the report.

Background

In the banking industry, the specific regulatory configuration depends on the type of charter the banking institution chooses. Bank charter types include

- *commercial banks*, which originally focused on the banking needs of businesses, but then over time broadened their services;
- *thrifts*, which include savings banks, savings associations, and savings and loans, were originally created to serve the needs—particularly the mortgage needs—of those not served by commercial banks;
- *credit unions*, which are member-owned cooperatives run by member-elected boards with a historic emphasis on serving people of modest means; and
- *industrial loan companies (ILCs)*, also known as industrial banks, which are state-chartered financial institutions that have grown from small, limited-purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions.[6]

These charters may be obtained at the state or national level for all except ILCs, which are only chartered at the state level. State regulators charter institutions and participate in the oversight of those institutions; however, all of these institutions have a primary federal regulator if they offer federal deposit insurance. The primary federal regulators are the following:

- The Office of the Comptroller of the Currency (OCC), which charters and supervises national banks. As of December 30, 2006, there were 1,715 commercial banks with a national bank charter. These banks held the dominant share of bank assets, about $6.829 trillion.
- The Federal Reserve, which serves as the regulator for state-chartered banks that opt to be members of the Federal Reserve System. As of December 30, 2006, the Federal Reserve supervised 902 state member banks, with total assets of $1.406 trillion.

[6]For more information on ILCs, see GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 (Washington, D.C.: Sept. 15, 2005).

- The Federal Deposit Insurance Corporation (FDIC), which supervises all other state-chartered commercial banks with federally insured deposits, as well as federally insured state savings banks. As of December 30, 2006, there were 4,785 state-chartered banks and 435 state-chartered savings banks, with $1.855 trillion and $306 billion in total assets, respectively. In addition, FDIC has certain backup supervisory authority for federally insured banks and savings institutions.

- The Office of Thrift Supervision (OTS), which charters and supervises federally chartered savings institutions. As of December 30, 2006, OTS supervised 844 institutions with $1.464 trillion in total assets.

- The National Credit Union Administration (NCUA), which charters and supervises federally chartered credit unions. As of December 30, 2006, 8,362 credit unions hold $710 billion in assets.

These federal regulators have established capital requirements for the depository institutions they supervise, conduct onsite examinations and offsite monitoring to assess an institution's financial condition, and monitor and enforce compliance with banking and consumer laws. Regulators also issue regulations, take enforcement actions, and close institutions they determine to be insolvent.

The securities and futures industries are regulated under a combination of self-regulation (subject to oversight of the appropriate federal regulator) and direct oversight by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), respectively. In the securities industry, the self-regulatory organizations (SROs) have responsibility for oversight of the securities markets and their participants by establishing the standards under which their members conduct business; monitoring business conduct; and bringing disciplinary actions against their members for violating applicable federal statutes, SEC's rules, and their own rules.[7] SEC oversees SROs by inspecting their operations and reviewing their rule proposals and appeals of final disciplinary proceedings. In the futures industry, SROs include the futures exchanges and the National Futures Association. Futures SROs are responsible for establishing and enforcing rules governing member conduct and trading; providing for the prevention of market manipulation,

[7]Recently, the two largest securities industry SROs merged into one SRO known as the Financial Industry Regulatory Authority (FINRA) which is responsible for overseeing nearly 5,100 brokerage firms.

including monitoring trading activity; ensuring that futures industry professionals meet qualifications; and examining members for financial strength and other regulatory purposes. The Commodity Futures Trading Commission (CFTC) independently monitors, among other things, exchange trading activity, large trader positions, and certain market participants' financial conditions.[8]

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

Many of the largest financial legal entities are part of holding company structures—companies that hold stock in one or more subsidiaries—and conduct business and manage risks on a consolidated basis. Many of these companies are subject to consolidated supervision that provides a basis for examining the financial and operating risks faced by holding companies and the controls in place to manage those risks at a consolidated, or holding company-wide, level. Companies that own or control banks are regulated and supervised by the Federal Reserve as bank holding companies, and their nonbanking activities generally are limited to those the Federal Reserve has determined to be closely related to banking. Under the Gramm-Leach-Bliley Act, bank holding companies can qualify as financial holding companies and thereby engage in a range of financial activities broader than those permitted for "traditional" bank holding companies. Savings and loan or thrift holding companies (thrift holding companies), that own or control one or more savings associations (but not a bank) are subject to supervision by OTS and, depending upon certain circumstances, may not face the types of activities' restrictions imposed on bank holding companies. Certain holding companies that own

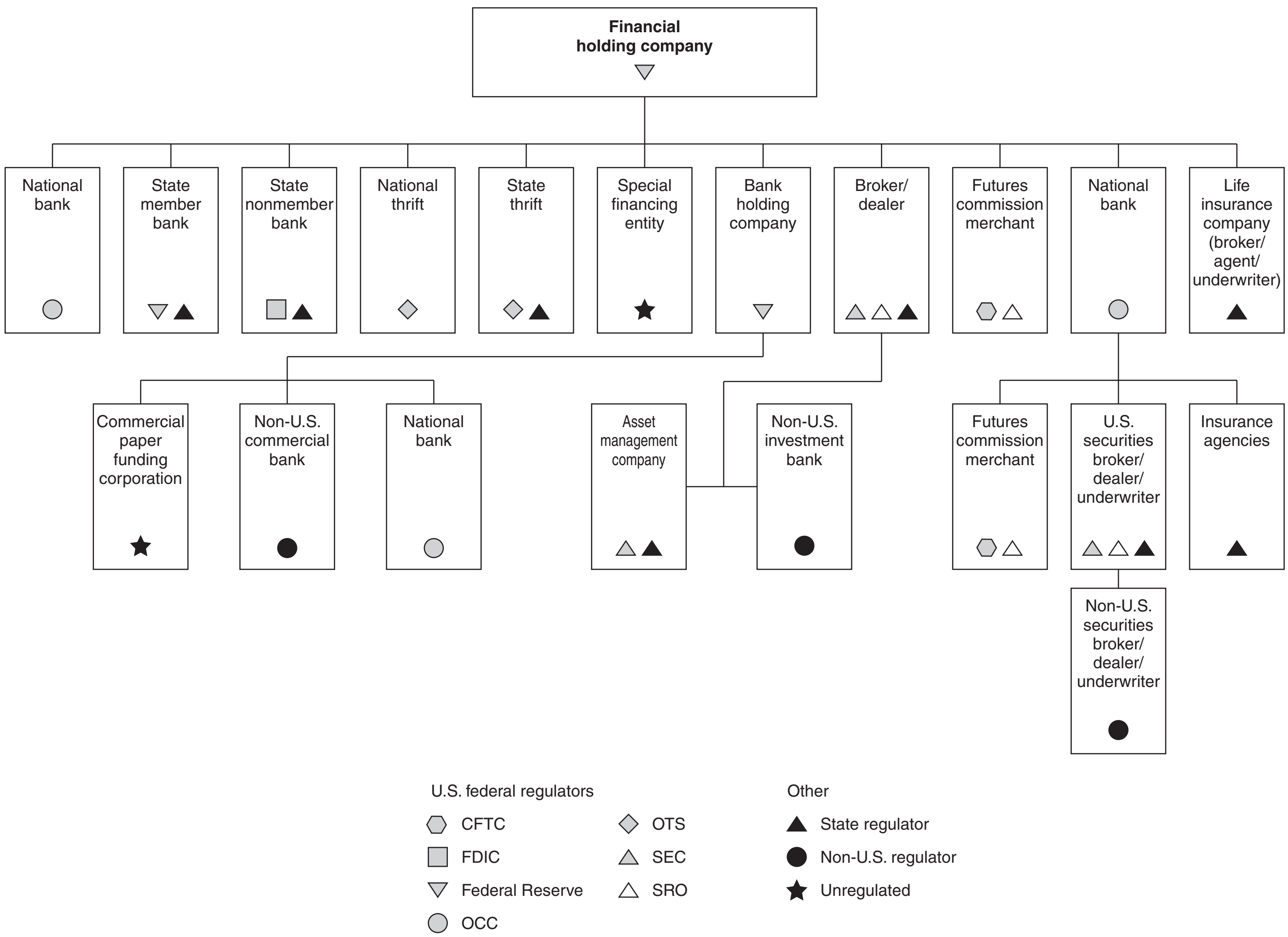
[8]For more information on securities and banking regulators, see GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington D.C.: Oct. 6, 2004).

large broker-dealers can elect to be supervised by SEC as consolidated supervised entities (CSE). SEC provides group-wide oversight of these entities unless they are determined to already be subject to "comprehensive, consolidated supervision" by another principal regulator. While holding company supervisors oversee the holding company, the appropriate functional regulator remains primarily responsible for supervising any functionally regulated subsidiary within the holding company.

In prior reports, we have noted that characteristics of the U.S. regulatory structure can have positive effects.[9] Specialization by regulatory agencies allows them to better understand the risks associated with particular activities or products. Competition among regulators helps to account for regulatory innovation, providing businesses with a method to move to regulators whose approaches better match businesses' operations. We also have noted that the system is complex, with a single large firm subject to oversight by multiple federal and state agencies, as figure 1 illustrates.

[9]See GAO-05-61, 9.

Figure 1: Federal Supervisors for a Hypothetical Financial Holding Company



Source: GAO.

The Federal Reserve and the Department of the Treasury (Treasury) also share responsibility for maintaining financial stability. Treasury also represents the United States on international financial market issues and, in consultation with the President, also may approve special resolution options for insolvent financial institutions whose failure could threaten the stability of the financial system. Two-thirds of the Federal Reserve's Board of Governors and FDIC's Board of Directors must approve any extraordinary coverage.

Measuring the Costs and Benefits of Regulation Has Been Difficult, Complicating Efforts to Reduce Regulatory Burden

Measuring the costs and benefits of financial regulation has posed a challenge to regulators and the financial services industry. Though precise measurement remains a challenge, many claim regulation has become more burdensome over time. Regulators have responded to these concerns by reviewing existing regulations to identify ways to reduce unnecessary regulatory burdens. Such reviews have, in some cases, assisted in identifying the costs and benefits of regulation and removing unnecessary burden. However, some groups still assert regulatory burden has increased significantly over time and regulators should do more to address such burdens. Forum participants agreed with these assertions, suggesting regulators improve measurements of the results of implemented regulations as a way to promote their own regulatory accountability. We recently recommended several steps that agencies should take to ensure they conduct effective and transparent reviews of regulations, including consideration of whether and how to measure the performance of regulation during the process of promulgating the regulation and steps to improve the communication of regulatory reviews to the public.[10]

Regulators and the Financial Services Industry Face Challenges Measuring Regulatory Costs and Benefits

The difficulty of reliably estimating the costs of regulation to the industry and to the nation has long been recognized, and the benefits of regulation are generally regarded as even more difficult to measure. This situation presents challenges for regulators that attempt to estimate the anticipated costs of regulations, and also for industry to substantiate claims about regulatory burden. For example, a 1998 Federal Reserve staff study concluded that it had insufficient information to reliably estimate the total cost of regulations for commercial banks.[11]

One limitation of efforts to measure regulatory costs is the difficulty that businesses have in separating the costs of regulatory compliance from other costs related to risk management or recordkeeping. For instance, bank capital adequacy regulation provides an example of the inherent difficulty of assessing the value of regulation. Our work on the

[10]GAO, *Reexamining Regulations: Opportunities Exist to Improve Effectiveness and Transparency of Retrospective Reviews*, GAO-07-791 (Washington, D.C., Jul. 16, 2007).

