MODERNIZING THE U.S. FINANCIAL REGULATORY SYSTEM

S. HRG. 111–42

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HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

THE GOVERNMENT ACCOUNTABILITY OFFICE'S FRAMEWORK FOR ASSESSING PROPOSALS TO MODERNIZE THE U.S. FINANCIAL REGULATORY SYSTEM AND THE GROUP OF 30's RECENT REPORT ON CREATING A FRAMEWORK FOR FINANCIAL STABILITY

FEBRUARY 4, 2009

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MODERNIZING THE U.S. FINANCIAL REGULATORY SYSTEM

WEDNESDAY, FEBRUARY 4, 2009

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The Committee met at 3:05 p.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DODD

Chairman Dodd. The Committee will come to order.

Let me thank all of my colleagues, and I think you all understood we intended, obviously, at some time earlier to have this hearing a little earlier. But as I think all of you may know, we had an interesting session on our side of the aisle, gathering today to listen to some of our new economic team under President Obama, as well as the President himself and others, talk about many of the issues that are confronting the country, not the least of which was the issue of the subject matter of this hearing, the modernization of the U.S. financial regulatory system. I am particularly honored and delighted to have Paul Volcker here with us, who has been a friend for many years, someone I have admired immensely for his contribution to our country.

How we will proceed is, because we are getting underway much later than normal for the conducting of Senate hearings, with the indulgence of my colleagues, I will make some opening comments myself, turn to Senator Shelby, and then we will go right to you, if we could, Chairman Volcker. Then I will invite my colleagues and tell them that any opening comments that they do not make for themselves, we will include them in the record as if given. And since there are not many of us here, we can move along pretty quickly, I hope, as well. So, with that understanding, we will get underway and, again, I thank all of you for joining us here today.

Today, we continue the Senate Banking Committee's examination of how to modernize our outdated financial regulatory system. We undertake this examination in the midst of a deepening recession and the worst financial crisis since the Great Depression in the 20th century. We must chart a course forward to restore confidence in our Nation's financial system upon which our economy relies.

Our mission is to craft a framework for 21st century financial regulation, informed by the lessons we have learned from the current crisis and designed to prevent the excesses that have wreaked havoc with homeowners and consumers, felled financial giants, and plunged our economy into a recession.

This will not be easy, as we all know. We must act deliberately and thoughtfully to get it right. We may have to act in phases given the current crisis. But inaction is not an option at all, and time is not neutral. We must move forcefully and aggressively to protect consumers, investors, and others within a revamped regulatory system.

Last Congress, this Banking Committee built a solid foundation upon which we will base our work today, and I want to once again thank Dick Shelby, former Chairman of this Committee, and my colleagues, both Democrats and Republicans, who played a very, very constructive role in the conduct of this Committee that allowed us to proceed as we did.

Subcommittees and Committees held 30 hearings to identify the causes and consequences of this crisis, from predatory lending and foreclosures, to the collapse of Bear Stearns, the role of the credit rating agencies, the risks of derivatives, the regulation of investment banks and the insurance industry, and the role and condition of banks and thrifts.

The lessons we have learned thus far have been rather clear, and let me share some of them with you.

Lesson number one: consumer protection matters. The current crisis started with brokers and lenders making subprime and exotic loans to borrowers unable to meet their terms. As a former bank regulator recently remarked to me, "Quite simply, consumers were cheated." Some lenders were so quick to make a buck and so certain they could pass the risk on to the next guy, they ignored all standards of prudent underwriting. The consumer was the canary in the coal mine, but no one seemed to notice.

Lesson number two: regulation is fundamental. Many of the predatory lenders were not regulated. No one was charged with minding the store. But soon the actions of these unregulated companies infected regulated institutions. Banks and their affiliates purchased loans made by mortgage brokers or the securities or derivatives backed by these loans, relying on credit ratings that turned out to be wildly optimistic. So we find that far from being the enemy of well-functioning markets, reasonable regulation is fundamental to sound and efficient markets, and necessary to restore the shaken confidence in our system at home and around the globe.

Lesson number three: regulators must be focused, aggressive, and energetic cops on the beat. Although banks and thrifts made fewer subprime and exotic loans than their unregulated competitors, they did so with impunity. Their regulators were so focused on banks' profitability, they failed to recognize that loans so clearly unsafe for consumers were also a threat to the banks' bottom line. If any single regulator recognized the abusiveness of these loans, no one was willing to stand up and say so. And with the Fed choosing not to use its authority to ban abusive home mortgages, which some of us have been calling for, for years, the regulators were asleep at the switch.

Lesson number four: risks must be understood in order to be managed. Complex instruments, collateralized debt obligations, credit default swaps designed to manage the risks of the fault loans that backed them turned out to magnify that risk. The proliferation of these products spread the risk of subprime and Alt-A loans like an aggressive cancer through the financial system. Institutions and regulators alike failed to appreciate the hidden threat of these opaque instruments, and the current system of regulators acting in discrete silos did not equip any single regulator with the tools to identify or address enterprise or systemwide risks. On top of that, CEOs had little incentive to ferret out risks to the long-term health of their companies because too often they were compensated for short-term profits.

I believe these lessons should form the foundation of our effort to shape a new, modernized, and, above all, transparent structure that recognizes consumer protection and the health of our financial system are inextricably linked. And so in our hearing today and those to come—and there will be many—I will be looking for answers to these questions. What structure best protects the consumer? What additional regulations are needed to protect consumers from abusive practices? We will explore whether to enhance the consumer protection mission of the prudential regulators or create a regulator whose sole job is protecting the American consumer.

How do we identify and supervise the institutions and products on which the health of our financial system depends? Financial products must be more transparent for consumers and institutional investors alike. But heightened supervision must not stifle innovation of financial actors and markets.

Third, how do we ensure that financial institution regulators are independent and effective? We cannot afford a system where regulators withhold bold and necessary action for fear that institutions will switch charters to avoid stricter supervision. We should consider whether a single prudential regulator is preferable to the alphabet soup of regulators that we have today.

Fourth, how should we regulate companies that pose a risk to our system as a whole? Here we must consider whether to empower a single agency to be the systemic risk regulator. If that agency is the Federal Reserve Board, we must be mindful of ensuring the independence and integrity of the Fed's monetary policy function. Some have expressed a concern—which I share, by the way—about overextending the Fed when they have not properly managed their existing authority, particularly in the area of protecting consumers.

Fifth, how should we ensure that corporate governance fosters more responsible risk taking by employees? We will seek to ensure that executives' incentives are better aligned with the long-term health of their companies, not simply short-term profits.

Of course, my colleagues and our witnesses today may suggest other areas. I do not mean to suggest this is the beginning and end-all of the questions that need to be asked, and I welcome today's witnesses' as well as our colleagues' contributions to this discussion and the questions that ought to be addressed.

I look forward to moving forward collaboratively in this historic endeavor to create an enduring regulatory framework that builds on the lessons of the past, restores confidence in our financial system, and recognizes that our markets and our economy will only be as strong as those who regulate them and the laws by which they abide. That is the responsibility of this Committee. It is the Republican of this Congress. It is the responsibility of the administration.

I will recognize Senator Shelby for an opening comment and ask my colleagues if they might withhold statements, at least at the outset, so we can get to our witnesses.

With that, I turn to Senator Shelby.

STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Today, the Committee will hear from one of this Nation's most respected economists and veteran policymakers. Dr. Volcker is no stranger to this Committee. Senator Dodd and I remember many years ago when he would come here as Chairman of the Federal Reserve Board. During the financial crisis in the late 1970s, it was Paul Volcker who helped put our economic house back in order, and, Dr. Volcker, I welcome you back to the Committee again.

While I am very interested in the views of our witnesses on regulatory modernization, I think the hearing could be a little bit premature. Let me explain.

As I have said many times and will continue to say, I believe that before we discuss how to modernize our regulatory structure, or even before we consider how to address the current financial crisis, we need to first understand its underlying causes. If we do not have a comprehensive understanding of what went wrong, we will not be able to determine with any degree of certainty whether our regulatory structure was sufficient and failed or was insufficient and must change.

I understand that next week Chairman Dodd plans to hold a hearing on the origins of the financial crisis, for which I commend him. I welcome that hearing, but I believe that one hearing, or even a handful of hearings, falls well short of what these exceptional times will demand. Instead, this Committee should, I believe, and must conduct a full and thorough investigation of the market practices, regulatory actions, and economic conditions that led to this crisis.

The Committee should hear testimony from all relevant parties and produce a written report of its findings. This work is crucial, I believe, if we are to develop policies that will help end this crisis and prevent it from occurring again.

While I understand many people have their own views of what happened, this Committee has yet to make that determination in a comprehensive and organized manner. As a result, nearly a year and a half later, we still have not documented what started the crisis and why it became so severe. The uncertainty about its origins has not only exacerbated our economic downturn by undermining confidence in our entire financial system, but it has left us without a clear understanding of what needs to be done. We need to remedy that. Thus far, the efforts of the Treasury Department and the Congress have been ad hoc at best.

When this all began, I strongly opposed the TARP bailout legislation because I believed Congress jumped right to a legislative solution without first identifying the problem it was trying to solve.

Since we never developed a consensus about what caused this crisis, neither Congress nor the Treasury Department can devise a targeted solution. And as a result, TARP has drifted rudderless since it was passed 4 months ago, wasting taxpayer dollars while the crisis rages on without an end in sight.

It is well past time that we investigate the origins of the financial crisis so that we can begin to lay the groundwork for a bipartisan, effective, and durable solution. In the absence of such effort, there is now talk of creating a commission to examine the origin of the financial crisis and to make recommendations for further action. At this time, I would oppose the creation of such a commission because a thorough investigation is something that this Committee can do and must do. The American people rightly expect their elects representatives, the Senators here, not unaccountable commissions to do the work necessary to solve the problems facing the country.

This Committee is uniquely positioned to conduct a transparent investigation that could build the necessary political consensus around the appropriate legislative remedy that we must seek. This particular Committee has a long history of conducting such investigations. The best precedent, I believe, for this type of investigation that our current economic situation demands is the year-long investigation of stock market abuses the Committee conducted during the Great Depression. The so-called Pecora hearings produced a detailed report exposing a wide range of abuses on Wall Street. The Committee heard testimony from hundreds of witnesses, producing nearly 12,000 pages of transcripts from over 100 hearings. The investigative staff was made up of dozens of individuals and included attorneys, accountants, and statisticians. They conducted scores of interviews and sworn depositions. The Committee subpoenaed corporate records and heard testimony from the heads of Wall Street and industry, including 3 days of testimony, I have been told, from Mr. Morgan himself. The Committee's investigative record comprises 171 boxes in the National Archives.

The record that the Pecora hearings established ultimately laid the groundwork for the passage of the Securities Act and the creation of the Securities and Exchange Commission. Recently, renowned economic historian Ron Chernow wrote an editorial in the New York Times calling for Congress to initiate an investigation in the tradition of the Pecora hearings. He stated the importance of such an investigation to resolving the current crisis by pointing out, and I will quote him:

> If history is any guide, legislators can perform a signal service by moving beyond the myriad details of the rescue plans to provide a coherent account of the origins of the current crisis. The moment calls for nothing less than a sweeping inquest into the twin housing and stock market crashes to create both the intellectual context and the political constituency for change.

I believe that he is correct.

