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GAO Proposes Framework for Assessing Proposals to Modernize the US Financial Regulatory System

In response to what it called the worst financial crisis in more than 75 years, the Government Accountability Office ("GAO") released a report, dated January 8, 2009, titled "Financial Regulation – A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System." Unlike other regulatory initiatives designed to address the recent credit crisis, and in light of the inevitable regulatory changes that will be adopted, the GAO's proposal represents a meta-framework that sets out many of the underlying causes for the crisis and identifies criteria to be used in evaluating any proposed regulatory change.

Indeed, changes are on the way. With the New York State Insurance Department's initial proposal on September 22, 2008 to regulate "covered" credit default swaps as insurance, at least three central clearing houses for the previously unregulated instruments have either been proposed or become operational. On January 15, 2009, the Group of 30, led by former Federal Reserve head Paul Volcker, presented its "Financial Reform: A Framework for Financial Stability," a proposal for regulation of the global banking system, hedge funds, derivatives and changes in accounting and international capital/liquidity standards. The Group of 30 is advocating a clearer distinction between commercial banks and their depositary activities, and those institutions engaging in riskier capital market activities. The proposal seeks to reduce systemic risk and increase regulatory oversight while eliminating redundancy and gaps in regulatory coverage on a global basis. In addition, Senator Susan Collins already has announced plans to reintroduce a bill which, for safety and soundness purposes, would subject investment bank holding companies to the supervisory purview of the Federal Reserve and require reporting requirements for credit default swaps, among other provisions. Tom Harkin, chairman of the Senate Agriculture Committee, is scheduled to introduce a bill that would require trading of all over-the-counter derivatives, including credit default swaps, to be done on regulated futures exchanges.

The GAO report is based on a review of prior GAO work and other studies, and meetings with regulators and industry representatives. In the report, the GAO concluded that the critical problem underlying the U.S. financial regulatory system arises from the fragmented, complex and overlapping regulatory structures, developed over a period of 150 years as a result of discrete responses by individual governmental authorities to perceived isolated market problems. The report identified almost a dozen federal banking, securities, futures and other regulatory agencies, including the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the National Credit Union Administration. In addition, it cited hundreds of state banking and insurance and other financial regulatory agencies.

The GAO then listed numerous problems in our regulatory system that either exacerbated or were highlighted by the crisis, including the inability of regulators and the existing regulatory system to: (i) mitigate the systemic risk posed by global financial conglomerates; (ii) address the increasingly significant activities of less-regulated entities such as non-bank lenders, hedge funds, credit rating agencies and special purpose investment vehicles; (iii) understand and regulate increasingly complex financial products such as retail mortgage and credit products, many of which are not subject to any regulatory requirements; (iv) ensure that accounting and audit standards have kept pace with developments in the financial markets and to work towards convergence of such standards on a global basis; and (v) coordinate with international regulators on a unified basis.

As a solution, the GAO offered a framework against which to evaluate any proposed revised regulatory system. The report set out those criteria that any regulatory system, in the view of the GAO, must meet, as follows:

- *Include clearly defined regulatory goals.* The GAO commented that a regulatory system should include an explicit statement that it is to ensure adequate consumer protections and the integrity and fairness of the markets, to monitor the safety and soundness of institutions and to provide for the stability of the overall financial system. The report stated that such a broad statement of intent should serve to focus future actions and clarify intended goals. This will be effective, of course, only with a proper grant of authority, as addressed below.
- *Be appropriately comprehensive*. The report noted that regulators need to identify which activities and products need to be regulated and how extensive the regulation needs to be. It is widely agreed that both unregulated participants, such as non-bank lenders, and unregulated instruments, such as credit default swaps, have contributed significantly to the current financial crisis and that any changes to the existing systems need to address these issues.
- *Have a systemwide focus*. The GAO concluded that any regulatory system needs to focus on risks to the financial system as a whole and not just risks to individual institutions. The report noted that during the current crisis, no one regulator held sufficient authority to examine, monitor or take action with respect to the systemic risks posed by recent events. Similarly, Treasury proposed last year in its "Blueprint for a Modernized Financial Regulatory Structure," that the Federal Reserve be granted additional authority to be allowed to establish a "market stability regulator" with sufficiently broad authority to take such action as necessary to maintain overall financial market stability after appropriately assessing systemic risks, both nationally and globally. Even absent such a market regulator, the GAO report suggested that individual regulators should take appropriate actions to monitor and reduce systemic risks.
- *Be flexible and adaptable*. Any regulatory system should allow regulators to adapt to market changes as they arise and include mechanisms for evaluating new market risks. One proposal cited by the GAO for consideration is a principles-based regulation, rather than a rules-based approach.
- *Be efficient and effective*. The report recommended eliminating unnecessary duplicative regulation and minimizing the regulatory burden on public resources. The GAO recognized that the determination as to what constitutes unnecessary overlap may be difficult, that our current fragmented system encourages regulatory arbitrage and has clearly resulted in regulatory failure. However, the report also noted that the existence of multiple regulators permits alternative approaches to regulation which may lead to innovation. The report concluded that, at a minimum, depository institution regulation should be simplified and the optional federal charter for insurance should be considered in order to harmonize state insurance regulation. The GAO warned, however, that these trade-offs need to be taken into account if consolidation is undertaken in the name of efficiency and advantages are lost.
- *Provide consistent consumer and investor protection*. In citing the failure of adequate consumer loan disclosure in the last few years, especially as housing prices declined, the GAO made a clear distinction between retail customers and more sophisticated consumers, such as institutional investors who may not require the same level of disclosure and regulatory protection as the first group. The GAO stressed that inadequacies in existing protections (such as with respect to suitability) must be addressed, coordination among fragmented regulatory systems should be required and consideration should be given as to whether certain instruments are too complex to be made generally available to retail consumers.
- *Provide regulators with independence from inappropriate influence, sufficient prominence and authority to carry out their mission and require accountability for meeting the stated goals*. The GAO

questioned whether an agency should be funded by the institutions it regulates and the effect of the method of funding on the decision-making process.

- *Provide consistent financial oversight*. The GAO noted that, although regulatory outcomes in the same situation should be consistent, regulators will not always be able to identify which institutions, products and activities present the same regulatory risk domestically and globally. In particular, the varying functional regulatory regimes based on the nature of the entity to be regulated makes it very difficult to provide consistent oversight of consolidated risk management strategies, especially on an international basis, and consolidation of such responsibilities is strongly recommended by the GAO. This issue was similarly raised in Treasury's Blueprint which proposed a rationalization of the existing system.
- *Minimize taxpayer exposure to financial risk in the event of institutional failure*. The GAO commented that while selected large financial institutions should be allowed to fail, public funds should be used in these instances to avoid unacceptable negative consequences from such failures. The GAO further noted, however, that any regulatory system must be able to identify the relevant problems before a decision is required whether to allow an institution to fail. The GAO concluded that the regulatory system should minimize the systemic risk arising from the interrelationship between firms that prevent the orderly unwinding of failed firms and that firms provided with a governmental guarantee should be subject to adequate supervision to assure they fulfill their responsibilities.

The report concluded that any transition to a regulatory regime satisfying the identified criteria must be as seamless as possible to avoid disrupting the functioning of the capital markets. There can be very little argument with principles set out by the report. Critically, however, the GAO does not and does not claim to demonstrate how to achieve the underlying goal of unifying or coordinating existing disparate regulatory systems.

Nevertheless, the GAO report has already elicited partisan criticisms. For example, unlike the Treasury's Blueprint, the GAO did not affirmatively recommend provisions for an optional federal charter for insurance companies. Rather, the report merely suggested that decision makers consider how to harmonize the roles of federal and state regulation. The insurance regulatory community has nevertheless contested the comments in the report noting the possibility of an optional federal charter. That proposal has been supported by the large insurers faced with oftentimes conflicting regimes in the various states but opposed by regional insurers, insurance trade associations and the National Association of Insurance Commissioners. Those parties quickly repeated their opposition to an optional federal charter, warning that unjustified changes might lead to deregulation and add additional complexity to the regulatory mix.

We will continue to monitor developments in this area.

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