[11]Gregory Elliehausen, "The Cost of Bank Regulation: A Review of the Evidence," Federal Reserve Staff Study. Washington, D.C., April 1998, 29. Earlier, we concluded that industry estimates of regulatory compliance costs for banks were not reliable because of methodological deficiencies. See GAO, *Regulatory Burden: Recent Studies, Industry Issues, and Agency Initiatives*, GAO/GGD-94-28 (Washington, D.C.: Dec. 13, 1993).

implementation of the Basel II risk-based capital framework noted that banks often could not separate out costs related directly to the implementation of the framework, as systems often served multiple purposes, such as reporting for many kinds of regulations and also for internal, risk management purposes.[12] Similarly, an analysis of financial regulation in the United Kingdom found that firms tend not to separate out costs for complying with regulations, and firms could not estimate hypothetical savings if certain regulations were removed.[13]

While regulation provides a broad assurance of the strength of financial markets, it is difficult to measure those benefits, in part because regulations seeking to ensure financial stability aim to prevent low-probability, high-cost events.

Concerns Exist that Regulation Could Hinder Market Efficiency

Recent reports by industry participants, academics, and policymakers also have suggested that regulatory burden may be lessening U.S. securities markets' viability and challenging their competitiveness.[14] A number of factors have been asserted as contributing to a perceived loss in U.S. competitiveness, with one potential factor being the litigious environment of the United States. Some industry representatives, market analysts, and academics argue that this environment creates concerns for firms about potential class action and other lawsuits that may impact their decision to engage in business in the United States. Another factor is the often limited coordination among regulators that at times results in overlapping regulatory jurisdictions and confusing regulations. Additionally, questions regarding the jurisdiction over some financial products raise doubts for firms about how such products will be regulated. For example, the U.S. Chamber of Commerce has questioned whether CFTC should have jurisdiction over securities futures products, and recommended that

[12]GAO, *Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework*, GAO-07-253 (Washington, D.C.: Feb. 2007).

[13]Deloitte, *The Cost of Regulation Study*, A report commissioned by the Financial Services Authority and the Financial Services Practitioner Panel, (London, June 28, 2006).

[14]U.S. Chamber of Commerce, *Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century*, March 2007; McKinsey and Company, *Sustaining New York's and the US' Global Financial Services Leadership*, a report commissioned by New York City Mayor Michael Bloomberg and New York Senator Charles Schumer. January 22, 2007; Interim *Report of the Committee on Capital Markets Regulation*, November 30, 2006.

jurisdiction be shifted to the SEC.[15] In our work we also have noted that SEC and CFTC share overlapping jurisdiction on financial products that have the features of both securities and futures, which can inhibit market innovation by potentially causing market participants to design products based on how they might be regulated.[16] However, some argue that regulatory competition helps bring about innovation in regulatory approaches, as one Forum participant noted.

U.S. Regulators Have Reviewed Existing Regulations

U.S. regulatory agencies have undertaken several efforts to lessen regulatory burden and cost of existing regulations. Federal banking agencies have undertaken a major initiative to address the regulatory burden of depository institutions in response to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). The act requires federal banking regulators to review their regulations at least once every 10 years and to identify and eliminate outdated, unnecessary, or unduly burdensome regulatory requirements, as appropriate. Agencies also are required to report to Congress on regulatory burdens that must be addressed through legislative action.[17]

Bank regulatory agencies have made changes to regulation and reporting requirements as part of the EGRPRA process. Bank agencies modernized their call report procedures, for instance,[18] and sought comments and suggestions on outdated, unnecessary, or overly burdensome regulations. In response to these comments, for example, OCC published a Notice of Proposed Rulemaking soliciting comments on proposed amendments to OCC regulations that, among other changes, would eliminate or streamline existing requirements or procedures.[19] Another outcome of the EGRPRA process was the development of proposals that were incorporated into the Financial Services Regulatory Relief Act of 2006.

[15] U.S. Chamber of Commerce, *Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century*, March 2007.

[16] GAO, *Financial Market Regulation: Benefits and Risks of Merging SEC and CFTC*, GAO/T-GGD-95-153 (Washington, D.C.: May 3, 1995).

[17] As of October 5, 2007, this report had not been released.

[18] Call reports provide financial and structural information, such as ownership, for FDIC-insured depository institutions.

[19] 72 Fed. Reg. 36550 (July 3, 2007).

Forum Participants Shared Concerns Regarding Regulatory Burden

A majority of Forum participants held the view that regulations had become more burdensome over the past decade. However, one participant noted that while some regulations may be considered burdensome to industry, they may be necessary to ensure public confidence. Others noted the importance of considering legislation's contribution to regulatory burden. In addition, some participants shared the opinion that federal regulation has hurt the competitiveness of U.S. securities markets.

Some Forum participants agreed that cost-benefit analysis presents a number of measurement challenges, primarily because some costs are easier to measure than benefits. One participant, for instance, noted the benefits from legislation or regulation could include enhanced confidence in markets, something that cannot be valued. Forum participants suggested measurement should focus on outcomes and results, and regulators should improve measurements for their own regulatory accountability. One participant noted the Bank Secrecy Act (BSA), for example, has resulted in filing many currency transaction reports and suspicious activity reports, but the benefits of such filings are sometimes unclear to banks.[20] The participant added that regulators should consider whether the BSA is providing the intended results and outcomes, considering the costs.[21]

To improve the measurement of costs and benefits, some Forum participants thought a good practice to adopt from the U.K.'s Financial Services Authority (FSA) would be its conduct of cost-benefit analyses. To assure that FSA accomplishes its regulatory goals efficiently, it is required to submit cost-benefit analyses for its proposals. In addition, FSA must report annually on its costs relative to the costs of regulation in other countries and must provide its next fiscal year budget for public comment 3 months prior to the end of the current fiscal year.

While regulators have attempted to address concerns about regulatory burden by issuing guidance, assessing the level of regulatory burden, and conducting retrospective reviews, a majority of Forum participants also

[20]We currently have ongoing work in this area to review the resources required for banks to file such reports.

[21]Agencies accomplish this task, in part, by conducting what GAO has referred to as "retrospective reviews" to determine the effectiveness of a regulation and its implementation. See GAO, *Reexamining Regulations: Opportunities Exist to Improve Effectiveness and Transparency of Retrospective Reviews*, GAO-07-791 (Washington, D.C.: July 2007).

believed regulatory bodies could take advantage of additional opportunities to reduce the regulatory burden placed on financial firms. One participant noted that the London Stock Exchange's Alternative Investment Market (AIM)[22] is an example of a market that has little regulation and might demonstrate how lighter regulatory approaches could be implemented. This participant also noted, however, that such approaches have been criticized for not providing adequate investor protection.

We Have Recommended Improved Review of Regulations

Retrospective reviews such as those conducted under EGRPRA and other legislation and guidance assist in assessing the effectiveness of how regulations were implemented and help identify opportunities to reduce regulatory burdens and validate regulatory cost and benefit estimates.[23] The EGRPRA process, for example, provided an opportunity for the financial industry to suggest ways to improve upon and simplify regulations applicable to federally-insured depository institutions. Regulatory agency officials reported that similar retrospective reviews have resulted in cost savings to their agencies and to regulated parties. For example, the agencies noted that modernized call report processing would decrease the cost of data collection and verification for all parties.

In a 2007 report, we recommended that agencies improve the effectiveness and transparency of retrospective regulatory reviews and identify opportunities for Congress to revise and consolidate existing requirements.[24] We found that though agencies have conducted many such reviews, the public generally remains unaware of the scope and frequency of such reviews, and agencies can be better prepared to undertake reviews

[22]The London Stock Exchange created AIM to offer smaller companies from throughout the world and in any industry the opportunity to list on its exchange and be subject to less regulation. Listing requirements do not require particular financial track records, a trading history, or minimum requirements for size or number of shareholders. Companies listed on AIM today represent many sizes and industries.

[23]Section 3 of the Regulatory Flexibility Act of 1980 (Pub. L. No. 96-354, 94 Stat. 1164, 1169 (1980) (codified at 5 U.S.C. § 610) requires agencies to periodically review all rules issued by the agency, within 10 years of their adoption as final rules, that have or will have a "significant economic impact upon a substantial number of small entities." The purpose of these reviews is to determine whether such rules should be continued without change, or should be amended or rescinded, consistent with the stated objectives of applicable statutes, to minimize any significant economic impact of the rules upon a substantial number of such small entities. These reviews are referred to as Section 610 reviews.

[24]GAO-07-791.

by planning how they will collect relevant performance data on regulations before promulgating the regulation, or prior to the review.

Developments in a Dynamic Financial Industry Environment Pose Challenges to the Federal Financial Regulatory Structure

Strengths of the current regulatory structure—including regulatory competition, regulatory specialization, and charter choice—have contributed to the development of a strong U.S. financial system. However, the structure is not always well-suited to handle challenges and emerging issues in the financial industry. Industry developments, including the trends of consolidation and globalization, as well as legislative changes, challenge regulators to provide consistent regulatory guidance and treatment of similar firms. Further, increased convergence in product offerings and increased concentration of assets in large, complex firms pose a challenge for regulatory agencies to act consistently in responding to risks that cut across the functional lines that define the regulatory structure. While the regulatory agencies have taken action to work collaboratively in response to the industry's trends, we have noted in the past that it is difficult to collaborate within the fragmented U.S. regulatory system and concluded that the structure of the federal regulatory system should be reexamined.

Aspects of the Current Regulatory Structure Have Contributed to a Strong Financial System but also Create Challenges

The current regulatory structure has contributed to the development of U.S. financial markets and to overall economic growth and stability. However, this structure, characterized by specialization of and competition among multiple regulatory agencies, has both strengths and weaknesses. On the positive side, specialization allows regulators to better understand the risks associated with particular activities or products and to better represent the views of all segments of the industry. Moreover, regulators have developed skilled staff with specialized knowledge of particular industries that can be brought to bear during supervisory examinations. Competition among regulators helps to account for regulatory innovation by providing businesses with a choice among regulators whose approaches better match the businesses' operations. Regulated financial institutions have learned to operate and even thrive under the existing regulatory system. Banks, for example, note the benefit of having multiple charter options that serve different business needs.[25] Competition among the banking regulators, especially the Federal Reserve and OCC, is credited with prompting certain changes in regulation. These changes include the removal of prohibitions against securities firms, banks, and insurance companies operating in a single holding company structure and increased regulatory attention to the provision of loans in certain minority areas.[26]

At the same time, these very characteristics may hinder the effective and efficient oversight of large, complex, internationally active firms that compete across sectors and national boundaries. The specialized and differential oversight of holding companies by different regulators has the potential to create competitive imbalances among firms based on regulatory differences alone. Specifically, although holding companies in different sectors may offer similar services and therefore have similar risk profiles, they may not be subject to the same supervision and regulation. For example, under the new CSE rules, some firms could be subject to both SEC and OTS holding company oversight, and as OTS pointed out in its response to the CSE proposal, perhaps subject to conflicting regulatory requirements.