The hearings this Committee has held to date on the credit crisis have been helpful, but I think they have lacked the focus and purpose displayed during the Pecora hearings, partly due to the Committee's lack of resources up to this time. To remedy this problem, Senator Dodd and I have already submitted an initial request for additional funding and office space for the Committee. We were recently informed that the Committee is going to receive additional funding, although not what is necessary, I believe, to conduct a thorough and fair investigation.

I am hoping that our colleagues on the Rules Committee would agree that this type of effort here in the Banking Committee right now is not only necessary but deserving of their support. I believe the investigation should start by calling before the Committee all of the regulators from the past decade or more who were appointed to make sure this crisis did not happen, but it did.

The Committee has heard from regulators on their views on how to solve the crisis, but it has yet to hear from present and former regulators on what caused the crisis and whether steps could have been taken to prevent it. The Committee, I believe, should supplement this testimony with an exhaustive review of the records of the regulators from that period. Once again, there will be a time to discuss what needs to be done, but before we entrust any new or existing regulator with additional responsibilities or authorities, I believe we need to know if and how our present regulatory structure failed us.

After we complete a thorough review of the role of the regulators, we should then call the CEOs of the largest banks, insurance companies, brokerage firms, home builders, realtors, and other financial services companies of the past 10 years to testify. This, of course, would be preceded by an extensive staff effort to examine the activities of each institution or industry.

Since the crisis began, the Committee has not yet heard from Wall Street CEOs on their role in creating the toxic assets that have spread through our financial system like a cancer. Nor have they publicly explained why their risk management systems failed or why they operated with such dangerous levels of leverage. Because many of these firms have either failed, received public money, or sought some type of Federal assistance, I believe they owe it to the American people to explain how this crisis started and what role they played in it.

Last year, I called for a hearing to examine the role of underwriters in spawning the crisis. The Committee announced that it would hold a hearing to examine underwriting practices, but it was postponed and is yet to be scheduled. That hearing could now be part of this effort.

Mr. Chairman, I am willing to work with you, as I have, and I believe this Committee is uniquely positioned, as you do, to perform this important service at this time for the American people. I pledge my full support should you choose to undertake your own version of the Pecora hearings, as long as they are comprehensive.

Chairman DODD. Well, I thank you, Senator, very, very much. I would just note for the record that there have already been some proposals, including one from Senator Isakson and Senator Conrad, for sort of a 9/11 Commission—some of my colleagues may be aware of this already—to be done outside of this Committee to go back and examine that, and that has, obviously, some appeal as well. Certainly we want to examine what happened, but also we need to go forward.

With that, I thank you very much, Chairman Volcker, for being with us, and for those are unfamiliar with our first witness, Chairman Volcker is the Chair of the President's Economic Recovery Advisory Board, Chairman of the Board of Trustees of the Group of 30, and former Chairman of the Board of Governors of the Federal Reserve System. Chairman Volcker worked in the Federal Government for almost 30 years, including positions at the Federal Reserve Bank of New York, the Treasury Department, and Chase Manhattan—he has a wealth of experience.

We thank you for coming and welcome you to the Committee.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, STEERING COMMITTEE OF THE GROUP OF 30

Mr. VOLCKER. Thank you, Mr. Chairman, Mr. Shelby, Members of the Committee. I am delighted to be here. I want to make clear that I am appearing as Chairman of the Steering Committee of the Group of 30 and not as Chairman of the President's Economic Recovery Advisory Board this morning.

Chairman DODD. It is so noted. We will make that distinction here.

Mr. VOLCKER. People accuse me of liking the title "Chairman," but I want to make sure Chairman of what.

[Laughter.]

Mr. VOLCKER. The Group of 30 is a group of people drawn from the private and public sectors with experience in finance, and I emphasize that it is international, and this report was directed not just toward the United States, although it is perhaps most relevant to the United States. But it is directed toward authorities in any country that has extensive financial operations around the world.

It does not discuss all the origins of the crisis. It does touch upon it, but that is not my purpose in appearing before you this morning. What is evident is, whatever the cause is—and we could go into that. What is evident is that we do meet at a time, as you have emphasized, of acute distress in financial markets. Strongly adverse effects on the economy more broadly are apparent. There is a clear need, I think, for early and effective governmental programs. They cannot wait a year for attacking the immediate problems to support economic activity and to ease the flow of credit. But I think it is also evident that more fundamental changes are needed in the financial system, and they will take some time to work out.

But to the extent that we have some sense of the direction of those reform efforts, I think it will help the more immediate problem. The important thing is that we do not and should not want to contemplate a repetition of this experience, and that is what this report is aimed at, and I am sure will be your concerns over time.

I understand that President Obama and his people are going to be placing before you some more immediate measures. They are not the subject of our report. But when we look further ahead, I do think the more we have a sense of the longer-term future, the better place you will be for appraising the immediate actions to make sure they are consistent with what we would like to see in the longer run.

The basic thrust of the G–30 report is to distinguish among the basic functions of any financial system. First, there is a need for strong and stable institutions that serve the needs of individuals, of businesses, of governments, and others for a safe and sound repository of funds, providing a reliable source of credit, and maintaining a robust financial infrastructure able to withstand and diffuse shocks and volatility that are inevitable in the future. I think of that as the service-oriented part of the financial system. It deals primarily with customer relationships. It is characterized mainly by commercial banks that have long been supported and protected by deposit insurance, by access to the Federal Reserve credit, and by other elements of the so-called Federal safety net.

Now, what has become apparent during this period of crisis is increasing concentration in banking and the importance of official support for what is known as systemically important institutions when they become at risk of failure. What is apparent is that a sudden breakdown or discontinuity in the functioning of those institutions risks widespread repercussions on markets, on closely interconnected financial institutions, and at the end of the day, on the broader economy.

The design of any financial system raises large questions about the appropriate criteria for, and the ways and means of, providing official support for these systemically important institutions.

In common ground with virtually all official and private analysts, the G–30 Report calls for "particularly close regulation and supervision, meeting high and common international standards" for such institutions deemed systemically critical. It also explicitly calls for restrictions on "proprietary activities that present particularly high risks and serious conflicts of interest" deemed inconsistent with the primary responsibilities, I would say the primary fiduciary responsibilities, of those institutions to its customers. Of relevance in the light of recent efforts of some commercial enterprises to recast financial affiliates as bank holding companies, the report strongly urges continuing past U.S. practice of prohibiting ownership or control of Government-insured, deposit-taking institutions by non-financial firms.

Second, the report implicitly assumes that while regulated banking institutions will be dominant providers of financial services, a variety of capital market institutions will remain active. Organized markets and private pools of capital will be engaging in trading, transformation of credit instruments, and developing derivatives and hedging strategies. They will take place in other innovative activities, potentially adding to market efficiency and flexibility.

Now, these institutions do not directly serve the general public; individually, they are less likely to be of systemic significance. Nonetheless, experience strongly points to the need for greater transparency. Specifically beyond some minimum size, registration of hedge and equity funds should be required, and if substantial use of borrowed funds takes place, an appropriate regulator should be able to require periodic reporting and appropriate disclosure.

Furthermore, in those exceptional cases when size, leverage, or other characteristics pose potential systemic concerns, the regulator should be able to establish appropriate standards for capital, liquidity, and risk management.

Now, the report does not deal with important and sensitive questions of the appropriate administrative arrangements for the regulatory and supervisory functions, which agency will supervise which institutions. These are in any case likely to be influenced by particular national traditions and concerns. What is emphasized is that the quality and effectiveness of prudential regulation and supervision must be improved. Insulation from political and private special interests is a key, along with adequate and highly competent staffing. That implies adequate funding.

The precise role and extent of the central bank with respect to regulation and supervision is not defined in the report. It is likely to vary country by country. There is, however, a strong consensus that central banks should accept a continuing role in promoting and maintaining financial stability, not just in times of crisis, but in anticipating and dealing with points of vulnerability and risk.

The report also deals with many more specific issues cutting across all institutions and financial markets. These include institutional and regulatory standards for governance and risk management, an appropriate accounting framework (including common international standards), reform of credit rating agencies, and appropriate disclosure and transparency standards for derivatives and securitized credits. Specifically, the report calls for ending the hybrid private/public nature of the two very large Government-sponsored mortgage enterprises in the United States. Under the pressure of financial crisis, they have not been able to serve either their public purposes or their private stockholders successfully. To the extent that the Government wishes to provide support for the residential mortgage market, it should do so by means of clearly designated Government agencies.

Finally, I want to emphasize that success in the reform effort, in the context of global markets and global institutions, will require consistency in approach among countries participating significantly in international markets. There are established fora for working toward such coordination. I also trust that the forthcoming G–20 meeting, bringing together leaders of so many relevant nations, can provide impetus for thoughtful and lasting reform.

Thank you, Mr. Chairman. I am delighted to have any comments or questions.

Chairman DODD. Well, thank you very much, Mr. Chairman as well. And what I am going to do is ask the clerk here to put the clock on at 8 minutes, and we will try to adhere to that so we can get around to everybody, since we have not had opening statements be made. And I will begin, then turn to Senator Shelby.

Let me, if I can, begin with a couple of—sort of a broad question, if I can. The GAO report states—and I am quoting it here. It says, “Mechanisms should be included for identifying, monitoring, and managing risks to the financial system, regardless of the source of the risk.”

What was the source of the risk in the current crisis, in your view?

Mr. VOLCKER. Well, that is a complicated question that goes to some of Senator Shelby’s concerns about what caused the crisis. If I were analyzing this crisis in a substantial way, you have to go back to the imbalances in the economy, not just in financial markets. But as you know, the United States has been consuming more than it has been producing for some years, and its savings have practically disappeared, and that was made possible by, among other things, a very fluid flow of savings from abroad, low interest rates—very easy market conditions, low interest rates, which in turn incited the great world of financial engineering to develop all kinds of complex instruments to afford a financing for businesses, and particularly in this case for individuals, homebuyers, that went on to exceed basically their capacity to pay. And it was all held up by rising house prices for a while, as you know, and everybody felt better when the house prices were rising, but that could not happen forever. And when house prices stopped rising, the basic fragility in that system was exposed.

So you had an underlying economic problem, but on top of that, you had a very fragile, as it turned, highly engineered financial system that collapsed under the pressure. I think of it as we built up kind of a Potemkin Village with very fancy structures, but they were not very solid.

Chairman DODD. Let me draw upon your experience as the Chairman of the Federal Reserve System, and you correct me if my facts are wrong about this thing. But as I understand it, there are about 1,800 economists that work for the various Federal Reserve banks across the country.

Mr. VOLCKER. How many?

Chairman DODD. I am told about 1,800. I do not know if that is true or not, but someone mentioned that number to me. But a very high number, whether it is 1,800 or not, but a significant number of people who do research all the time in the various banks. Can someone explain to me why there was not someone sounding the alarms out of the Federal Reserve System as people who monitor and watch what is happening economically that would have sent a signal to us back in the days of, I think, in 2005 or 2006 even, that this was a problem emerging in a glaring way? Why didn't we hear?

Mr. VOLCKER. Well, I have to say I do not think economists are very good at this kind of analysis. In a macro world, I am sorry to say that, but I am not sure there has been much improvement over the years. But I think if there are 1,800 economists, I am sure some of them were concerned and did in their own way raise some questions.

But, you know, when things are going well—this is the bane of regulation. When things are going well, nobody wants to hear about regulation and restraints.

Senator SHELBY. Absolutely right.

Mr. VOLCKER. And so it is very hard to have your voice heard. When things are going poorly, everybody wants to regulate everything. And somehow we have to find a balance between too little and too much.

This was an extreme case, but it is not unusual for imbalances to go along for a while without anybody really wanting to stand up and take strong action.

Chairman DODD. Well, I would love to at some point further pursue the discussion about the Federal Reserve System and how it is working.

Let me ask you, if I can as well, about the consumer protection issue. Your report describes the need to establish standards for capital liquidity and risk management for financial institutions.

But do you also believe that strong consumer protections play an integral part in financial stability? I am sure you do, by the way. And if so, what regulatory structure would best protect consumers? A separate consumer protection agency, as has been suggested by some? Elizabeth Warren, who will be before us tomorrow, has made a recommendation along those lines. Distinct consumer protection missions of the prudential regulator? Which of those two options do you find——

Mr. VOLCKER. Well, let me say, first of all, our report does not deal with that question.

Chairman DODD. You do not. I realize that.

Mr. VOLCKER. Quite deliberately. But there is—obviously, this administrative question you raise is relevant. We were dealing with what we think of as safety and soundness of the system. We were not dealing with protection of consumers, protection of investors, business practices—which are related but a different function. And one of the questions—which we did not deal with, but I think the Congress has to deal with it and the administration has to deal with it—do you adopt a separate agency and a separate administrative structure for what I will call "business practices," including consumer protection, separate from the prudential regulator—which is a development which is true in some countries now, and it is along the lines that Secretary Paulson proposed in his thinking about the long run.

I think that is a serious issue. I do not want to express an opinion now, but I have certain sympathy for exploring it, at least, personally.

Chairman DODD. Well, I would welcome that as you give it more thought.

Last, let me address the issue of systemic risk regulation again. And I realize I am not specifically referring to the report in some cases. I am drawing upon your knowledge and expertise in these areas.

The G–30 report describes one of the lessons from the current crisis as follows, and let me quote it. It says:

> Unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise and its ability to meet its responsibilities to its clients, counterparties, and investors.

Three questions: Should we allow financial institutions to become large and systemically significant? Should there be a single systemic risk regulator or should that substantial be shared among different agencies? Should the systemic risk responsibility be given to the Federal Reserve, in your view? And are you concerned that it would also be a burden on the Federal Reserve with numerous divergent tasks which you and I have discussed? And I will not elaborate here. You know the point I am trying to make. And, third, are you concerned that extensive involvement by the Fed in so many aspects of day-to-day operations of the economy and the financial system might jeopardize its independence?

Mr. VOLCKER. Again, these are questions we did not deal with in the report. We dealt with the structural question that we felt these basic, systemically important institutions and banking institutions that are protected by the Government and are dealing in a fiduciary way with customers should not engage in the kind of activities that you read from the report, these highly risky proprietary activities, because it undermines potentially their basic function.

When it gets to who regulates it, it is just simply not in the report. But I tell you, the kind of considerations that you raise for the Federal Reserve, or without the Federal Reserve, I think are very relevant to that decision. You will have a different Federal Reserve if the Federal Reserve is going to do the main regulation or all the regulation from the prudential standpoint. And you have to consider whether that is a wise thing to do given their primary—what is considered now their primary responsibilities for monetary policy.

They obviously have important regulatory functions now, and maybe those functions have not been pursued with sufficient avidity all the time. But if you are going to give them the whole responsibility, for which there are arguments, I do think you have to consider whether that is consistent with the degree of independence that they have and focus on monetary policy.

Chairman DODD. I hope I am not over-reading you there. I hear that tone suggesting that that kind of a super-regulatory function would, I think, put into question the very issues that are raised by it. A systemic risk regulator might have less of a problem, in your view.

Mr. VOLCKER. That is true. Then you have to consider how the systemic risk regulator matches up with the other prudential regulators. There are very interesting questions here.

The G–30 issued a report, a rather detailed report, a year or so ago or 9 months ago, on different regulatory practices around the world, which raised the questions that you are raising, and almost all countries are struggling with these questions now.

Chairman DODD. I thank you.

Senator Shelby.

Senator SHELBY. I want to pick up, Chairman Volcker, on some of the area that Senator Dodd is getting into. I think it is very important.

Do you have any concerns, Dr. Volcker, that if the Fed assumes too many responsibilities, its ability to conduct monetary policy could be undermined?

Mr. VOLCKER. Yes.

Senator SHELBY. And what are your views on the separation of monetary policy from banking policy along the lines of the reforms that were enacted in the United Kingdom in the late 1990s that gave banking regulation to the FSA and monetary policy to the Bank of England?

Mr. VOLCKER. Well, that is an interesting experience. That was rather widely acclaimed, and other countries attempted to or did follow that pattern. But then when they had a crisis, they found out it did not work so well.

Senator SHELBY. It did not work.

Mr. VOLCKER. And whether that was some idiosyncratic reasons in the U.K. or whether it is a more general reason, I do not know. But the underlying problem——

Senator SHELBY. Why didn't it work, if you could——

Mr. VOLCKER. Well, I——

Senator SHELBY. I know it did not work.

Mr. VOLCKER. It seemed to be a lack of coordination between three agencies involved—the U.K. Treasury, the Bank of England, and the FSA, the regulatory agency—even though they had overlapping personnel to some extent. But it seems clear that coordination was not close enough.

But I would make one point in connection with your observation. Supervision regulation has implications for the performance of the financial system and the economy, and it can work in support of monetary policy or it can work contrary to monetary policy. And that is one reason for giving the Federal Reserve responsibility for both.

Senator SHELBY. Dr. Volcker, as you keep up with all this, and as a former Chairman of the Federal Reserve, you know the Fed has had a dramatic expansion of its liquidity facilities over the past year, and it has raised concerns that the Fed has moved out of the realm of monetary policy and into the realm of fiscal policy.

The Group of 30 Report, as I understand it, recommends that central bank liquidity support operations should not involve lending against or outright purchases of high-risk assets. Instead, your report, as I understand it, recommends that those forms of support should be handled by directly accountable Government entities.

In your view, what role should be given to the President or the Treasury Secretary in approving Government bailouts or other support for institutions that will likely involve taxpayer dollars?

Mr. VOLCKER. Well, in cases where they do involve risk and the use of taxpayers' dollars, we are pretty clear that the administration, particularly the Treasury, ought to be involved in that decision, and the Federal Reserve should not undertake those kinds of actions, if they do it at all, without the concurrence of the administration.

Senator SHELBY. Is this in the line under our constitutional system that it would be inappropriate for unelected central bankers to determine whether a company or industry receives a taxpayer-funded bailout? Shouldn't those decisions be made by the President and the Congress, who are accountable to the people? Is that——

Mr. VOLCKER. Well, Congress can provide a framework for making those decisions, but I think they do involve political questions that the President and the administration should be involved in. I think just to clarify, my own understanding from outside is when the Federal Reserve has done this recently, they have worked closely with the Treasury. They have not gone off on their own and undertaken these measures.

Senator SHELBY. It seems like a new role for the Fed than when you were Chairman.

Mr. VOLCKER. Yes, it is a non-traditional role.

Senator SHELBY. Non-traditional role. You are very——

Mr. VOLCKER. The report takes a traditional view of the functions of the Federal Reserve.

Senator SHELBY. Dr. Volcker, recently Stanford economist and, somebody you know, a former Under Secretary of the Treasury, John Taylor, argued that excessively loose monetary policy during the first part of this decade caused the financial crisis.

Mr. VOLCKER. Well, I do not think I am going to get into that question this afternoon. I do think that conditions in financial markets which were related to the large balance of payments deficit, large current account deficit, and the free flow of money from abroad laid the groundwork for many of the excesses in the market.

Senator SHELBY. Now, this is in your report, as I understand it. One of the key recommendations of the G–30 Report is creating a failure resolution regime that imposes discipline—that is, actual losses—not only on managers and shareholders but also on sophisticated creditors.

I believe one of the primary failings of the recent bailouts of the GSEs, AIG, and Bear Stearns was the intent of protecting any creditors from losses.

Dr. Volcker, in terms of who qualifies as a "sophisticated creditor," do you believe that both financial institutions such as investment banks and foreign central banks would count as sophisticated creditors? Or should?

Mr. VOLCKER. Well, they individually are sophisticated, yes. Whether they need to be protected in some particular occasions is another question.

Senator SHELBY. Given that the large creditors of the GSEs, AIG, and Bear had no legal claim to being bailed out—which they did not—what specific mechanisms would you suggest that we think up here to put in place to assure that such sophisticated creditors take losses in the future, which helps bring discipline to the market?

Mr. VOLCKER. The premise of your question included the GSEs?

Senator SHELBY. Yes.

Mr. VOLCKER. Well, the GSEs, I think, if I may say so, with the connivance of the Congress, were considered to be something special and they would be protected. And there was a general understanding, rightly or wrongly, while officially they did not have the full legal requirement of a guarantee, through the years——

Senator SHELBY. But they had the implicit guarantee, didn't they?

Mr. VOLCKER. Pardon me?

Senator SHELBY. The implicit guarantee.

Mr. VOLCKER. Yes, they had an implicit guarantee and that was——

Senator SHELBY. Was that because they were hybrid——

Mr. VOLCKER.——I think, generally understood.

Senator SHELBY.——you know, stock owned and Government sponsored?

Mr. VOLCKER. We are very clear on one recommendation in this report. We should not have that kind of hybrid institution anymore.

Senator SHELBY. I totally agree with you.

Mr. VOLCKER. You know, you cannot change it overnight, but I think as we design a new financial system, we ought to avoid that kind of compromise that is going to get you in trouble.

That does not mean that Congress or the Government cannot support the mortgage market if they want to.

Senator SHELBY. Right.

Mr. VOLCKER. But they ought to do it directly.

Senator SHELBY. Yes, sir. Thank you.

Thank you, Chairman Dodd.

Chairman DODD. Thank you very much.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

Dr. Volcker, I have got three questions, and I think they follow up on both the Chairman's and Senator Shelby's approach. It seems from the report a clear understanding that there needs to be some level of regulation of some of these institutions that fell between the cracks. Yet it seems that even though major money center banks that clearly were regulated followed the market to start putting out these same kind of complex new instruments, your term of "over the top financial engineering."

I guess on a going-forward basis, as we move forward to some new structure, even with regulation and transparency, is that going to be enough or should there be some point of an evaluation, almost a societal value evaluation, of some of these instruments, whether the extra ability to price that risk down to the last decimal point is worth all of the side risks that we have seen taking place by some of these instruments?

Mr. VOLCKER. Well, we do a lot of talking about the importance of risk management and so forth, but, in essence, the conclusion that we have is that some of these innovations and some of these very risky activities are almost inevitably going to get ahead of the regulators, and these basic institutions—the big commercial banks, in particular—are of systemic importance, therefore should not get involved in those activities. They are too risky, and I think it is clearly demonstrable they involve conflicts of interest that add to the uncertainty and risk.

Senator WARNER. So you would see some system whereby there might be bright-line prohibitions——

Mr. VOLCKER. Yes, I see—we suggest some bright-line prohibitions for hedge funds and equity funds, and you asked me about proprietary trading—you did ask me about proprietary trading. I think these big financial institutions probably have to have some capacity, do need some capacity for trading. But if they have very aggressive trading in very large amounts, where it is not quite such a bright line, you probably need special attention, and we suggest special attention via special capital requirements if they are going to engage in those activities.