Key Trends Have Changed the Financial Services Industry

Legislative and industry developments have brought about four key interrelated and ongoing trends in the financial services industry:[27]

- *consolidation:* fewer firms comprise the industry than in the past;
- *conglomeration:* firms have merged or acquired one another, creating fewer, often larger firms in terms of asset size;
- *convergence:* banking, securities, and futures firms offer similar products; and

[25]Charter choice is influenced by many factors, including the size and complexity of banking operations, an institution's business needs, and regulatory expertise tailored to the scale of the bank's operations. See GAO, *OCC Preemption Rules: OCC Should Further Clarify the Applicability of State Consumer Protection Laws to National Banks*, GAO-06-387 (Washington, D.C.: Apr. 28, 2006), 25-28.

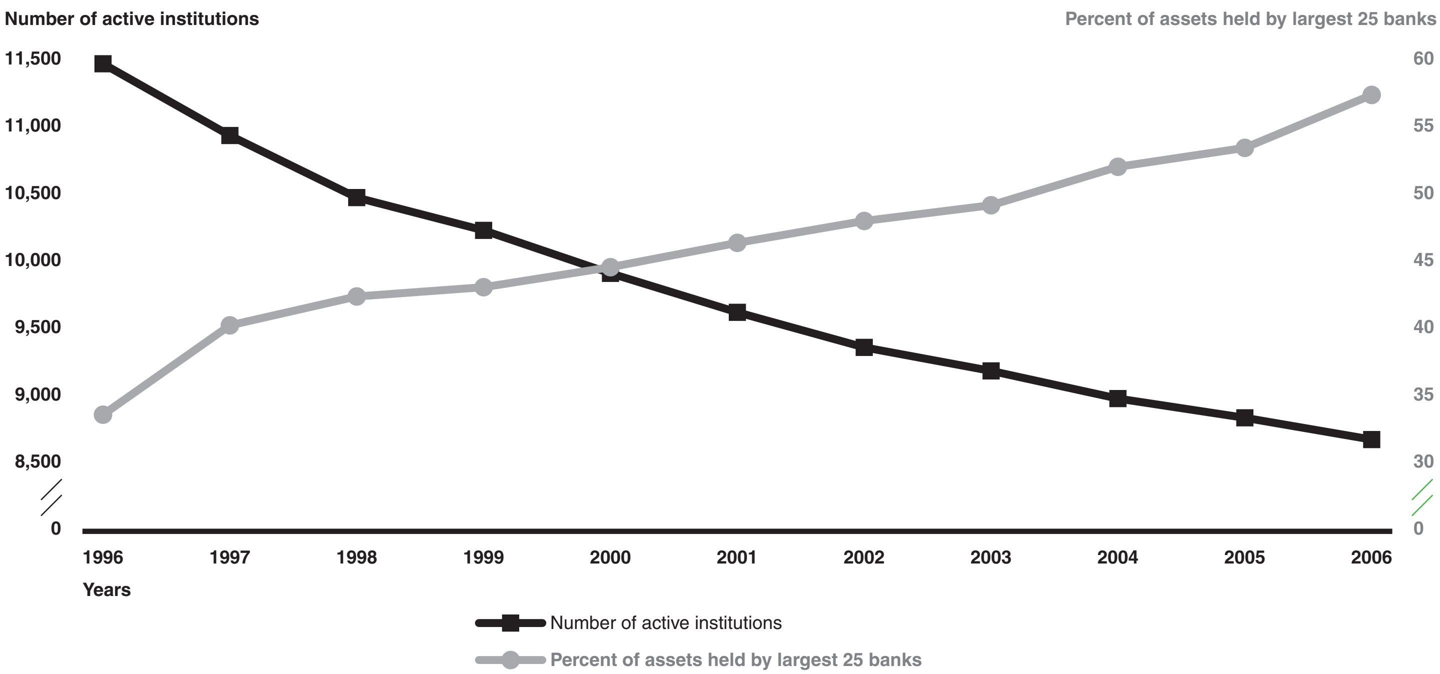
[26]GAO-05-61, 114.

[27]These trends are discussed in greater detail in GAO-05-61, ch. 2.

- *globalization:* firms have expanded throughout the country and the world.

The financial services industry, generally, has seen an increased concentration of assets in the largest firms, combined with a decrease in the overall number of firms. This trend is most dramatic in the banking sector of the financial services industry. During the 10-year period between 1996 and 2006, banking institutions merged or acquired each other to such an extent that 24 percent fewer institutions existed in 2006 than 10 years earlier (decreasing from 11,480 to 8,683 institutions). At the same time, the share of banking assets held by the largest 25 banks grew from about 34 percent to about 58 percent (see fig. 2.).

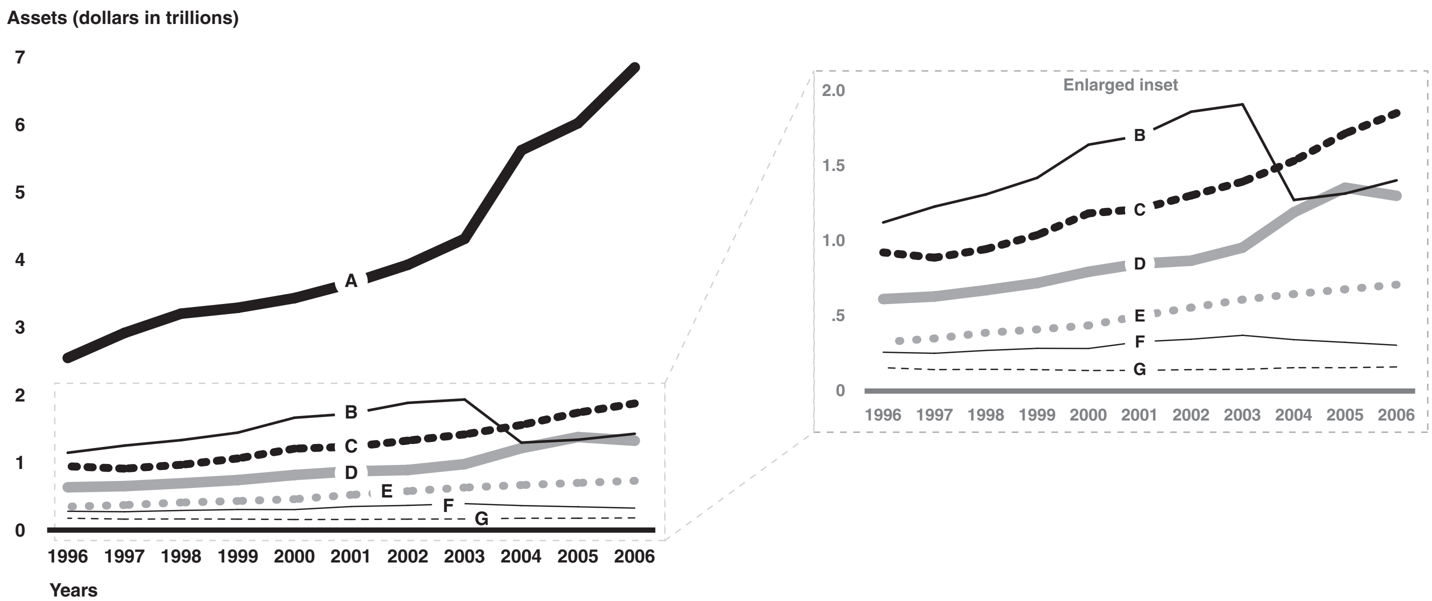
Figure 2: Percent of Assets Held by Largest 25 Banks and Number of Active Banking Institutions, 1996-2006



Source: FDIC data on active insured depository institutions.

Small institutions, such as small credit unions and state-chartered banks, are the most numerous, though the number of all institutions under the various charters has decreased over time.[28] Consolidation has been pronounced in national banks. The number of national banks has decreased by 37 percent, from 2,726 to 1,715, and their assets increased nearly three-fold, from $2.5 trillion to $6.8 trillion (see fig. 3). The increase in assets from 1996 through the end of 2006 has been significant for other institutions as well, with assets at least doubling among state-chartered commercial banks that are not members of the Federal Reserve (from $925 billion to $1.9 trillion), federally chartered savings banks (from $614 billion to $1.3 trillion), and credit unions (from $327 billion to $710 billion).

Figure 3: Changes in Assets by Bank Charter, 1996-2006



A National charter commercial banks (OCC)
B State member commercial banks (Federal Reserve)
C State nonmember commercial banks (FDIC)–includes ILCs
D Federal charter savings bank (OTS)
E Credit unions (NCUA)
F State savings banks (FDIC)
G State/federal charter savings & loan (OTS)

Source: GAO analysis based on data from FDIC and NCUA.

[28]The number of ILCs actually grew during the period 1996-2006; however, they represent a very small percent of total deposits in the banking industry; insured deposits in ILCs represented less than 3 percent of the total estimated deposits in 2006.

The securities and futures segments also have seen substantial growth in volume. Since 1996, assets among securities firms have increased about 70 percent—from about $1.8 trillion to about $5.9 trillion, according to the Securities Industry and Financial Markets Association.[29] The securities industry has long been concentrated, with the assets of the largest 10 firms exceeding 50 percent since at least 1996.[30] Similarly, the annual volume of active trading in futures contracts increased from about 499 million contracts to more than 2.5 billion between 1996 and 2006, according to the CFTC.

The conglomeration of firms and convergence of products offered by firms across sectors increasingly have come to characterize the large players in the industry. With regard to increased conglomeration, a research report by International Monetary Fund (IMF) staff—based on a worldwide sample of the largest 500 financial services firms in terms of assets—shows that the percentage of U.S. financial institutions in the sample engaged to some significant degree in at least two of the functional sectors of banking, securities, and insurance increased from 42 percent in 1995 to 61.5 percent in 2000. In addition, the conglomerates included in the IMF review held 73 percent of the assets of all of the U.S. firms included in the sample.[31]

As a result of conglomeration, financial institutions have converged in their products, increasingly offering products that are less distinct than in the past. For example, banks, broker-dealers, and investment companies all offer variable annuities. In addition, these institutions offer accounts or services that are legally distinct but function in similar ways, such as checking accounts, cash management accounts, and money market mutual funds.[32]

[29]Assets, though an imperfect measure of increased growth in the securities industry, tend to be more stable than revenues and show a clearer picture of the size of the industry over time. This figure includes total assets and not assets under management. Revenues, another measure commonly used to reflect the growth of the securities industry, increased by about 61 percent over this same period from about $172 billion to $437 billion.

[30]GAO-05-61, 46-47.

[31]Gianni DeNicolo, Philip Bartholomew, Jahanara Zaman, and Mary Zephirin, “Bank Consolidation, Internationalization, and Conglomeration: Trends and Implications for Financial Risk” (IMF Working Paper 03/158, Washington, D.C., July 2003).

[32]GAO-05-61.