Senator WARNER. And as you said, sometimes these instruments get ahead of the regulators, and how do you——

Mr. VOLCKER. No question about that.

Senator WARNER. You do not want to stifle innovation, but it seems to me that some of these instruments recently were more about fee generation than they were about appropriately pricing risk?

Mr. VOLCKER. Well, I think that is true, but there is plenty of room for innovation outside of the basic banking system, and that is a distinction we make. All kinds of sophisticated capital market techniques, a derivative explosion which may have gone too far, but the whole idea of securitization could be developed outside the banking system. To the extent it is inside the banking system, we say, well, the bank should hold onto what they securitize. That is a traditional function. But outside, they can engage in all kinds of trading and——

Senator WARNER. But wouldn't you say some of these outside functions now need to have some kind of regulatory——

Mr. VOLCKER. Yes, well, I guess we are trying to say we want to go relatively lightly, if they are relatively small institutions without systemic significance. But if they get big enough—and some of the hedge funds have, and we had the experience of Long Term Capital Management in the past where, rightly or wrongly, people thought it had systemic implications. Then you have to think about leverage requirements and capital requirements and liquidity requirements.

I myself think that would just be a handful of those institutions, and most of them—we do call for reporting and registration, but I do not think they would take heavy regulation.

Senator WARNER. Well, let me follow up on Chairman Dodd's question as well, one of the points he raised. A lot of your focus is on systemic risk. We have heard the comment a lot in the popular press, you know, certainly these institutions are "too big to fail." On a going-forward basis to try to alleviate that systemic risk, should there be some examination of sizing of some of these institutions?

Mr. VOLCKER. Yes, well, we make a fleeting reference to that actually in the report. There is now more concentration than you ever had in the United States. The degree of concentration is not as great as many foreign countries have, but it is very large from our history. And I think that is a question you want to ponder. It has got political, obviously, as well as economic circumstances, whether there is such a thing as not only "too big to fail," "too big to exist."

Senator WARNER. Right.

Mr. VOLCKER. And it has got—we certainly have seen how difficult it is to manage these institutions given the variety of functions they have been performing. Now, we suggest that their functions be simplified. That would be easier to manage. But, still, there is in present law, as you know, a limit on deposit-taking. I think it is 10 percent. You cannot go beyond 10 percent. Back when I was Chairman, we once suggested 5 percent, which some people thought was too big. Now it is 10 percent.

You know, it raises a question at some point. When is enough enough?

Senator WARNER. Right.

Mr. VOLCKER. And I think you ought to look at it.

Senator WARNER. One last question. Over the last decade, as somebody who spent some time in the financial markets, there has always been the argument, oftentimes from our friends in the U.K., you know, to come over to their markets. Wall Street was complaining that if there was additional regulation, we would see a flight of all these firms abroad, development of new money centers all around the world with not as stringent a regulatory structure.

In light of this complete worldwide collapse, do you think there will be an ability to come up with some strong international standards? Or are we going to be able to patch this over and still have a few 2-years later, 5-years later, a rush to the bottom as firms try to go around the world to find the least regulatory——

Mr. VOLCKER. I think we have had a real wake-up call, here and elsewhere, in Europe, Japan, China. And this wake-up call I hope is strong enough so that we will emerge from this with consistency and the basic regulatory and supervisory framework. If it does not, I would still do what we think is appropriate here and let them go if they want to be in——

Senator WARNER. Even if we have a regulated system, you could make the argument that might be the safer system.

Mr. VOLCKER. Yes, and I think in the long run—suppose we now had a strong regulatory system, and it was Europe and Japan and elsewhere that was in worse shape. All the money would be flowing into us because it was the strongest system.

Now, unfortunately, that is not the case right now. But it should be the case. What should be the case is we have a high degree of uniformity. And I do not think that is impossible. You already have that pretty much in the capital area. Now, that is just one area. You have got a lot of other areas—the hedge fund regulation, rating agency regulation, accounting is one place where I am sure—I have a special background here, but I think we should have uniform accounting around the world.

Senator WARNER. If I just follow where you are headed, you would actually say a strong regulatory system with appropriate oversight in this country would not be counterproductive to the continued growth of capital markets in the United States. It might still be a long-term benefit to our country.

Mr. VOLCKER. Yes. That does not mean you want unproductive regulation. Good regulation we ought to have, regardless of what the rest of the world does.

Senator WARNER. All right. Thank you, sir.

Chairman DODD. Thank you very much, Senator. I asked someone once, "Why do you think it is that the world comes here?"—talking about, obviously, not the present day, but a little time ago. "Why does the world come here and bring its wealth?" The answer I was given, two reasons: one, we are very good at making money, and as importantly or more importantly, it was a safe place to be. You might make a bad bet, but you were not going to lose your money because the system was corrupt or did not work. And I think that is the point that Senator Warner is making, and I think if you have a strong, sensible, balanced regulatory system, the world could also follow us. They may not join us, but they will move in that direction.

Mr. VOLCKER. I have hopes that, given what has happened, you will get some uniformity. You know, the argument always was we will lose all this business to London. Well, London has got the problem at least as much as we have, and I think that is generally recognized at this point.

Chairman DODD. Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman.

In reference to your last comment, I will offer an observation, and that is that the financial crisis is bad enough; where I do think there is a good chance of uniformity, just as you suggest, I think over time it is hard to sustain that. Why? Just simply because one country is going to look at this and, you know, when things stabilize—and hopefully they will stabilize—that country is going to say, you know, we could get more banking business here if we tweaked this a little bit and tweaked that a little bit. So you almost need to think about what mechanism you have in place to deal with that economic phenomenon. Countries want business, and they are going to do things. Sometimes over time we see it is bad judgment, but I would just offer that observation.

A couple more observations, and then I would like to ask you a question. It seems to me—and this is so complicated. It is hard to say there are a couple of reasons for what is going on, but it seems to me that there are two really, really important things that really have led in a substantial way to this financial crisis.

Number one is whatever mechanism was in place to evaluate risk accurately just failed. Highly compensated, enormously bright people being advised by the best in the business simply lost their way when it came to evaluating risk.

The second thing was that, for whatever reason, as regulatory agencies or departments tried to get a handle on this, it was very difficult for them or they dropped the ball, or whatever, in terms of themselves blowing the whistle on unreasonable risk being taken.

Those two things strike me as really fundamental to what we are dealing with here. If you agree with that statement, I would really be interested, Dr. Volcker, in your educating us on how your recommendations would deal with that, number one, the failure to accurately evaluate risk and, number two, the failure, for whatever reason, to blow the whistle on that risk.

Mr. VOLCKER. Well, we have got a lot of rhetoric in this report about the importance of risk management and trying to deal with the problem you have and the failures of risk management in our leading financial institutions—partly, and importantly, because the complexity became so great that we lost sight of how to measure the risk.

Now, I have got a point of view on this, but the markets were taken over by financial engineers. They were mathematicians. They were not market people. They somehow thought that financial markets would follow the laws of physics or some natural law and everybody had a nice, normal distribution curve. And they kept being surprised by outlying events. Well, they seemed outlying if you thought of the world of a normal distribution curve, but that is not the world of finance that I know. Financial markets are affected today by what happened yesterday, and what is happening right now affects thinking and affects what happens tomorrow. So you get people going to extremes in both directions. And these financial engineers kind of thought that they had the answer to how to measure risk and take care of it.

Things were very complex. When you mixed together these enormous compensation practices, the enormous gains possible, with obscure financial engineering, you had a recipe for extremes, I think, that kind of came back to haunt us.

Senator JOHANNS. If I might just——

Mr. VOLCKER. That will be addressed by what is happening, but so much of the best talent in the United States is going off into financial markets. I wish more of it would go building bridges instead of financial markets.

Senator JOHANNS. If I might just offer another observation, and your thoughts on compensation, I think, really warrant this Committee kind of digging deep on that issue. But there is another piece to it, too. There was a point in time where someone was compensated based upon the quality of the loan that they wrote. You know, when I bought my first house, you didn't get that loan unless you had a reasonable chance of continued employment, you had 20 percent down in the bank, *et cetera*. However, the compensation structure turned to how many loans you could write and bundle and then sell, and like I said, nobody was figuring out how to evaluate the risk, or if they did, they threw all the rules out the window.

Mr. VOLCKER. Well, I think that is a good example. In the old days, you had a customer. You evaluated his ability to pay, the value of the house, and so forth. But then they came along and said, well, look. If we put 80,000 of these loans together, our statistical analysis says 85 percent of them will be OK and the result was you put poorer and poorer loans in the package. It turned out that 85 percent were no longer good, and that is where we are.

Senator JOHANNS. And the frustrating thing about that, and I will wrap this up, for the average citizen out there is that 15 percent now has been labeled toxic assets and somehow the taxpayer feels like they are being imposed upon to own that risk today and they are saying, "why me?"

Mr. VOLCKER. I don't know how you want me to respond to that——

Senator JOHANNS. You don't have to respond, Doctor. You are——

Mr. VOLCKER. There comes a time when you have to support these institutions in the interest of the greater good and the stability of the markets. But one of the difficulties in this whole business is very much commented on today, is how you price those assets when the taxpayer takes them over.

It is possible you could think of a scenario where if the taxpayer has to take them over and the markets are stabilized, the taxpayer may actually make money. But you certainly don't want to go into it with the taxpayer unnecessarily losing a lot of money. But it is a very—this is all complex enough so it is very hard to unscramble all this stuff.

Senator JOHANNS. Thank you very much.

Chairman DODD. Thank you, Senator. Very good questions.

Senator Reed?

Senator REED. Thank you, Mr. Chairman, and thank you, Chairman Volcker, for not only your testimony, but for your service on this G–30 Commission as well as so many other commissions.

We have been confronted with a long to-do list by the G–30 report, but our capacity is limited. I wonder, could you focus on what you consider to be the top two or three systemic risks that should be dealt with immediately? A sense of priority, I think, would help—I will speak for myself—would help.

Mr. VOLCKER. Well, when you say immediately——

Senator REED. Well, immediately in the——

Mr. VOLCKER. First of all, we are going to have—I am not sure this is what you meant in asking the question—it is going to cost more money to deal with this financial crisis. There shouldn't be any mistake in your mind about that, that this has deteriorated to the point where it is going to take Government support in the interest of overall economic stability and recovery, and it is going to be lots more billions of dollars. I don't know how many. But that is necessarily a priority, which I hope and believe the administration will face you with shortly.

Now, looking ahead, I think we rather put the priority in what I put in my statement as our first point, that you have got to take these big protected institutions, particularly the large ones, but all the banks are going to be protected to some extent, and you have got to develop apparatus for protecting, but you have also got to limit what they can do, and you want to do that as intelligently as you can, because you want them to compete. You want them to be innovative in providing services. But you don't want them taking a kind of risk that is inconsistent with the fact that at the end of the day, Government support is in the background. Now it is in the foreground. But ordinarily, it is in the background. And I think that is the, I think, the most fundamental thing.

But there are so many things that need attention that it is hard for me to rank them in priority. The accounting problem is a real one. And apart from the fact of the desirability of uniformity, and there has been a lot of progress in that area. That is one area I think we are going to get uniformity, and we should get uniformity. But then uniformity is one thing, but uniformity according to what standard? And there, there is a problem with all this mark to market business and fair value accounting. When should that be applied? When should it not be applied? If it is not mark to market, what else do you do?