Banks and securities firms have greatly extended their reach throughout the world, comprising an industry that has global operations. Such international presence has brought about links among markets, as evidenced by recent negative impacts on German and French banks as a result of subprime mortgage defaults in the United States.[33] Increasingly, non-U.S. operations also form a substantial percentage of revenues for U.S.-based financial services firms. For example, Goldman Sachs reported to SEC that in the first half of 2007, it had earned the majority of its revenues (over 50 percent) from non-U.S. operations.[34] Similarly, Citigroup reported that about 44 percent of its income came from regions other than the United States.[35] U.S.-based financial services firms have also increased their operational presence in other countries over time, with some firms booking most of their credit derivative trades, for example, in major markets such as London.[36]

Recent Legislative Changes Have Affected the Financial Services Industry

The financial services industry and the manner in which it is regulated have changed in recent decades as a result of legislative action. The legislation both responded and contributed to the industry trends. For example, while banking and securities activities had generally been separated in the United States after the Glass-Steagall Act of 1933, the Gramm-Leach-Bliley Act of 1999 eased many of the restrictions limiting the ability of banks and securities firms to affiliate with one another; some restrictions, however, had been gradually eased as a result of regulatory interpretations of prior law.

As figure 4 indicates, changes in legislation have affected business practices of the financial services industry as well as its regulatory oversight. In many cases, legislation responded to a crisis. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of

[33]IKB Deutsche Industriebank, PNB Paribas, and other foreign banks experienced losses due to defaults on subprime mortgages in the United States, according to news reports.

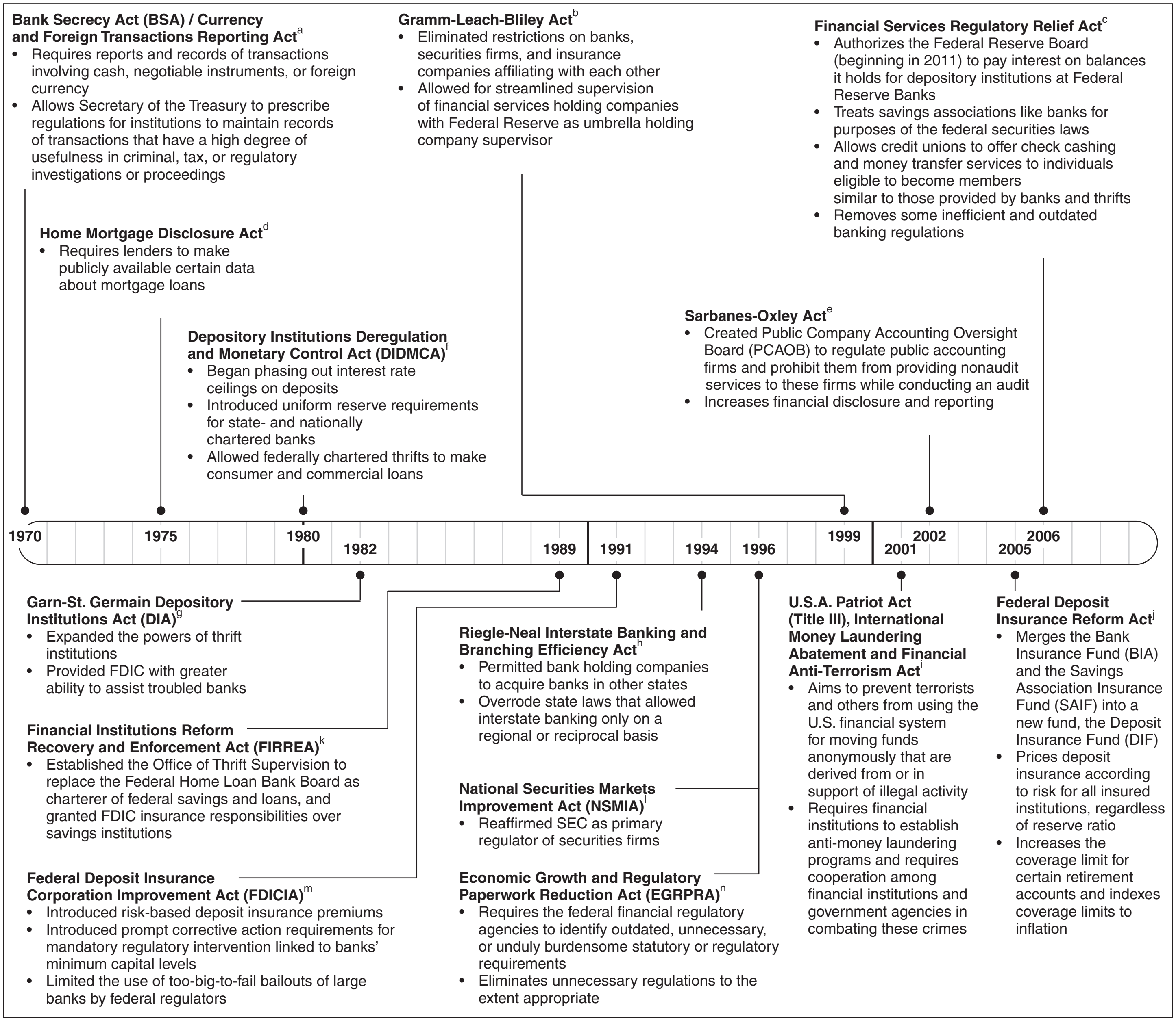
[34]According to SEC filings, 51.3 percent of Goldman Sachs revenues in the first half of 2007 were earned in Asia, Europe, the Middle East, and Africa. Revenues earned in the Americas were 48.7 percent, most of which was earned in the United States.

[35]Citigroup, Form 10-K for 2006, filed with SEC; p. 5.

[36]GAO, *Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, but Were Successfully Addressed after Joint Regulatory Action*, GAO-07-716 (Washington, D.C.: June 13, 2007).

1991 responded, in large part, to the savings and loan crisis of that period. FDICIA, for instance, mandated that the agencies take "prompt corrective action" when a bank's capital falls below specified thresholds; this responded to concerns that regulatory forbearance with troubled institutions was excessive and contributed to further problems.

Figure 4: Selected Legislation Resulting in Financial Regulatory Changes



Source: GAO.

[a]Pub. L. No. 91-508, Titles I, II, 84 Stat. 1114, 1118 (1970).

[b]Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[c]Pub. L. No. 109-351, 120 Stat. 1966 (2006).

[d]Pub. L. No. 94-200, Title III, 89 Stat. 1124, 1125 (1975).

[e]Pub. L. No. 107-204, 116 Stat. 745 (2002).

[f]Pub. L. No. 96-221, 94 Stat. 132 (1980).

[g]Pub. L. No. 97-320, 96 Stat. 1469 (1982).

[h]Pub. L. No. 103-328, 108 Stat. 2338 (1994).

[i]Pub. L. No. 107-56, Title III, 15 Stat. 272, 296 (2001).

[j]Pub. L. No. 109-171, Title II, 120 Stat. 4, 9 (2005).

[k]Pub. L. No. 101-73, 103 Stat. 183 (1989).

[l]Pub. L. No. 104-290, 110 Stat. 3416 (1996).

[m]Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[n]Pub. L. No. 104-208, Title II, Div. A, 110 Stat. 3009-394 (1996).

In addition, legislation over the past two decades has created new reporting requirements for firms, such as disclosures required by the Home Mortgage Disclosure Act and enhanced antiterrorism and antimoney-laundering requirements, such as those imposed by the USA Patriot Act.

These laws, however, have not led to comprehensive changes in the federal financial regulatory structure. For example, the landmark Gramm-Leach-Bliley Act in some ways recognized the blurring of distinctions among banking, securities, and insurance activities that had already happened in the marketplace and codified regulatory decisions that had been made to deal with these industry changes. While recognizing industry and regulatory changes, that act changed neither the number of regulatory agencies nor, in most cases, the primary objectives and responsibilities of the existing agencies.

Recent Industry Changes Demonstrate the Challenges Confronting Financial Regulators

The industry's trends, coupled with legislative changes, challenge regulatory agencies to provide adequate regulatory oversight while ensuring that regulation does not place any segment of the industry at a disadvantage relative to the others. The current structure—with its multiple regulators and charters—is further challenged by the need to recognize sector differences and simultaneously provide similar regulatory treatment for similar products. Regulatory agencies do collaborate to ensure consistent treatment of similar activities across institutional charters and legal entities, as well as in consolidated supervision of large, complex organizations. However, our prior work involving (1) consolidated supervision of holding companies, (2) the ILC charter, (3) U.S. capital adequacy regulation, (4) charter choice and OCC preemption rules, and (5) the regulation of securities and futures markets found instances where regulatory differences could lead to unequal treatment of firms.

Consolidated Supervision of Holding Companies

Consolidated supervision[37]—holding company supervision at the top tier or ultimate holding company in a financial enterprise—has become more important in light of changes in the financial services industry, particularly with respect to the increased importance of enterprise risk management of large, complex financial services firms. The Gramm-Leach-Bliley Act recognized the blurring of distinctions among the banking, securities and insurance activities happening in the marketplace, and recognized consolidated supervision as a basis for regulators to oversee the risks of financial services firms on the same level that the firms manage those risks. In March 2007, we reported that many large U.S. financial institutions were being supervised on a consolidated basis and that this was consistent with international standards that focus on having regulators familiar with the organizational structure, risk management and controls, and capital adequacy of these enterprises.[38]

In this prior work, however, we found some evidence of duplication and inconsistency when different agencies are responsible for consolidated and primary supervision, suggesting that opportunities remain for enhanced collaboration to promote greater consistency.[39] For example, we found that while the Federal Reserve and OCC have and generally follow procedures to resolve differences, a large, complex banking organization initially received conflicting information from the Federal Reserve, its consolidated supervisor, and OCC, its primary bank supervisor, about the firm's business continuity provisions. Also, SEC and OTS both have consolidated supervisory authority for some of the same firms but we found they did not have an effective mechanism for collaborating to prevent duplication and ensure consistency. In response, the Director of

[37]For enterprises engaged in commercial activities, consolidated supervision also may refer to supervision of the enterprise consolidated at the highest-level holding company engaged in financial activities. For foreign banking firms that operate in the United States without a U.S. holding company, consolidated supervision may refer to the oversight of all U.S. activities of the foreign firm.

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

[39]GAO-07-154, 39, 48-51.

OTS said that he would take steps to develop an effective mechanism for OTS and SEC to work together.

In order to ensure that consolidated supervisors, specifically the Federal Reserve, SEC, and OTS, are promoting consistency with primary bank and other supervisors and not duplicating efforts, we recommended in March 2007 that these agencies identify additional ways to more effectively collaborate with primary bank and functional supervisors (e.g., developing appropriate mechanisms to better define responsibilities and to monitor, evaluate, and report jointly on results).[40] To take advantage of opportunities to promote better accountability and limit the potential for duplication and regulatory gaps, we recommended that these agencies foster more systematic collaboration among themselves to promote supervisory consistency, particularly for firms that provide similar services. In particular, we recommended that OTS and SEC clarify accountability when the agencies both had jurisdiction over a single company. Systematic collaboration would help to limit duplication, ensure that all regulatory areas are effectively covered, and ensure that resources are focused most effectively on the greatest risks across the regulatory system.

ILC Holding Company Regulation

In 2005 we reported that the parent companies of ILCs were not being overseen at the consolidated level by bank supervisors with clear authority for consolidated supervision.[41] ILCs typically are owned or controlled by a holding company that also may own other entities, and thus pose risks to the deposit insurance fund that are similar to those presented by other parents of depository institutions. However, FDIC, the primary bank supervisor for ILCs, has less extensive authority to supervise ILC holding companies than the Federal Reserve or OTS, the consolidated supervisors of bank and thrift holding companies, respectively. In addition, the parents of some ILCs—because they are exempt from the Bank Holding Company Act—are able to mix banking and commerce to a

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

[41]See GAO-05-621. In most respects, ILCs may engage in the same activities as other depository institutions insured by the FDIC and thus may offer a full range of loans, including consumer, commercial and residential real estate, small business, and subprime. ILCs are also subject to the same federal safety and soundness safeguards and consumer protection laws that apply to other FDIC-insured institutions.

greater extent than the parents of other insured depository institutions.[42] Because of these inconsistencies, we (and the FDIC Office of the Inspector General) concluded that ILCs in a holding company structure may pose more risk to the deposit insurance fund than other types of insured depository institutions operating in a holding company. We recommended that Congress consider (1) options that would better ensure supervisors of institutions with similar risks have similar authorities and (2) the advantages and disadvantages of a greater mixing of banking and commerce by ILCs or other financial institutions. In July 2006, FDIC announced a moratorium on ILC applications from commercial entities for 6 months. On February 5, 2007, the agency extended the moratorium for another year.[43]

Basel II Implementation

Efforts to revise capital adequacy regulations for U.S. banks and bank holding companies also highlight the challenges regulatory agencies have in treating institutions consistently while also respecting their differences. Current capital adequacy regulations are based on a 1988 international accord to establish a common framework and reduce competitive inequalities among international banks. Advances in risk management strategies and other developments since 1988, however, have prompted an effort through the Basel Committee on Banking Supervision to present a new framework—commonly called Basel II—that would reflect these developments.

Applying Basel II in the United States has raised serious concerns, however. Because each federal regulator oversees a different set of institutions and has different perspectives and goals, reaching consensus on some issues in developing the Basel II framework has been difficult even though all of the agencies generally agree that limitations in the current Basel I framework have rendered it increasingly inadequate for supervising the capital adequacy of the largest, most complex banks. For example, officials from FDIC have been concerned about the use of banks' risk-based capital models under Basel II because, while these models have been used for internal risk assessment and management for years, with the exception of certain market risk models, they are relatively unproven as a regulatory capital tool, and questions remain about the reliability of data

[42] GAO found that nonfinancial, commercial firms in the automobile, retail, and energy industries, among others, own ILCs, many of which directly supported their parent's commercial activities.

[43] 72 Fed. Reg. 5290 (Feb. 5, 2007).

underlying the models. To address some of these concerns, agencies have proposed a number of safeguards in the proposed Basel II rule. Officials from the Federal Reserve and OCC—as the regulators of the vast majority of core banks that would be required to adopt Basel II's "advanced approach"— acknowledged data limitations and the uncertain impact on capital requirements, but highlighted the limitations of Basel I, the increased risk sensitivity of Basel II, the advances in risk management at large banks, the safeguards to ensure capital adequacy, and regulator experience in reviewing economic capital models as reasons to proceed with implementing Basel II. Further, regulatory agencies noted concerns about potential competitive inequities between large and small banks in the United States, if small banks are required to hold more regulatory capital than large banks for some similar risks. Finally, U.S. banks implementing Basel II's advanced approach have expressed concerns that the U.S. leverage requirement would put them at a competitive disadvantage against international financial institutions that do not face such a requirement.[44]

On September 25, 2006, the regulators issued a joint Notice of Proposed Rulemaking (NPR) that proposed a new risk-based capital adequacy framework that would require some and permit other qualifying banks to use an internal ratings-based approach to calculate regulatory credit risk capital requirements and advanced measurement approaches to calculate regulatory operational risk capital requirements. According to the NPR, the framework is intended to produce more risk-sensitive capital requirements than currently used by the agencies. The framework also seeks to build upon improvements to risk assessment approaches adopted by a number of large banks over the last decade. However, concern remained that applying different capital adequacy regulations to different institutions, even though it is intended to respect differences among institutions, may lead to competitive inequities. In our report, we made several recommendations to the agencies to improve the transparency of the process of developing new regulations.[45] On July 20, 2007, the agencies announced an agreement regarding implementation of Basel II and to

[44]In addition to the risk-based capital requirement, U.S. banks must also satisfy a leverage requirement that defines a minimum level for a simple ratio of specified components of total capital (those defined as Tier I under current rules) to on-balance sheet assets. See GAO-07-253, 32 ff.

[45]See GAO-07-253, 77-79.

finalize rules implementing the advanced approaches for computing large banks' risk-based capital requirements expeditiously.

OCC Preemption and Charter Choice

Bank regulatory agencies and others have argued that charter choice, allowing for differences in the regulation of financial institutions, is a central element in promoting an efficient U.S. financial services industry. This choice permits institutions to not only select the charter that best corresponds to their business plans and organization but also to protect themselves against arbitrary regulation. Differences in regulation reflect, at least in part, differences between the types of charters. In turn, regulatory competition has prompted changes to modernize the regulatory structure and allow financial institutions to offer a diverse range of products and services to meet the needs of their customers. However, such diversity challenges regulatory agencies to ensure supervisory and regulatory differences are based on legitimate differences in business plans and intended markets among the institutions under supervision and not an attempt to give one type of institution a competitive advantage over others.

The recent debate regarding OCC's interpretation of its authority to preempt state laws brought particular attention to the question of regulatory consistency, charter choice, and safety and soundness. In January 2004, OCC issued two final rules that are jointly referred to as the preemption rules. The "bank activities" rule addressed the applicability of state laws to national banking activities, while the "visitorial powers" rule set forth OCC's view of its authority to inspect, examine, supervise, and regulate national banks and their operating subsidiaries. The rules addressed OCC's authority to preempt state laws that applied to operating subsidiaries of national banks if those operating subsidiaries were conducting banking activities permitted for the national bank itself. However, the rules do not fully resolve uncertainties about the applicability of state consumer protection laws, particularly those aimed at preventing unfair and deceptive acts and practices. National banks are subject to federal consumer protection laws, including the Federal Trade Commission Act's prohibition of unfair or deceptive acts or practices. OCC supervises national banks and helps to enforce their compliance with these federal requirements. Opponents of OCC's position stated such preemption would weaken consumer protections and the rules could undermine the dual banking system, because state-chartered banks would have an incentive to change their charters from state to federal since national banks do not have to comply with state laws that apply to banking activities and, to the extent that compliance with federal law is less costly or burdensome than state regulation, the federal charter provides for lower regulatory costs and easier access to markets.[46] Supporters of the rules asserted that providing consistent regulation for national banks, rather than differing state regulatory regimes, was necessary to ensure efficient nationwide operation of national banks. Recently, the Supreme Court upheld OCC authority under the National Bank Act to preempt state regulation of the mortgage lending activities of a national bank's operating subsidiary.[47]

In our review of OCC's preemption rulemaking, we recommended that the Comptroller of the Currency clarify the characteristics of state consumer protection laws that would make them subject to federal preemption. OCC responded that the Consumer Financial Protection Forum, chaired by the U.S. Department of the Treasury, was established to bring federal and state regulators together to focus exclusively on consumer protection issues and to provide a permanent forum for communication on those issues. OCC believes this will provide an opportunity for federal and state regulators to better understand their differing perspectives, but what effect the Consumer Financial Protection Forum will have remains to be determined.

SEC and CFTC Joint Jurisdiction over Certain Products

Securities and futures markets, regulated by SEC and CFTC respectively, have become increasingly interconnected, raising the question whether separate regulatory agencies over these markets remain appropriate. SEC has authority over securities trading and the securities markets, whose primary purpose historically has been to facilitate capital formation. CFTC has authority over futures trading and the futures markets, which have primarily been used for risk management purposes. However, distinction between a financial product as a security or a future has become increasingly difficult as more and more products are developed that combine characteristics of both securities and futures. Derivatives—including security-based futures and options as well as traditional commodity-based contracts—have grown dramatically in recent years.[48] There is concern that the split in regulatory responsibility between SEC and CFTC could result in uncertainty about regulatory jurisdiction over

[46] GAO, *OCC Preemption Rules: OCC Should Further Clarify the Applicability of State Consumer Protection Laws to National Banks*, GAO-06-387 (Washington, D.C.: Apr. 28, 2006).

[47] Watters v. Wachovia, N.A., 127 S. Ct. 1559 (Apr. 17, 2007).

[48] For example, since their introduction in the early 1990s, credit derivatives surpassed a notional amount of $34 trillion at year-end 2006. See GAO-07-716.

some types of derivative products and possibly encourage companies to structure new products and activities so they avoid oversight completely.

We have long reported that the differences in U.S. securities and futures laws and markets will continue to require both SEC's and CFTC's regulatory staff to have some specialized expertise.[49] However, the two agencies also have had to work together to clarify their joint jurisdiction over certain products, such as futures on single stocks and certain stock indexes. Concerns that restrictions in a 1981 agreement between CFTC and SEC to prevent such trading on futures exchanges may have limited investor choice led to calls to repeal the restrictions. These calls were countered by concerns about doing so without first resolving applicable differences between securities and commodities laws and regulations, including the lack of comparable insider trading restrictions and consumer protection requirements. We recommended that CFTC and SEC work together and with Congress to develop and implement an appropriate legal and regulatory framework for removing the restrictions.[50] In 2000, CFTC and SEC reached agreement to jointly regulate single stock futures under a framework aimed at promoting competition, maintaining market integrity, and protecting customers. In turn, Congress codified the agreement in the Commodity Futures Modernization Act of 2000.

Regulators Have Often Collaborated to Respond to Regulatory Challenges but More Could Be Done

Under the current structure, financial regulatory agencies often have collaborated to achieve their goals. For example, in 2007, we reported on a joint regulatory initiative of bank and securities regulators that recently facilitated the monitoring of industry-wide progress on reducing confirmation backlogs in the regulation of over-the-counter credit derivatives.[51] In 2006, we reported that in an effort to establish greater consistency in their examination procedures and oversight directed at preventing, detecting, and prosecuting money laundering, the federal banking regulators, with participation from the Financial Crimes Enforcement Network, jointly developed and issued an interagency examination procedures manual describing the risk assessments for Bank

[49]See, for example, GAO, *CFTC/SEC Enforcement Programs: Status and Potential Impact of a Merger*, GAO/T-GGD-96-36 (Washington, D.C.: Oct. 25, 1995).

[50]GAO, *CFTC and SEC: Issues Related to the Shad-Johnson Jurisdictional Accord*, GAO/GGD-00-89 (Washington, D.C.: Apr. 6, 2000).

[51]GAO-07-716.

Secrecy Act (BSA) examinations.[52] To further strengthen BSA oversight, the agencies said that they were committed to ongoing interagency coordination. The bank regulatory agencies and NCUA also participate in the Federal Financial Institutions Examination Council, established in 1979 as a formal interagency communication vehicle for prescribing uniform supervisory standards.[53] A representative of state banking authorities was added to this council as a full voting member by the Financial Services Regulatory Relief Act of 2006. FDIC, the Federal Reserve, and OCC also work collaboratively under the Shared National Credit Program (a joint review of large, syndicated loans shared by banks that may have different supervisors) and the Interagency Country Exposure Review Committee (a joint determination of the level of risk for credit exposures to various countries). Moreover, both the Comptroller of the Currency and the Director of OTS are members of the FDIC Board of Directors.