My own feeling is that is something that has to be thought about by the regulators themselves and they ought to have a voice in the accounting for the basics, banking anyway, banking, insurance companies. But intellectually, that is a very tough problem.

Senator REED. Let me ask this related question. We are debating a significant recovery package at the moment. That, I would think, would complement any efforts we make to further aid the financial institutions, because without this recovery package, then the potential hole has got to be much bigger. Is that your view, also?

Mr. VOLCKER. That is right. No, you have got kind of a three-legged stool. You have got the stimulus package to help provide direct support to the economy. You have got to have the financial package to unleash the flow of credit. And then related to both those things, I think you have got the individual mortgage problem, which nobody has figured out how to deal with very effectively, but it is an important part of the problem. So you have got to advance on all those fronts.

Senator REED. Let me——

Mr. VOLCKER. Let me just point out——

Senator REED. Yes, sir?

Mr. VOLCKER.——the obvious. If you didn't have the stimulus package, let us say, the worse the economy gets, the more problems you are going to have in the banking system. That is obvious.

Senator REED. And the bigger the hole that has to be filled.

Mr. VOLCKER. The hole gets bigger.

Senator REED. In the G–30 report, the reported noted that credit rating agencies are not held legally accountable for their ratings. Do you believe that has to change?

Mr. VOLCKER. I believe this is an area that has to be reviewed. We made a few suggestions in the report, including the one that you mentioned. I don't feel that that is the last word, frankly, what we say in this report. The whole compensation structure is important and we allude to it, but we don't say what the answer is. I am not prepared now to say I think I know the answer to that, but it is not an unimportant question, obviously.

Senator REED. Let me ask you a final sort of set of questions. The Chairman raised the issue of 1,800 economists at the Federal Reserve. Did anyone sort of notice the implications of the housing bubble building up and other problems? The Ranking Member has talked about sort of looking into the regulatory practices of the Federal Reserve, particularly regulating these large institutions.

My assumption is that on a daily basis, the Federal Reserve would have hundreds, perhaps, of examiners within these institutions. Why wasn't anyone aware of some of these off-balance sheet devices, liquidity puts? Was it an area of concern? Was this an issue they were aware or, or were they completely blindsided? I think it goes to the point of trying to discover who knew what when so we have an idea of how we can restructure the——

Mr. VOLCKER. I do not know the answer to your question. A perfectly reasonable question. I was not there. I can't answer the question.

Senator REED. That is a perfectly reasonable response.

Thank you, Mr. Chairman.

Chairman DODD. Thank you.

Senator Bennett?

Senator BENNETT. Thank you, Mr. Chairman.

Dr. Volcker, welcome. We have had three simultaneous bubbles. They haven't burst simultaneously, but they were going on simultaneously. We have had the housing bubble. We had the oil bubble. And then we had a credit bubble. The oil bubble, everyone who pumps gas is delighted that it has burst. Everyone who produces gas and oil is probably a little sorry that it has burst. But all of the dire consequences that we heard predicted with respect to the oil bubble are now no longer on the front page and we no longer talk about the oil shock and its impact on the economy and the rest of us because the price——

Mr. VOLCKER. What about the opposite? The price isn't high enough to stimulate the——

Senator BENNETT. That is right. It has gone from $145 a barrel to $35 a barrel and then bounced around. But that is a bubble that burst and a collapse that happened very rapidly and the American motorist is delighted.

The housing bubble has burst and we don't know where the bottom is. It is uneven across the country, and that is why I am a little suspect of the Case-Shiller number, because that takes the worst parts. There are some places in the country where housing prices have actually risen, but the mortgage problem remains very much a difficulty because nobody knows what the securities are worth. They don't know how much toxic paper they have, and so on.

Let us talk about the credit bubble. It is different from the classic bubbles of the housing bubble and the oil bubble, but we still don't have a firm handle on what is happening with respect to credit. We don't have any kind of normalcy. There was a time when credit was enormously available. Now, it is almost not available at all, except again, like the housing thing, there are some parts of the country where it is available, or there are some markets where it is available and others where it is not.

Look into your crystal ball and tell me, or tell us what it is going to take for the credit bubble to resolve itself and how long you think that might be.

Mr. VOLCKER. Well, I won't profess to know the answer to that question with any reliability. It is going to take some time. We are not at the end of this business. And I think the immediate challenge is to provide some basis for greater confidence in the banking system and in lending. You know, it is kind of a spiraling process. The worse the economy gets, the less confidence there is, and the less confidence there is, the more difficult creditors and the worse the economy gets.

So we have got to break into that cycle, and I think that is why I emphasized earlier the importance of dealing with the banking situation. It is going to cost some money. And if we do that effectively, then I think we could begin seeing the end of this. But it is, I don't know how many months, but it is not going to be overnight.

Senator BENNETT. It is not going to be soon——

Mr. VOLCKER. We have had a great shock to confidence and trust in markets and these markets depend upon confidence and trust and it is going to take a while to restore that.

Senator BENNETT. It is not going to be soon and it is not going to be cheap.

Mr. VOLCKER. And it is not going to be cheap.

Senator BENNETT. Now, since you have put your finger, I think, on the real core of all of this, which is confidence, you talk about a three-legged stool, a stimulus package, something, for want of a better summary term, I will call more TARP to deal with the financial institutions, and then resolving the mortgage crisis. I am perfectly willing to go down all three roads, but what happens if we pass a stimulus package that is not stimulative? Doesn't that produce a greater hit to the confidence circumstance than if we did nothing?

That is what I think the debate is all about. I don't subscribe to those who say, well, we want the economy to fail because then Obama will fail and then the Republicans will come back. This is one Republican who rejects that, absolutely, and for the good of the country.

But it is one thing to say, let us pass a stimulus package. It is another to be sure it is going to be stimulative. It is one thing to say, well, let us shore up the financial institutions. Then it is another thing to be sure that the way we do that is going to be helpful, and so on. Can you give us your advice as an economist as to what you think is the most stimulative?

Mr. VOLCKER. Well, I want a stimulus package that stimulates.

Senator BENNETT. Well, we all stipulate to that.

Mr. VOLCKER. To the extent—you know the dilemma here—to the extent you can take action that not only stimulates but is in accordance with some longer-term needs of the economy, obviously you are sympathetic toward that. I am sympathetic toward that, and that, among other things, leads you to infrastructure.

Senator BENNETT. Right.

Mr. VOLCKER. The problem is, that takes time. So what do you do in the immediate future? There are things that are very compelling in the short run in terms of helping people that are out of work in terms of unemployment compensation and other things where there is the pressure of immediate money in their hands. But when you take those two different kind of extremes, both useful, put it together in as good a package as you can and get it passed, would be my advice. I am not an expert on all the particulars of this program. I haven't looked at it. But I am aware of the debate. But I hope that gets resolved in a constructive way as quick as you can.

Senator BENNETT. I have talked to some bankers who say, well, the injection of capital that has come as a result of TARP is not only welcome, but essential, but we still do not have sufficient capital to make any loans. We have sufficient capital to sustain our present balance sheet, which we didn't have before. But we are unable to attract any private capital and we are unlikely to get any more public capital. Do you have any prescription for us as to what we should be doing there with respect to——

Mr. VOLCKER. Well, I don't know what the administration is going to propose, but I suspect there is going to need to be some public capital——

Senator BENNETT. And then——

Mr. VOLCKER.——maybe quite a lot of it.

Senator BENNETT. Then the question arises, in what form? The first TARP, for which I voted, contrary to my friend, Senator Shelby, was sold to us on the basis that it was going to acquire the toxic assets and clean up the balance sheets of the bank, and then it changed toward a program of buying preferred stock or making some other kinds of loans, warrants, and so on. Along with Senator Dodd, I agreed we ought to give the Secretary of the Treasury full authority to do whatever he thought was best, but the track record, at least coming from somebody's analysis, has been a little bit spotty as to whether that is——

Mr. VOLCKER. Well, I think it is fair to say, if you look back over the last 6 months or so, that they were kind of repeatedly firefighting, on some crucial weekends in particular, and it may have been successful or unsuccessful in particular cases, I think mostly successful in putting out a particular fire, but it didn't come across as being very consistent and very credible in terms of what comes next and I think we have suffered from that. And what we need now is, I think, a kind of comprehensive program that recognizes the breadth of the problem—it is not just one or two institutions—and provides a framework for dealing with this in a consistent way. I think that is essential to get confidence back in this situation. I hope that is what is going to happen in the next couple of weeks.

Senator BENNETT. Thank you very much.

Chairman DODD. Thank you, Senator Bennett.

Just a quick question before I turn to Senator Schumer. In your view, Doctor, looking back, did we do the right thing in early October in supporting that TARP program or not?

Mr. VOLCKER. You know, it is very hard to sit on the outside and say what should have been done in particular circumstances. All I know is something had to be done. Whether it was perfect foresight or whatever, we could have done it differently, you mentioned the TARP program, which was designed in the first instance—I had actually written something about it before it happened and suggested that we get rid of some—buy up some of these so-called toxic assets, and that was the original intention and then they switched, maybe for good reason. But the whole thing wasn't as persuasive as it might have been.

Now understand, as time goes past, these loans are getting worse. They are not getting better because the economy is worse, so that makes it more difficult.

Chairman DODD. So the answer——

Mr. VOLCKER. Well, the answer, as I say, I think you need, apart from the stimulus program, you need a program that looks big enough, powerful enough, across the board enough, not that it necessarily has to be applied, but you have something there that can be applied in terms of further deterioration of the market or individual institutions. You hope that by the mere fact of being there, confidence might begin to be restored. The better looking the program, the less you have to use it.

Chairman DODD. So I think I hear you saying, yes, you agree that it should have been done. How it was executed is another matter. Is that a fair characterization?

Mr. VOLCKER. I think—yes, I think so.

Chairman DODD. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman, and thank you, Mr. Chairman. It is good to see you. I have been on Banking Committees for 28 years and I think you have been testifying before them for about 28 years.

Mr. VOLCKER. Just about.

Senator SCHUMER. So it is good to see you. I have an opening statement, Mr. Chairman. I am going to forego reading it. It outlines my general views on regulatory reform, including a much more unitary—well, controlling systematic risk, ensuring stability—I have always thought all holding companies should be regulated by one regulator, maybe the Fed, maybe not, but one regulator, and I know you have been asked about that—unifying our regulatory structure—we have too many regulators, too many holes between the cracks, too many conflicting organizations. Third, regulating the currently unregulated part of the markets, both instruments and entities, hedge funds and others. We need to do that. Fourth, to recognize that we are in a global financial world, global solutions, and increase transparency. Those have been my five principles. I wrote an op-ed about this about a year ago and I have been sticking with them. It hasn't changed. So I ask unanimous consent that that be put in the record.

Senator SCHUMER. I would like to focus on the international part first, because to me, the biggest challenge we face when we set up a new system of regulation is not what we do here. I think there is sort of a consensus. I mean, I have heard Chairman Dodd has said, Chairman Frank, the administration, they are very similar to the five things that I have outlined here. But how in this international financial world, with a national system of regulation, don't you always flee—doesn't money always flee to the lowest common denominator? And if we regulate swaps here or regulate hedge funds here, they just migrate to a place where they are not regulated because the individual operators, regulation is a common good.

Mr. VOLCKER. Well, I expressed some optimism on this point earlier, before you came in——

Senator SCHUMER. Good. Well, I welcome hearing again, because there isn't much——

Mr. VOLCKER. I have optimism only because this crisis is so serious. We here in this country, in the U.K., in Japan, potentially in China, have never seen anything like this, and so this kind of focuses the mind. I think the leaders in Europe and the United States, Canada, Latin America, they are all interested in this subject.

You have a forum in the G–30. I don't think it is an ideal forum for this purpose, frankly, for getting into the detail, but it is a good forum for making sure that somebody else does it. And we do have some international bodies that are making progress.

In many of the areas that you would be concerned with, take hedge funds, the Europeans are more concerned about regulating hedge funds than we are.

Senator SCHUMER. You know, I am not so worried—I mean, although the details, look how long it took to get some agreement on Basel and the capital accords.

Mr. VOLCKER. Right.

Senator SCHUMER. Everyone had general agreement and it took five or 10 years to get this done.

Mr. VOLCKER. Now wait a minute, I was largely, or importantly responsible for the first so-called Basel Agreement. It only took 2 years.

Senator SCHUMER. Right, but Basel II took much longer.

Mr. VOLCKER. The revision took much longer because we did such a good job the first time.

[Laughter.]

Senator SCHUMER. But, you know, in this new global world, Hong Kong could decide that they don't want the Western consensus. They will go for the short-term hit of having——

Mr. VOLCKER. I——

Senator SCHUMER. You know, it is just difficult.

Mr. VOLCKER. Look, one area where this is front and center is in accounting——

Senator SCHUMER. Yes.

Mr. VOLCKER. and I have a special interest in this because I used to be the Chairman of the International Accounting Standards Committee.

Senator SCHUMER. Right.

Mr. VOLCKER. And there, the suspicion in the United States has been our U.S. GAAP is better than anything else and that we have international accounting standards and we ought to adopt U.S. GAAP. Well, I think that has been proven to be a bit of an illusion. U.S. GAAP is not God, either——

Senator SCHUMER. Right.

Mr. VOLCKER. and there are lots of problems, and I see no reason—I do not believe that the international standards are in any sense weaker than GAAP. They are more principle-based——

Senator SCHUMER. Yes.

Mr. VOLCKER.——but in terms of the substance, they are no weaker, and there has been a lot of progress.

Now, there are political pressures on the international standard setters and we ought to be alert to that and those pressures, frankly, are—well, they are in the United States, too, but they are particularly strong in Europe, and I think we all have an interest in maintaining the independence of the standard setters and we want to put pressure on them to do a good job.

Senator SCHUMER. Yes.

Mr. VOLCKER. But I think that is a promising area and a very difficult area.

Senator SCHUMER. Yes, it has been difficult, the most difficult. My worry is a year from now, when we begin to see the light at the end of the tunnel here, say China will decide they want to gain the immediate advantage and just set up rather sophisticated——

Mr. VOLCKER. No, but we——

Senator SCHUMER.——trading operations, and it just——

Mr. VOLCKER. We said——

Senator SCHUMER. My experience——

Mr. VOLCKER. We said earlier, if we have got good regulation, and good is not synonymous with a lot of regulation necessarily, but if we have intelligent regulation and the rest of the world doesn't follow us, well, that is too bad, because I think in the end, it will be recognized that we have the best and the business will come here.

I am tempted to say, because this is not the first time I have been before this Committee and this problem arising in the United States, where when you talk about—the Senator talked about everybody wants to tweak the regulation to their advantage.

Senator SCHUMER. Yes.

Mr. VOLCKER. That is true of American States. They are always trying to tweak——

Senator SCHUMER. Of course.

Mr. VOLCKER.——financial regulation to the advantage of particular States. So we have had a certain experience there.

But all I can say is if we can't deal with this now, given the extent of the problem not just in the United States——

Senator SCHUMER. Around the world.

Mr. VOLCKER.——but around the world, we have an opportunity to do it.

Senator SCHUMER. Yes. I agree, it is a unique opportunity. It is just my experience has shown everyone agrees 10,000 feet up, and you start getting into the details and they don't, and then there are new instruments that come along and new opportunities for one country to gain on the other and they trade that short-term benefit to everyone's long-term detriment. But good. I am glad you are optimistic.

Mr. VOLCKER. One thing I would say in that connection, maybe I am optimistic and out of it and don't know what is going on, but there are bodies——

Senator SCHUMER. I doubt that.

Mr. VOLCKER.——internationally to deal with this, and to the extent it can be left to these more or less expert bodies, and accounting is one example, but the Basel Committee is another example——

Senator SCHUMER. Yes.

Mr. VOLCKER.——and there are several other examples, the political leaders ought to put pressure on those expert groups. When they try to do it themselves——

Senator SCHUMER. I understand.

Mr. VOLCKER.——I think you get a problem.

Senator SCHUMER. All you need is one significant outlier to throw off the—to toss up the apple cart.

One other question, because my time is running out, credit rating agencies, where there has been real trouble. Do you think the model ought to change, that we ought to——

Mr. VOLCKER. I mean, I can answer that question yes. But if you ask the next question, how——

Senator SCHUMER. Yes.

Mr. VOLCKER.——I will tell you, I am not ready to make a pronouncement. I think that——

Senator SCHUMER. Well, what about the old model, where instead of the issuer paying for it, it was the investor that did?

Mr. VOLCKER. Well, I was surprised to learn, or I had forgotten, because ever since I have been *compos mentis* and an adult, I think the AAA ratings or AA or whatever they were, but 20 or 30 years ago, they were paid by the investor.

Senator SCHUMER. Exactly. Yes, and it worked.

Mr. VOLCKER. And it worked. It seemed to work. So why can't it work again? I don't know the answer.

Senator SCHUMER. The one—and this will be my last, because my time is expiring—the one thing people say is that when the investor pays, the investor doesn't want to make it public and there is sort of a public good.

Mr. VOLCKER. Yes.

Senator SCHUMER. What would you think of some quasi-governmental intervention here?

Mr. VOLCKER. I can't see the governmental agency making the credit rating. The potential political pressures that will come on, everybody——

Senator SCHUMER. Well, that is why I said quasi. Don't you think the Fed is pretty well removed from political pressures?

Mr. VOLCKER. Well, I think the Fed is more removed, properly so——

Senator SCHUMER. Yes, it should be.

Mr. VOLCKER.——than any other agency, and I like to think it has earned that in part over time by competence in the way it acts.

But I don't think you just want to pile everything on the Federal Reserve. At some point——

Senator SCHUMER. Yes.

Mr. VOLCKER.——it breaks.

Senator SCHUMER. Well, to clarify, my view would be to go back to the investor-paid initially. We have got to do something to change it.

Mr. VOLCKER. Well, I agree with that.

Senator SCHUMER. Thank you. Thank you, Mr. Chairman.

Chairman DODD. I won't ask you to comment on this, but since your knowledge and background in accounting, the FASB model, and I realize they are very different functions we are talking about here, but a FASB model has worked fairly well in accounting standards, particularly when we got away from the industry supporting it and financially underwriting it.

Mr. VOLCKER. Well, that is—the IASB is the FASB model writ large internationally.

Chairman DODD. So there is a value in maybe talking about that model, as well.

Senator Crapo has been, of all the members of this Committee, probably has worked as hard on Government regulation, reform regulation as any member, so we welcome your continuing participation in the Committee, Mike. Thank you.

Senator CRAPO. Thank you, Mr. Chairman.

Chairman Volcker, I want to go back to the Group of 30 report just to kind of try to understand maybe in a little more detail with you what was intended by it. I am going to first focus on one of the concepts that Senator Schumer mentioned—I apologize for my voice, I might lose it during the questions—and that is the principle of unifying our regulatory system.

For some time even before we ran into this crisis, I have been arguing that we need to unify our regulatory system and really make sure that we had the right regulatory system for our financial system and for our capital markets. In that context, as I look at what we have today, it seems to me we have a lot of overlap that is unnecessary. We have gaps where there is no regulation where there should be. And we have weaknesses in some parts of our system. And what we need to do, as I think you said earlier, we need to get good regulation, not necessarily a lot of it. We have got to be thorough. We have got to cover everything, and in my opinion, eliminate overlaps.

As I look at the first principle of the Group of 30's report, it talks about dealing with gaps and weaknesses and so forth in the system. But one of your first points is that the activities of banks should be subject to prudential regulation and supervision by a single consolidated regulator. Do I understand you or the report at that point to be talking about something like merging the functions of the OCC and the OTS and perhaps other regulators?

Mr. VOLCKER. Well, we deliberately did not get into the specifics. We were at a high level of generality when it came to the administrative arrangements. But we do recognize the problem that you just described and that you had to have some kind of a unified system, at least for banks.

Senator CRAPO. And when you say at least for banks, I noticed one of your other points was that the activities of large insurance, investment banks and broker dealers require consolidated supervision. Are you not saying essentially the same thing there in other contexts?

Mr. VOLCKER. Well, I can't say, speaking in the report, we were saying the same thing, because we deliberately didn't want to get into the detail. I think it is an important subject, but we were concentrating on what the substance of the regulation should be. At some points, we said it should be consistent. But we didn't opine about who should do what.

Senator CRAPO. Well, let me try to take you there, and you don't have to speak for the report right now. A lot of discussion has been made about whether we should have a single regulator like they have in England, whether we should have three regulators, one for the systemic, one prudential, and one consumer protection——

Mr. VOLCKER. Well, one of——

Senator CRAPO. Do you agree with those approaches or that idea of consolidating?

Mr. VOLCKER. I think you should at least explore the idea of two regulators, which was raised by Secretary Paulson's report a year or so ago, that you have one on so-called business practices and consumer protection and investor protection and one on prudential safety and soundness concerns. They overlap. They are not entirely separate, but there is substantial difference between those two approaches. In fact, there is enough difference in approaches you will get a clash between those agencies. But maybe that is healthy——

Senator CRAPO. Right.

Mr. VOLCKER.——instead of just having one. Now, you take the English pattern, they went all one way and away from the Central Bank. Now, that didn't work so well in terms of crisis. So how do you get——what we did say very clearly is whatever system you have, you had better get the Central Bank involved enough so they can respond effectively to a crisis.

Senator CRAPO. And that is consistent also with Secretary Paulson's blueprint——

Mr. VOLCKER. Yes.

Senator CRAPO.——in terms of the suggestions made there?

Mr. VOLCKER. Yes.

Senator CRAPO. One other point that was made in the report is that the money market mutual funds that were wanting to continue to offer bank-like services should be required to be reorganized as special purpose banks. Could you expand on that a little bit? What was intended by that?

Mr. VOLCKER. Well, what was intended by that—you go back in history a little bit. Money market funds developed because—to escape regulation, effectively. This is a way to provide a banking service outside of banks, and they had some competitive advantages because they weren't banks and they didn't subject to banking regulations. So when a crisis came along, the framework was not adequate. In some cases, they were owned by rich parents and it was OK. When they weren't owned by a rich parent, you had a collapse with widespread repercussions.

We said, you should not essentially say we should not have institutions out there that promise to act like a bank, but they are not regulated and protected like a bank. And if they are going to be protected de facto, which is what happened here, in effect, they got a free ride, and they shouldn't have gotten a free ride. So if they are going to act—if they are going to talk like a bank and squawk like a bank, they ought to be regulated like a bank.

Senator CRAPO. Well, one of the principles that I tend to follow as I approach this issue is that similar products or similar functions should be regulated with the same rules or by the same regulators. Would you agree with that principle?