More broadly, federal financial regulators have been involved in interagency efforts, including the President's Working Group, which provides a framework for coordinating policies and actions that cross agency jurisdictional lines.[54] We have reported, however, that the Group is not well suited to orchestrate a consistent set of goals or objectives that would direct the work of the different agencies. We noted that agency officials involved with the Group were "generally adverse to any formalization of the group and said that it functions well as an informal coordinating body."[55]

While the agencies do exchange information, they have opportunities to improve collaboration. We have noted in the past that it is difficult to collaborate within the fragmented U.S. regulatory system and have recommended that Congress modernize or consolidate the regulatory system. However, we previously have reported that under the current system, agencies have opportunities to collaborate more systematically

[52]GAO, *Bank Secrecy Act: Opportunities Exist for FinCEN and the Banking Regulators to Further Strengthen the Framework for Consistent BSA Oversight*, GAO-06-386 (Washington, D.C.: Apr. 28, 2006).

[53]See GAO-05-61, 97-98.

[54]See GAO, *Financial Regulatory Coordination: The Role and Functioning of the President's Working Group*, GAO/GGD-00-46 (Washington, D.C.: Jan. 2000).

[55]GAO/GGD-04-46, 3.

and thus ensure that institutions operating under the oversight of multiple financial supervisors receive consistent guidance and face minimal supervisory burden. In our consolidated supervision report, we made recommendations to the Federal Reserve, OTS, and SEC to improve efforts to collaborate and increase consistency in their consolidated supervision program. In addition, we recommended that agencies foster more systematic collaboration among their agencies to promote supervisory consistency, particularly for firms that provide similar services.[56] In particular, we recommended that OTS and SEC clarify accountability for holding companies that operate under both agencies' jurisdictions. (The agencies have reported subsequent actions to improve their programs in these regards.)

Accountability for Identifying and Responding to Risks that Span Financial Sectors Is Not Clearly Defined

Because our regulatory structure relies on having clear-cut boundaries between the "functional" areas, industry changes that have caused those boundaries to blur have placed strains on the regulatory framework, and accountability for addressing risks that cross boundaries is not clearly defined. While diversification across activities and locations may have lowered the risks faced by some large, complex, internationally active firms, understanding and overseeing them also has become a much more complex undertaking, requiring staff who can evaluate the risk portfolio of these institutions and their management systems and performance. Regulators must be able to ensure effective risk management without needlessly restraining risk taking, which would hinder economic growth. Similarly, because firms are taking on similar risks across "functional" areas, to understand the risks of a given institution or those that span institutions or industries, regulators need a more complete picture of the risk portfolio of the financial services industry as a whole, both in the United States and abroad.

As we have discussed above, some of the means by which U.S. regulators collaborate across sectors do not provide for the systematic sharing of information, making it more difficult for regulators to identify emerging threats to financial stability. These means also do not allow for a satisfactory assessment of risks that cross traditional regulatory and industry boundaries and therefore may inhibit the ability to detect and contain certain financial crises, as can be seen in the following:

[56] GAO-07-154.

- With regard to the President's Working Group, we reported in 2000 that although it has served as a mechanism to share information during unfolding crises, its activities generally have not included such matters as routine surveillance of risks that cross markets or of information sharing that is specific enough to help identify potential crises.[57] The Group has served as an informal mechanism for coordination and cooperation rather than as a mechanism to ensure accountability for issues that span agency jurisdiction.

- In reviewing the near collapse of Long-Term Capital Management (LTCM)—one of the largest U.S. hedge funds—in 1998, we reported that regulators continued to focus on individual firms and markets but failed to address interrelationships across industries; accountability for those relationships was not clearly defined. Thus, federal financial regulators did not identify the extent of weaknesses in bank, securities, and futures firm risk management practices until after LTCM's near collapse and had not sufficiently considered the systemic threats that can arise from unregulated entities.[58]

- In reviewing responses to the events of September 11, 2001, we reported that the multiple agency structure of U.S. financial services regulation has slowed the development of a strategy that would ensure continuity of business for financial markets in the event of a terrorist attack.[59]

- In a recent review of interagency communication regarding enforcement actions taken by the regulatory agencies against individuals and firms, we reported that while information sharing among financial regulators is a key defense against fraud and market abuses, regulators do not have ready access to all relevant data related to regulatory enforcement actions taken against individuals or firms. We also reported that many financial regulators do not share relevant consumer complaint data amongst themselves on certain hybrid products such as variable annuities (products that contain characteristics of both securities and insurance

[57]GAO/GGD-00-46.

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

[59]GAO, *Potential Terrorist Attacks: Additional Actions Needed to Better Prepare Critical Financial Market Participants*, GAO-03-251 (Washington, D.C.: Feb. 12, 2003).

products) in a routine, systematic fashion, compounding the problem that consumers may have in identifying the relevant regulator.[60]

Through its supervision of bank and financial holding companies, the Federal Reserve has oversight responsibility for a substantial share of the financial services industry. The scope of its oversight, however, is limited to bank and financial holding companies. While each agency develops its own strategic plan for meeting its mission, no government agency has the authority to identify and address issues in the financial system as a whole, and monitor the ability of regulators to meet their objectives on an ongoing basis.[61] We repeatedly have noted that regulators could do more to share information and monitor risks across markets or “functional” areas to identify potential systemic crises and limit opportunities for fraud and abuse.[62]

From an overall perspective the system is not proactive, but instead reacts in a piecemeal, ad hoc fashion—often when there is a crisis. During a crisis, or in anticipation of one, no one has the authority and there is no formal cooperative mechanism to conduct risk analyses, prioritize tasks, or allocate resources across agencies, although the Office of Management and Budget may perform some of these tasks for agencies funded by federal appropriations. Several Forum participants, for instance, suggested that Congress establish an agency with authority to set regulatory standards and goals and to hold regulators accountable to those goals.

The federal financial regulatory agencies face challenges posed by the dynamic financial environment: the industry’s trends of consolidation, conglomeration, convergence, and globalization have created an environment that differs substantially from the prevailing environment when agencies were formed and their goals set by legislation. In particular, the fact that different agencies have jurisdiction over large, complex firms that offer similar services to their customers creates the potential for inconsistent and inequitable treatment. Differences, even subtle ones, among the agencies’ goals exacerbate the potential for inconsistency.

---

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

[61]We have noted limitations on effectively planning strategies that cut across regulatory agencies. See GAO-05-61.

[62]GAO-05-61.

Several Forum participants noted that subtle differences among agency goals can be significant. Further, despite the changes posed by the industry's dynamic environment, clear accountability for addressing issues that span agencies' jurisdiction is not clearly assigned in the current system. These issues have led us to suggest that modernizing the federal financial regulatory system is a key challenge facing the United States in the 21st century.

Options to Change the Federal Financial Regulatory Structure

In our previous work, we suggested options for Congress to consider to modernize the current regulatory system. Additionally, others have recommended changes, frequently intended to simplify the complex multiagency structure. The financial regulatory structure, however, has remained largely the same despite changes in the financial services industry. Forum participants and others have suggested that some lessons could be learned from the principles-based approach to regulation of the United Kingdom's Financial Services Authority (FSA). However, participants also noted that the lessons should be considered in light of the differences between the United States and the United Kingdom and the limited experience of FSA, particularly the fact that it had not dealt, at the time of the Forum, with a significant economic crisis or downturn. Defining clear and consistent goals for regulatory agencies would be a significant step toward modernizing the regulatory structure.

Modernizing the Financial Regulatory System Remains a Challenge

As early as 1994, we voiced our support for modernizing the federal financial regulatory structure. More recently, we provided various options for Congress to consider, including

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

Each of these options would provide potential improvements, as well as some risks and costs. Consolidating the regulatory structure within "functional" areas, such as banking and securities, would provide a central point of communication for a sector's issues and could reduce barriers to communication and coordination among the regulatory agencies; it also could remove opportunities for regulatory experimentation and the other positive aspects of regulatory competition. A “twin peaks model” would involve setting up one safety and soundness regulatory entity and one conduct-of-business regulatory entity charged with ensuring compliance with the full range of conduct-of-business issues, including consumer and investor protection, disclosure, money laundering, and some governance issues. On the positive side, this could ensure that conduct-of-business issues are not subordinated to safety and soundness issues, as some fear. However, this structure would not facilitate regulators’ understanding of linkages between safety and soundness and conduct-of-business, such as a financial services firm’s reputational risk. A single regulator, like FSA, would have the ability to evaluate such linkages, but ensuring the accountability of such a large agency to consumers or industry would be difficult. Finally, a single agency charged with oversight of large, complex firms could be able to provide consistent regulatory treatment and to identify and respond to issues that cross current regulatory agency boundaries. However, it might be difficult to find and maintain an appropriate balance between the interests of the large, internationally active firms and smaller entities; this option, further, might add another agency to a regulatory system that already has many agencies.[63]

IMF noted these options in suggesting that the United States review the rationalization for its financial regulation.

As we previously have noted, the specifics of a regulatory structure, including the number of regulatory agencies and roles assigned to each, may not be the critical determinant in whether a regulatory system is successful. The skills of the people working in the regulatory system, the clarity of its objectives, its independence, and its management systems are also critical to the success of financial regulation.[64]

Others also have proposed changes to modernize the financial regulatory system, including the following:

[63] GAO-05-61.

[64] GAO-05-61.

- 1994 Treasury proposal.[65] This proposal would have realigned the federal banking agencies by core policy functions—that is, bank supervision and regulation function, central bank function, and deposit insurance function. Generally, this proposal would have combined OCC, OTS, and certain functions of the Federal Reserve and FDIC into a new independent agency, the Federal Banking Commission, that would have been responsible for bank supervision and regulation. FDIC would have continued to be responsible for administering federal deposit insurance, and the Federal Reserve would have retained central bank responsibilities for monetary policy, liquidity lending, and the payments system. Although FDIC and the Federal Reserve would have lost most bank supervisory rule-making powers, each would have been allowed access to all information of the new agency, as well as retain limited secondary or backup enforcement authority. In addition, the Federal Reserve would be authorized to examine a cross section of large and small banking organizations jointly with the new agency. FDIC would have continued to oversee activities of state banks and thrifts that could pose risks to the insurance funds and to resolve failures of insured banks.

- H.R. 1227 (1993).[66] This proposal would have consolidated OCC and OTS in an independent Federal Bank Agency and aligned responsibilities among the new and existing agencies. It also would have reduced the multiplicity of regulators to which a single banking organization could be subject while avoiding the concentration of regulatory power of a single federal agency. The role of the Federal Financial Institution Examination Council would have been strengthened; it would have seen to the uniformity of examinations, regulation, and supervision among the three remaining supervisors. According to a Congressional Research Service (CRS) analysis, this proposal would have put the Federal Reserve in charge of more than 40 percent of banking organization assets, with the rest divided between the new agency and a reorganized FDIC.[67]

[65]This proposal was outlined in the statement of the Honorable Lloyd Bentsen, Secretary of the Treasury, before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate (Mar. 1, 1994).