Mr. VOLCKER. Well, I think if you adopted that regulation on money market mutual funds, the natural thing would be to have the same regulator as the banking regulator.

Senator CRAPO. Thank you. One more thing I would like to ask a little clarification on and that is your comment and the report's comments about the way we should handle our GSEs, Fannie and Freddie. You indicate that a clear separation of Government financial support from the private profit-seeking sector of this should be done. It is not clear again whether you are saying that we should nationalize the Fannie and Freddie functions or whether we should withdraw the Federal guarantees or accomplish the Federal guarantees in some other way. What exactly are you saying?

Mr. VOLCKER. We are saying that is your choice. You ought to do one or the other.

[Laughter.]

Senator CRAPO. All right.

Mr. VOLCKER. You shouldn't leave them hung up in between, because it is confusing and when you got into trouble, were they public agencies or were they not? And if they were acting in the public interest, were they doing right for their fiduciary responsibility to the stockholder? I think they got placed in an impossible position. They were supposed to be important constructive factors in the mortgage market. The crisis came along and they were so over-extended in pursuit of their stockholder interests that they couldn't perform the public function. And if they performed the public function, their stockholders would squawk. And you shouldn't permit that to happen.

Senator CRAPO. Thank you very much. Just one last question, and really, this is sort of a summary to go back to what we have already talked about and that you have already expressed a comment on, but I would just like to explore it a little further with you, and that is it seems to me that right now, depending on whether you count the FDIC, there are six or seven Federal regulators with overlapping responsibilities in some cases, and as I said earlier, gaps in some places and so forth.

It seems to me that regardless of the specifics, that Secretary Paulson's blueprint, the Group of 30 report, even though it didn't get into the details, and a number of the other reports that have dealt with this same issue have all concluded that we have too complex a system that needs unifying and simplification. Now, whether we go to a single regulator or whether we go to a smaller number than the seven that we have now, that we need to simplify and reduce the number of regulators and clearly identify the functions they are regulating and then move forward from there. Is that general statement something you could agree with?

Mr. VOLCKER. Yes, I agree with that, but I guess what I would say is when you get to that stage, that stage ought to be second. I don't mean it should be way off, but you ought to have some feeling about the substance of the regulation and then decide who should do it rather than decide who should do it and worry about the substance afterwards.

Senator CRAPO. Agreed, and in that context, just to help me in my mind, I am starting to think of that substance part of it as something focusing on systemic risk, prudential regulation, and then consumer protection, and there may have to be some other insurance aspects or whatever.

Mr. VOLCKER. Yes.

Senator CRAPO. But would that tend to be the kind of thing you were talking about?

Mr. VOLCKER. I think it is one of the possibilities, yes. A good possibility.

Senator CRAPO. Thank you very much.

Mr. VOLCKER. The report doesn't say so, but——

Senator CRAPO. I understand. I understand.

Chairman DODD. No, and let me just say, too, I appreciate Senator Crapo's longstanding involvement in this and I think we are sort of heading in the same direction on a lot of this. Obviously, the devil is in the details, a lot of it, but you are getting sort of a consensus emerging up here and some ideas and thoughts in this direction. That is why your testimony is so tremendously helpful.

I can't—first of all, I don't disagree at all about the conflicting missions of the GSEs of protecting your shareholder interests and the public policy notion of housing. I am struck by the notion that we are sort of doing—aren't we doing the same thing now? When I look at Citi and Bank of America and Goldman Sachs and the infusions of massive amounts of taxpayer money, once again, now you have got the exact same situation we talked about with the GSEs. In effect, we have a massive amount of public money going in, so that we are setting public criteria on private institutions. What is the difference?

Mr. VOLCKER. Well, the difference, I hope, is that this is a reaction to a particular emergency and it is transitional and nobody is thinking you are keeping it that way.

Chairman DODD. All right. I hope so.

Senator CRAPO. You are right, and I hope so, too.

Chairman DODD. Let me just also, and Senator Shelby had to go on to another meeting, let me just in a sense respond and ask, as well. I mean, look, we obviously know that we have got to go back. We are reviewing all the time how we get here. We are asking everyone what their thoughts were on how this happened and it is a very important question. None of us disagree with it.

As the Chairman of a committee here, and all my members serve on other committees, as well, and we have obviously got a very important agenda to deal with, not the least of which is the modernization of the regulatory structure and some sense of urgency, I happen to believe, and I think you have implied this, if there is any silver lining in all of this right now, it is that I think there is a willingness and an understanding that we have to move. In the absence of this moment, if this were, quote, "normal" times, I think we would have a hard time engaging in this debate and discussion because of the vested interests that don't want anything to change at all. So we have been given a moment, unfortunately, here, tragically, I might add. But it is a moment.

Now, what do we do with the moment, and my fear is that if I end up squandering a year going back and reviewing for the next number of months how we got here—not an illegitimate question—that I may miss the moment, and I will look back and this Committee will look back and say, we had an opportunity. Recognizing the moment, we need to do something about this.

And so I respect immensely the idea that we ought to spend time, and I want to move carefully, obviously, and deliberately. But my concern is if we miss the moment, we will find ourselves in a deeper hole for a good many years to come.

So let me ask you, Doctor, if I can, do you sense that, as well? Should this Committee and the others responsible, obviously the House and the President, the executive branch, move? And again, as I sensed it, your priority would be to deal with systemic risk up front and soon. Is that correct?

Mr. VOLCKER. Yes, you know, with all deliberate speed.

Chairman DODD. I agree.

Mr. VOLCKER. I am not enchanted by, you know, talking about combining the SEC and the CFTC. It is an important issue, but do that as part of the whole thing. Just don't pick out particular issues like that, in my view, but I——

Chairman DODD. Deal with the totality of it. And an issue that Senator Crapo brought, and I care about, as well, is sort of the forum shopping that went on by the major interests that restructure themselves in order to pick out a regulator. It is all backwards, in a sense. We should be determining who is going to be regulated, not you choosing who you are going to be regulated by, and that has been a constant problem, as well.

So as I hear you say it, the systemic risk would be the area you think we ought to be aggressively pursuing, carefully but aggressively pursuing. Am I correct?

Mr. VOLCKER. Yes.

Chairman DODD. Do my colleagues have any additional questions? Senator Warner?

Senator WARNER. One quick question. Thank you, Mr. Chairman, and I had to step out for a moment, so if Senator Crapo asked this question, I apologize.

One of my questions earlier was about the argument over the last decade, if we added more regulation, how the capital markets would migrate elsewhere, and it seemed like, and I was one of those folks who held up what looked like the model in the U.K. as maybe one to go after. Clearly, it has not proven to be all it was made out to be. Is there some other—as we think through this, is there some other nation around the world that has got a regulatory structure that you say, hey, as you think through this in America, look at country X or country Y?

Mr. VOLCKER. I hate to make an advertisement for the Group of 30, but we just issued a big report on that subject. We described, I don't know, what, two dozen countries, different systems. We refrained from saying which is best, but we did pronounce a lot of pros and cons, what looked more promising and the advantages, disadvantages of different systems.

There seems to be some intellectual and other movement toward what the Senator was describing of two agencies, one for business practices and one for prudential. I can't claim that that is widespread, but there are two or three countries, or four or five countries that now follow that. For a while, this business of putting everything in one agency seemed to attract a following. That enthusiasm has been a bit dampened by the fact it didn't solve all the problems in the U.K.

But those are the two alternatives that need to be looked at. The United States is big enough and complicated enough, we may have a system like nobody else's, but I don't think anybody is very happy with the system we have and it takes this kind of a crisis to change it.

Senator WARNER. Well, you could, Dr. Volcker, maybe you could share with the Chairman at some point which of those countries you think might be models or might give us some guidelines or lessons we could learn from.

Mr. VOLCKER. We do have—your staff can, I am sure, look at the report we have on that subject because it does try to describe the strengths and weakness of different approaches. And there is a pretty strong feeling, which is not the case in the United States historically, that similar functions should be subject to the same regulator and the same regulations, which is——

Senator WARNER. So focused on function rather than on institution?

Mr. VOLCKER. Than by institution, yes.

Senator WARNER. Thank you, Dr. Volcker.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, and Doctor, we thank you immensely. Let me just recommend, as well, and I am sure you will agree based on your last comment, why don't we make available the staff of the Group of 30, and for any interested members and their staffs, we will try and set something up and have a session where they can go through and do exactly that, get into more details and the questions back and forth as part of our ongoing effort here. It might be very worthwhile and we will arrange that to occur, as well.

And I should have said at the outset, by the way, and I apologize, Doctor, you and the Group of 30, the people who are involved in this, I know the names are listed in the report itself, but I want the record to reflect how much we appreciate that effort. This was a very comprehensive effort made to examine this——

Mr. VOLCKER. Thank you.

Chairman DODD.——and it is appropriate that our first witness in a series of hearings we are going to be having on this subject matter comes from this very group that brings a wealth of knowledge and expertise to this subject matter. We are going to hear from the GAO and staff, who have also been involved in this. I am going to bring them up here shortly, but I want the record to reflect how much we appreciate that effort.

You have begun a very important discussion, obviously not a completely comprehensive one, but one that touches on the very major issues we will have to address in the coming days if we are going to effectively respond to the challenge of modernizing our regulatory structure, so I thank you.

Mr. VOLCKER. Well, I think I can speak for my colleagues that engaged in the study that we appreciate your interest. We feel it was worthwhile, so——

Chairman DODD. Well, this is the moment. This is the moment. We have been given, unfortunately, a moment.

Mr. VOLCKER. And just in terms of all this competition between countries and so forth, this is an international report.

Chairman DODD. I know that.

Mr. VOLCKER. There is no sharp cleavage between people from different nationalities.

Chairman DODD. Thank you very much.

We will leave the record open a little bit. There may be others who couldn't be here today who would like to maybe submit some ideas and questions to you, as well, and if you have a chance to respond to those. We thank you.

Mr. VOLCKER. Thank you.

Chairman DODD. I will invite our second witness up, our second panel. Welcome to Dr. Gene Dodaro, who is the Acting Comptroller General of the U.S. Government Accountability Office, the GAO. Mr. Dodaro has worked for over 30 years in a number of key positions at GAO, including Chief Operating Officer. He will also be testifying tomorrow before the Committee on the Troubled Asset Relief Program, so he is a busy man with being here today and tomorrow.

Mr. Dodaro will be accompanied by two GAO staff members, Rick Hillman and Ms. Orice Williams. We thank you for joining us, as well.

Why don't you come on up and sit with—have both of you come up and sit there, because I know you worked very closely on the details of all of this and I know Mr. Dodaro would appreciate having you sit there with him, as well, and respond to some of this.

Again, we thank you very, very much. I am sorry about the delay, but obviously a lot of questions for Dr. Volcker. So we welcome your comments, and again, congratulations on this. All of us have great respect for the GAO and the work you do, but this is a very important effort you have put forward and sort of a template for us to begin this very important discussion of regulation modernization.

STATEMENT OF GENE L. DODARO, ACTING COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

ACCOMPANIED BY RICHARD J. HILLMAN, U.S. GOVERNMENT ACCOUNTABILITY OFFICE; AND ORICE M. WILLIAMS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. DODARO. Thank you very much, Mr. Chairman. I appreciate the opportunity to appear before you and the members of the Committee this afternoon to assist your deliberations on the financial regulatory system.