[66]The Bank Regulatory Consolidation and Reform Act of 1993, H.R. 1227, 103rd Cong. (1993).

[67]CRS, *Bank Regulatory Agency Consolidation Proposals: A Structural Analysis* (Washington, D.C., Mar. 18, 1994).

- 1994 LaWare proposal.[68] The LaWare proposal was outlined in congressional testimony but never presented as a formal legislative proposal, according to Federal Reserve officials. It called for a division of responsibilities defined by charter class and a merging of OCC and OTS responsibilities. The two primary agencies under the proposal would have been an independent Federal Banking Commission and the Federal Reserve, which would have supervised all independent state banks and depository institutions in any holding company whose lead institution was a state-chartered bank. The new agency would have supervised all independent national banks and thrifts and depository institutions in any banking organization whose lead institution was a national bank or thrift. FDIC would not have examined financially healthy institutions, but would have been authorized to join in examination of problem banking institutions. Based on estimates of assets of commercial banks and thrifts performed by CRS, the LaWare proposal would have put the new agency in charge of more commercial bank assets than the Federal Reserve.

- 2002 FDIC Chairman proposal. Donald E. Powell, then Chairman of the FDIC, proposed to design a new regulatory system that would reflect the modern financial services marketplace. Three federal financial services regulators would carry out federal supervision: one would be responsible for regulating the banking industry, another for the securities industry, and a third for insurance companies that choose a federal charter.

- Similarly, proposals have been made to restructure futures and securities regulation. In particular, proposals have been made to consolidate SEC and CFTC, partly in response to increasing convergence in new financial instrument and trading strategies of the securities and futures markets.

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

Some Lessons May Be Learned from the United Kingdom's FSA Model which Emphasizes a Principles-based Approach to Regulation

Beginning in 1997, the United Kingdom consolidated its financial services regulatory structure, combining nine different regulatory bodies, including SROs, into the FSA. While FSA is the sole supervisor for all financial services, other government agencies, especially the Bank of England and Her Majesty's Treasury, still play some role in the regulation and supervision of financial services.[69]

FSA government officials and experts on the model cited important changes in the financial services industry as some of the reasons for consolidating the regulatory bodies that oversee banking, securities, and insurance activities. These included the blurring of the distinctions between different kinds of financial services businesses, and the growth of large, conglomerate, financial services firms that allocate capital and manage risk on a groupwide basis. Other reasons for consolidating included some recognition of regulatory weaknesses in certain areas and enhancing the United Kingdom's power in the European Union[70] and other international deliberations.[71]

A number of participants in the Forum believed that lessons can be learned from the FSA's single regulator model. Specifically, some participants noted that FSA's establishment and use of regulatory goals through its principles-based approach to regulation may help to improve the effectiveness of the U.S. regulatory structure. In particular, several participants suggested adopting a principles-based approach to prudential regulation.

[69]While FSA is responsible for supervision of financial entities, the Bank of England retains primary responsibility for the overall stability of the financial system. It retains lender-of-last-resort responsibilities but must consult with the Treasury if taxpayers are at risk. High-level representatives from the three agencies meet monthly to discuss issues of mutual concern. See GAO-05-61, 67.

[70]The European Union (EU) is a treaty-based organization of European countries in which countries cede some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level. GAO-05-61, 62.

[71]In 1996, Japan also consolidated and modified its financial services regulatory structure in response to persistent problems in that sector. A single regulator, the Financial Services Agency (Japan-FSA), is responsible for supervising the entire financial services industry. Since its creation, Japan-FSA has overseen the mergers of several large banks and has reported progress in addressing the issue of nonperforming loans held by Japanese banks. In the review of Japan-FSA issued in 2003, however, IMF raised questions about the independence and enforcement powers of the agency.

According to FSA, principles-based regulation means, where possible, moving away from dictating industry behavior through detailed, prescriptive rules and supervisory actions describing how firms should operate their business. Instead, the FSA established 11 high-level principles that give firms the responsibility to decide how best to align their business objectives and processes with regulatory outcomes that have been specified.

Some Forum participants noted that in the United States, such principles or goals would work best if established for regulators rather than for the industry since rules provide a safe harbor effect that principles for industry behavior would not provide. Specifically, one participant noted that the litigious business environment in the United States makes specificity in rules essential so that firms know explicitly what behavior is acceptable in the market. Similarly, consumers and investors of financial products in the United States may feel most comfortable with an industry regulated by rules since they may provide greater assurance that violators will be prosecuted. Some participants said principles would be more appropriate in guiding prudential or safety and soundness regulation than they would be for consumer protection or conduct-of-business regulation. Another participant stated that principles-based regulation may provide some benefits, but benefits may not result in cost savings and must be considered carefully in relation to the U.S. financial regulatory system. In fact, most Forum participants stated that a move toward principles-based regulation in the United States would have a small or moderate impact on lowering regulatory costs. In addition, some participants cautioned against wholesale adoption of the FSA's model of principles-based regulation noting that the UK's regulatory system had not yet been tested by an economic downturn or the failure of a large institution at the time of the Forum. Finally, one Forum participant noted that the FSA's focus on regulatory outcomes would be a good practice to adopt in the United States.

According to CFTC officials, the agency currently uses a principles-based approach to supervising the futures industry. Under the Commodity Exchange Act (CEA), exchanges and clearing houses must adhere to a set of statutory "core principles." According to CFTC, the agency may set out acceptable practices that serve as safe-harbors for the industry's compliance with each principle. Conversely, the CEA allows for the industry and SROs to formulate their own acceptable practices and submit them to the CFTC for approval. CFTC officials noted that, with a few exceptions, there are no longer prescriptive regulations that dictate exclusive means of compliance; rather, exchanges have the choice of following CFTC-approved acceptable practices or adopting their own measures for complying with the overarching principle.

Clear, Consistent Regulatory Goals Are Important Steps to Improve Regulatory Effectiveness

In addition to suggesting options to modernize the federal financial regulatory structure, our prior work also has identified the importance of clear and consistent goals for financial regulation. Such goals would facilitate consideration of options to modernize the regulatory structure. In 1996, we identified the following four goals:[72]

1. Consolidated and comprehensive oversight, with coordinated regulation and supervision of individual components. The Basel Committee, for example, indicates in its core principles, that "an essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide."[73] Regulators would rely upon functional regulators for information and supervision of individual components, but remain responsible for ascertaining the safety and soundness of the consolidated organization as a whole.

2. Independence from undue political pressure, balanced by appropriate accountability and adequate congressional oversight. Effective regulatory oversight would recognize the need to guard against undue political influence by incorporating appropriate checks and balances.

3. Consistent rules, consistently applied for similar activities. Effective regulatory oversight would ensure that institutions conducting the same lines of business or offering equivalent products are generally subject to similar rules, standards, or guidelines for those lines of business or products.

4. Enhanced efficiency and reduced regulatory burden. By establishing consolidated, comprehensive, and coordinated oversight and applying consistent rules across similar activities, inefficiencies such as duplication of effort and regulatory burden caused by reporting similar data to multiple regulators, could be eliminated or reduced.

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

[73]Basel Committee on Banking Supervision, *Core Principles for Effective Bank Supervision*. (Basel, Switzerland, October 2006), 5.

A review of our work suggests three additional goals that would also be important to improve regulatory effectiveness:

1. Transparency in rule making. Transparency in rule making in an environment where multiple regulators bring multiple goals and perspectives would entail the maximum possible disclosure regarding the intended goals of proposed regulations, the basis for the selection of the regulatory approach, and planned evaluation of the implemented regulation. This would help reduce industry uncertainty about, and possible opposition to, proposed rules and their impact on the industry. Transparency also would help to ensure consistent expectations of regulators and the industry.[74]

2. Commitment to consumer and investor protection. Currently, consumer protection (including consumers as investors) is administered by a variety of agencies and can result in differential regulation and the inequitable treatment of firms competing in the same market. In addition, consumers can suffer if they receive different levels of protection when they purchase different products and services from different types of financial firms. Equal treatment and equal access to credit also are important objectives.[75]

3. Ensuring safety and soundness. Ensuring a safe and sound banking system and promoting financial system stability require a balance between the need for effective regulatory oversight and the possibility that too much oversight could hinder competition. Fulfilling this goal also requires developing a system that limits the extension of the federal safety net in order to encourage market as well as regulatory discipline.[76]

Other organizations have noted the importance of clearly specified regulatory goals for regulatory effectiveness. The Basel Committee on Banking Supervision developed 25 core principles for effective banking supervision that have been used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying a baseline level of sound supervisory practices. The core principles are a framework of

[74]See, GAO-07-791.

[75]GAO, *OCC Preemption Rulemaking: Opportunities Existed to Enhance the Consultative Efforts and Better Document the Rulemaking Process*, GAO-06-8 (Washington, D.C.: Oct. 17, 2005).

[76]See GAO-05-61.

minimum standards for sound supervisory practices and are considered universally applicable.[77] The first of the principles states that an effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

In August 2007, IMF issued a report regarding the findings of its consultation with the United States as part of its mission to review U.S. economic developments.[78] IMF concluded that while the U.S. economy continues to show remarkable dynamism and resilience, it faced important challenges, such as the need to maintain a robust financial system. IMF found that the current structure's multiple federal and state regulators overseeing the evolving financial market system may limit regulatory effectiveness and slow responses to pressing issues. Therefore, IMF suggested the United States increase the use of general principles or goals to guide financial regulation. According to IMF, general regulatory goals may ease interagency coordination and shorten reaction times to industry developments.

Treasury Has Announced Plans to Consider Regulatory Structure Modernization

The Secretary of the Treasury recently announced an action plan that will consider reforms to modernize the U.S. financial regulatory structure as part of a plan to maintain the global leadership of U.S. capital markets. According to Treasury's press release, the plan seeks a modern regulatory structure with improved oversight, increased efficiency, reduced overlap, and the ability to adapt to market participants' constantly changing strategies and tools.[79] Treasury officials noted they recognize that designing such a system is a long-term endeavor. They said, however, they

[77]The Basel Committee's core principles for effective banking supervision are conceived as a voluntary framework of minimum standards for sound supervisory practices; national authorities are free to put in place supplementary measures that they deem necessary to achieve effective supervision in their jurisdictions. In 2006, the Committee revised the core principles, in part, to enhance consistency between the core principles and the corresponding standards for securities and insurance. While the Committee recognized there may be legitimate reasons for differences in core principles within each sector, the changes recognized the importance of consistency across sectors.

[78]IMF undertakes missions, in most cases to member countries, as part of regular (usually annual) consultations under article IV of IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from IMF), as part of discussions of staff-monitored programs, and as part of other staff reviews of economic developments.

[79]Department of the Treasury, *Paulson Announces Next Steps to Bolster U.S. Markets' Global Competitiveness.* (Washington, D.C., June 27, 2007.)

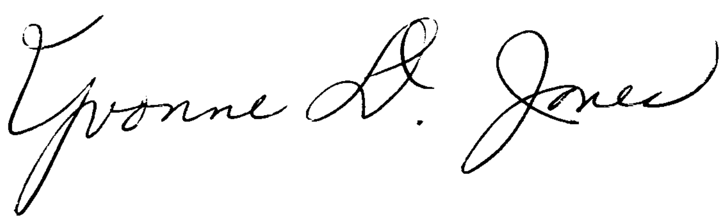
will seek to propose first steps that would begin the process. Treasury intends to publish the result of its study in early 2008.

Agency Comments and Our Evaluation

We provided the Secretary of the Treasury and the heads of CFTC, the Federal Reserve, FDIC, NCUA, OCC, OTS, and SEC with drafts of this report for their comment. We received written comments from the Chairman of the Board of Governors of the Federal Reserve System and the Chairman of NCUA who generally agreed with the thrust of our report; these are reprinted in appendixes II and III. In particular, the Federal Reserve concurred with GAO's emphasis on periodically reviewing the financial regulatory framework for potential modifications and the importance of continued federal oversight of financial services firms on a consolidated, group-wide basis. We also received technical comments from the staffs at the Treasury, the Federal Reserve, CFTC, FDIC, NCUA, OCC, OTS, and SEC that we have incorporated in the report.

We are sending copies of this report to other interested congressional committees and to the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Chairman of the Securities Exchange Commission, the Chairman of the Commodities and Futures Trading Commission, the Director of the Office of Thrift Supervision, and the Chairman of the National Credit Union Administration. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at (202) 512-8678 or jonesy@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors are acknowledged in appendix IV.



Yvonne Jones
Director, Financial Markets and Community Investment

Appendix I: Participants in the June 11, 2007, Comptroller General's Forum

Moderator	Title	Organization
David M. Walker	Comptroller General	U.S. Government Accountability Office
Participant		
Wayne Abernathy	Executive Director	American Bankers Association
Scott Albinson	Managing Director	J.P. Morgan Chase
Konrad Alt	Managing Director	Promontory Financial Group
John Bowman	Deputy Director and Chief Counsel	Office of Thrift Supervision
Richard Carnell	Associate Professor of Law	Fordham University School of Law
Gerald Corrigan	Managing Director	Goldman, Sachs & Co.
John Damgard	President	Futures Industry Association
Roger Ferguson	Chairman	Swiss Re America Holding Corporation
Peter Fisher	Chairman	BlackRock Asia
Jeffrey Gillespie	Deputy Chief Counsel	Office of the Comptroller of the Currency
Robert Glauber	Visiting Professor	Harvard Law School
Carrie Hunt	Sr. Counsel & Director, Regulatory Affairs	National Association of Federal Credit Unions
Marc Lackritz	President and CEO	Securities Industry & Financial Markets Association
Walter Lukken	Acting Chairman	Commodity Futures Trading Commission
Dave Marquis	Director, Examination & Insurance	National Credit Union Administration
Michael Menzies	Vice Chair	Independent Community Bankers of America
Art Murton	Director, Insurance and Research	Federal Deposit Insurance Corporation
Vincent Reinhart	Director, Division of Monetary Affairs	Board of Governors of the Federal Reserve System

Participant	Title	Organization
Thomas Russo	Vice Chair and Chief Legal Officer	Lehman Brothers
Mary Schapiro	Chairman and CEO	NASD
William Seidman	Chief Commentator	CNBC
Erik Sirri	Director, Market Regulation	Securities and Exchange Commission
Mike Stevens	Sr. Vice President, Regulatory Policy	Conference of State Bank Supervisors
Peter Wallison	Senior Fellow	American Enterprise Institute
Julie Williams	First Senior Deputy Comptroller & Chief Counsel	Office of the Comptroller of the Currency

Note: Organizational affiliation for identification purposes only.

Appendix II: Comments from the Chairman of the Board of Governors of the Federal Reserve System

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

BEN S. BERNANKE
CHAIRMAN

September 28, 2007

Mr. Richard J. Hillman
Managing Director
Financial Markets and Community Investment
Government Accountability Office
Washington, D.C. 20548

Dear Mr. Hillman:

The Federal Reserve appreciates the opportunity to comment on a draft of the GAO's report on the regulatory structure for financial services and trends in the financial services industry and (GAO-08-32). The report draws on several reports previously prepared by the GAO as well as the perspectives of participants in a forum hosted by the Comptroller General on June 11, 2007. This forum, in which the Federal Reserve was pleased to participate, included representatives of various financial services regulatory authorities, financial services organizations and others.

As your report notes, the current regulatory structure for financial services in the United States is somewhat complex. This is due in part to Congress' decision, which was reviewed and reaffirmed in the Gramm-Leach Bliley Act of 1999, to build on the well established, "functional" regulatory structures in place for the banking, securities and commodity sectors. This framework recognizes that the different financial services sectors are governed by differing statutory requirements, builds on the expertise of the relevant agency or agencies in each sector, and helps ensure that regulatory requirements and burdens remain tailored to the relevant sectors. Importantly, the current framework also provides for firms that control an insured depository institution to be subject to consolidated or "umbrella" supervision by a Federal agency.[1] As your report notes, the current regulatory framework has contributed to the development of U.S. financial markets and overall economic growth and stability.

We agree that it is useful to periodically review ways of enhancing this regulatory framework to determine if, in light of the ever-changing financial services marketplace, modifications would allow the system to achieve its fundamental goals more effectively, efficiently and consistently. Any potential changes should be carefully

[1] Your report also recognizes that the corporate owners of industrial loan companies (ILCs) currently are not subject to the same consolidated supervisory framework as bank holding companies and that, due to these differences, ILCs in a holding company structure may pose more risk to the deposit insurance fund.

Richard J. Hillman
Page 2

evaluated and consistent with the core public policy objectives of financial regulation and supervision.

As I have noted previously, these objectives in the broadest sense are financial stability, investor and consumer protection, and market integrity. On a slightly more granular level, achieving these objectives requires laws, regulations and coordinated actions to protect the safety and soundness of depository institutions that have access to the Federal safety net (deposit insurance and access to the Federal Reserve's discount window and payments systems); promote financial innovation, evolution and competition; limit the potential for explicit or implicit expansion of the Federal safety net; promote market discipline; and provide consumers of financial products and services appropriate protections.

Recent market events highlight the importance of financial stability, the critical role of the Federal Reserve in protecting against financial crisis and systemic risks, and the important synergies between the Federal Reserve's supervisory and financial stability responsibilities. The Federal Reserve's supervision and regulation of banking organizations provide the Federal Reserve with information, expertise and powers that are highly valuable in carrying out our responsibilities for deterring and managing financial crises, overseeing the payments system, acting as a liquidity provider through the discount window and conducting monetary policy.

We also agree that changes in the financial services marketplace make it even more important for firms that control an insured depository institution to be overseen by a Federal agency on a consolidated or group-wide basis. As your report notes, the Federal Reserve oversees a substantial share of the financial services industry in its role as consolidated supervisor for all bank holding companies (including financial holding companies formed under the Gramm-Leach-Bliley Act). As the GAO previously has recognized, the Federal Reserve has a well-developed, systematic and risk-focused program for the supervision of bank holding companies on a consolidated basis.

In its role as consolidated or "umbrella" supervisor for bank holding companies, the Federal Reserve collaborates extensively with other bank supervisors and functional regulators. We have worked hard to establish the requisite information sharing agreements and protocols that make systematic collaboration possible and rely, to the fullest extent possible, on the examination and other supervisory work conducted by the primary bank and functional supervisors of a bank holding company's subsidiaries in assessing the risks of the organization as a whole. Through these efforts, as well as through our participation in the Federal Financial Institutions Examination Council and the President's Working Group on Financial Markets, we seek to advance the important goals of providing consistent supervision to similarly situated organizations in a manner that promotes financial stability, market efficiency, consumer protection and the other goals of Federal supervision, while at the same time respecting the individual statutory

Richard J. Hillman
Page 3

missions and responsibilities of all involved agencies.[2] I'm pleased to note that we recently instituted a variety of changes to the Federal Reserve's Quality Management Framework for Reserve Banks to further enhance the consistency in our supervisory processes and products.[3] The Federal Reserve will continue to look for opportunities to enhance our supervisory program for banking organizations and to collaborate with other agencies and Congress to bring greater consistency to the supervision of organizations that control an insured depository institution.

Federal Reserve staff separately has provided GAO staff with technical and correcting comments on the draft report. We hope that these comments were helpful.

Sincerely,

cc: James M. McDermott, GAO

[2] The draft report notes one instance where a bank holding company informed the GAO that it initially had received conflicting views from the Federal Reserve and the Office of the Comptroller of the Currency ("OCC"), the primary supervisor of the holding company's lead bank subsidiary, concerning the adequacy of the organization's business continuity plans. However, in that case, the Federal Reserve and OCC worked cooperatively to develop a uniform view regarding this important aspect of the organization's risk management systems and controls. This consistent view was formally communicated in writing by both agencies to the organization, whose senior management concurred with these findings.

[3] See Revised Guidelines for Reserve Bank Quality Management Frameworks, AD Letter 07-23/CA Admin Letter 07-11 (Aug. 30, 2007).

Appendix III: Comments from the Chairman of the National Credit Union Administration

National Credit Union Administration

Office of the Chairman

September 25, 2007

United States Government Accountability Office
James McDermott
Assistant Director, Financial Markets
And Community Investment
Washington, D.C. 20548

Dear Mr. McDermott:

I am responding to your September 11, 2007 letter, which contained the U.S. Government Accountability Office's (GAO) draft report entitled Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure (GAO-08-32). We originally provided written comments to GAO in April 2007 prior to the Comptroller General's Forum held in June 2007 on this subject matter and also met with GAO staff on September 5, 2007.

We appreciate the opportunity to comment on industry trends given the current federal regulatory structure in the United States. We do not have any additional comments than those already provided both verbally and in writing to GAO.

If you have any additional questions, please contact me.

Sincerely,

JoAnn Johnson

JoAnn Johnson
Chairman

1775 Duke Street—Alexandria, VA 22314-3428—703-518-6300—703-518-6319-Fax

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Yvonne Jones (202) 512-8678 or jonesy@gao.gov

Staff Acknowledgments

In addition to the individual named above, James McDermott, Assistant Director; Emily Chalmers; Tiffani Humble; Clarette Kim; Robert E. Lee; and Marc Molino made key contributions to this report.

Related GAO Products

Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements. GAO-07-29. Washington, D.C.: November 30, 2006.

Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority. GAO-06-961T. Washington, D.C.: July 12, 2006.

Bank Secrecy Act: Opportunities Exist for FinCEN and the Banking Regulators to further Strengthen the Framework for Consistent BSA Oversight. GAO-06-386. Washington, D.C.: April 28, 2006.

Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies. GAO-06-361. Washington, D.C.: April 13, 2006.

Mutual Fund Industry: SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain. GAO-05-415. Washington, D.C.: August 17, 2005.

Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage. GAO-05-313. Washington, D.C.: April 20, 2005.

Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management. GAO-04-91. Washington, D.C.: October 27, 2003.

Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation. GAO-02-362. Washington, D.C.: May 3, 2002.

Large Bank Mergers: Fair Lending Review Could be Enhanced with Better Coordination. GAO/GGD-00-16, Washington, D.C.: November 3, 1999.

Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure. GAO/GGD-97-23. Washington, D.C.: November 20, 1996.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "E-mail Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, DC 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Susan Becker, Acting Manager, BeckerS@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

PRINTED ON RECYCLED PAPER