As you mentioned, we in this report embarked on an effort to assist this Committee and the Congress in tracing the evolution of the financial regulatory system over the last 150 years, how it has evolved; to talk, second, about some of the developments in the market that has really challenged that regulatory system; and to put forth a framework to help guide decisions on how to craft and evaluate proposals to change the system going forward.

Our bottom line conclusion is that the current system is outdated, it is fragmented, and it is ill suited to meet the 21st century needs of our nation. There are many reasons for this. Three I would point out, trends that we identified in the report.

First is that the regulators have struggled and often failed to mitigate the systemic risks of large interconnected financial conglomerates or to adequately ensure that they have managed their own risks. There is no one single regulator charged with looking at risk across the financial system. This, as mentioned in the earlier discussions today, is a problem that needs to be addressed.

Second, regulators have been confronted with some large market participants that are less regulated. Non-bank mortgage lenders, credit rating agencies have been mentioned here. They are two that we point out in our report, as well.

Third, both the regulators, consumers, investors have all been challenged by the emergence and growth of complex financial instruments, whether it is collateralized debt obligations, credit default swaps, over-the-counter derivatives. All these products have really evolved and introduced new dimensions into the system that really outpace the regulators' ability to be able to handle that.

Now, going forward, we think that action needs to be taken. It needs to be deliberative, as pointed out here in the discussion so far. And in order to assist this, we outline nine characteristics in our report which we think are good touchstones.

First is that the regulatory goals need to be clear and articulated in statute, and the goals really ought to drive the substance of the organization, as Dr. Volcker mentioned earlier, and they ought to be in statute so that they can be used to hold the regulators accountable going forward and can provide consistency over a period of time and ensure that there is consistency in the regulation going forward.

Next, it has to be—reform has to be comprehensive. The current institutions and products that, where there are gaps, the gaps need to be closed and it needs to be looked at in an interrelated set of, as has been mentioned, in a unified basis going forward.

System-wide risk needs to be addressed. Somebody needs to be in charge of making sure that the system-wide risks are monitored going forward.

It needs to be flexible and adaptable, and by that we mean it has to allow for innovation, but somebody has to be staying abreast of risks that are emerging going forward. We know where the risks are now. What shape they will take in the future is really anybody's guess at this point, but we need to have a monitoring system in place that can triage those risks, make determination, not be totally reactive to the situations going forward.

It needs to be efficient and effective. By this we mean there is overlapping jurisdictions right now that can be consolidated or looked to to consolidate so we have an efficient system going forward.

Consumer protection has to be also a paramount consideration here. Every time we have evaluated an activity for this Committee or another committee in Congress in terms of whether it is credit card fees or whether it is mutual fund fees, the disclosures invariably aren't adequate enough going forward, and I believe there also needs to be more attention to financial literacy concerns. The Federal Government has a commission on this, but it hasn't been—had a strategic plan, been resourced properly. That needs to be part of the package, as well.

The regulators have to have the right authorities. They have to have proper independence, and that involves the funding sources that they draw upon to ensure that independence going forward.

And last, taxpayer exposure has to be minimized. We believe that whatever structure is put in place, that future failures are borne by the cost of the market participants and not by taxpayers going forward. An example here is what is set up currently in the Bank Insurance Fund, where fees are paid and then institutions, if they fail or are taken over, then the fund is recapitalized by the participants in the fund and not by taxpayers going forward.

Now, to your point about seizing the moment, one of the things that we did in order to highlight attention to dealing with this issue was add the need to modernize the financial regulatory system to our most recent update for the High-Risk List that we keep for the Congress and unveil at the beginning of each new Congress, and this is important because we have added areas in need of broad-based transformation as one of the criteria to be put on the High-Risk List. We think it was important to do that, to feature this as the attention of need of change both by the executive branch and importantly by the Congress, in this case, through legislative initiatives.

So that sort of concludes my opening statement. My colleagues and I would be happy to answer any questions that you have.

Chairman DODD. I must say, you are always a spectacular witness. That was his testimony given without reading, and your comprehensive knowledge of your own report is pretty impressive. You have testified before us on numerous occasions and you always do an excellent, excellent job, and so I command you and your staff for your depth of understanding and appreciation of the issue.

Am I to understand, by the way, when you listed the list, the list is not necessarily in the order of importance, because consumer protection comes sort of at the mid-point in that list and I don't interpret that to mean that that is less important than the first issue you raised.

Mr. DODARO. That is correct. Basically, these nine characteristics all have equal value. The only thing I would say is we list the regulatory goals articulation up front, which could include—and should include—consumer protection as sort of an overarching starting point. But other than that, they are all of equal importance.

Chairman DODD. And the last comment you made is I understand to be that you believe this ought to be a high-priority item for this Congress, the 111th Congress.

Mr. DODARO. Definitely.

Chairman DODD. Yes. Let me, if I can, begin with the first question I asked Dr. Volcker, because again, while obviously we are looking forward here, Senator Shelby's point, whether you want to have this Committee do it or someone else do it or however, and I think you can walk and chew gum, that we can actually do both functions maybe simultaneously, that is analyze how we got here as we decide what steps to take going forward, is an important question.

And so the question I asked Dr. Volcker was, I will repeat, and that is your, in fact, the report here states, and I quote here:

> Mechanisms should be included for identifying, monitoring, and managing risk to the financial system regardless of the source of the risk.

What was the source of the risk?

Mr. DODARO. I think, you know, basically the three areas that I pointed out in terms of these developments that have occurred that have outpaced the ability of the financial regulatory system. It depends on how you want to frame it. Our report frames it in terms of market developments compared with the regulatory system. Our report is not a comprehensive inventory of every, perhaps, poor decision that was made by individual regulators or by companies or by other institutions going forward. Clearly, that is worthy of investigation.

But our point was that there are these broad trends, and these trends, you know, we have seen emerge over a period of time. In 1994, we issued a report on the problems that were emerging in derivatives. In 2004, at the request of this Committee, we issued a report talking about the need to modernize the financial regulatory system. So a lot of the need to change the system, I believe has been emerging over a period of time. It was definitely brought to the forefront over this past year in the scope and dimensions of the problem. But I think there is enough basis of study being done that could begin to build the record that Senator Shelby was talking about.

But until action is taken, we continue to have these exposures and vulnerabilities, and I don't think, you know, some of this can proceed on a parallel path.

Chairman DODD. I agree with you, as well.

Let me—the structure of the financial regulation. Again, we have heard a lot of different ideas today. I keep sensing some commonality among members up here and I would like to raise, if I can, in order to address the problem, should we consolidate regulatory agencies? If so, which agencies should be consolidated and what public policy goals would such consolidation achieve? Is there a role for maintaining a State-Federal system of optional bank charters, for instance, in your view? What are the advantages and disadvantages of creating a Federal insurance regulator?

We are debating up here, and this subject has been before us, on the Optional Federal Charter. A lot of people think there is not much debate over life issues. There is a significant debate over property casualty issues of how we go. What are your thoughts on those questions?

Mr. DODARO. I will ask Mr. Hillman to comment on the insurance industry. He has done a lot of work on that area. But in terms of your first question about consolidation, some of our work in the past, in the banking regulators agency, we raised the issue of the potential benefits of merging OTS and OCC and perhaps the supervisory responsibilities of the FDIC as a potential area that ought to be examined going forward. Obviously, many people have mentioned the SEC-CFTC potential issue going forward.

But my point would be, at this juncture, those decisions need to be made in concert with identifying who the systemic regulator would be, because the relationship between that regulator and the other regulators that may have more specific prudential responsibilities, I think needs to be thought of in a holistic fashion. Otherwise, we are going to put in place another potentially fragmented system to replace a fragmented system that we already have.

Chairman DODD. So get to the systemic risk issue first?

Mr. DODARO. First, and then in parallel with that decide how to make the other system support that, and it will also help the systemic risk regulator because they won't be having to deal with as many other entities going forward and it does address the issue of regulatory arbitrage that you mentioned earlier, Mr. Chairman.

But Rick can comment on the insurance area.

Chairman DODD. Yes.

Mr. HILLMAN. The notion of an alternative national insurance regulator is something that is deserving of significant merit, that we need to best understand the tradeoffs associated with that. But in recent years, the preponderance of evidence, particularly amongst the larger insurance companies, suggests that they are at a disadvantage compared to the banking and security sectors in that the banking and security sectors can bring new products to the market more swiftly that are similar to products that are also being sold by the insurance industry. However, the insurance industry, rather than having one or a small number of regulators to get product approval, has 54 separate regulators from the 50 different States and four different Territories. So the idea of having some commonality associated with the introduction of products of similar nature in the marketplace is something that deserves close attention.

Chairman DODD. Yes. Well, it does and this Committee cares a lot about it. What about the State-chartered versus federally chartered institutions?

Mr. DODARO. I think what we have seen and observed over time, the State function, particularly as it relates to consumer protection, has provided an important safeguard and we think the benefits of that need to be preserved going forward. There needs to be obvious coordination in this area. There are—it is important always to have some checks and balances in the system, and I think the Federal-State issue is one of the important checks and balances that needs to be maintained in a revised system. Most of our work is focused on the Federal level, of course.

Chairman DODD. Let me jump, if I can, to the issue of failing institutions. The GAO report suggests that a regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure. Can you give us an example of some of those safeguards?

Mr. DODARO. I mentioned, alluded to one in my opening statement. The Bank Insurance Fund, I think, is the model that we have in mind going forward here extended across the system whereby the banks pay fees into the system. The fund is then capitalized. There is a statutory ratio that is set, and if the fund falls below that ratio, FDIC has a number of years in order to recapitalize the fund——

Chairman DODD. Right.

Mr. DODARO.——but that is done by the financial institutions in the system and not supported by taxpayer funds. I mean, that was something that was modernized during the savings and loan and banking crisis we had in the 1990s.

Chairman DODD. Yes.

Mr. DODARO. We think there ought to be something like that more broadly speaking in this system so that the taxpayers aren't turned to to provide anywhere near the level of investment that we are being asked to provide today.

Chairman DODD. The former SEC Chairman, Bill Donaldson, once warned against executive compensation plans that emphasized rewards for short-term financial targets, and I quote him here. He says, "People with targets and jobs dependent on meeting them will probably meet the targets, even if they have to destroy the enterprise to do it," end of quote.

I wonder if you might explain the relationship of compensation to risk taking, particularly when oriented toward short-term goals and discuss how they should be addressed.

Mr. DODARO. This is an area that we haven't studied extensively going forward, but clearly the role of incentives here are important going forward and you are seeing some of that. We point some of that out in our report in terms of the number of mortgages lent, for example, and the incentives systems build into it. So I think that is an area that needs a lot more study and attention, but clearly, the incentives in the corporate governance aspects of this can't be overlooked going forward.

Chairman DODD. So the issue of proxy voting and so forth on compensation issues, it has been discussed a little bit in the past, but to what extent shareholders at what level have a right to participate in making—first of all, they find out invariably a lot of these contracts are entered into and you don't discover all the details of them until someone is leaving.

Mr. DODARO. Mr. Chairman, let me go back and look at what we have done in the past. I don't have a ready answer for you on that today and we will provide one.

Chairman DODD. I appreciate it. I thought you might, but it was one I wanted to raise.

Let me turn to Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman.

A couple of thoughts. Having run a State government from the Governor's office and having a Director of Insurance which I appointed and regulating insurance at the State level, I will tell you, and we were a fairly small State population-wise, at least, that there was a closeness of regulation there that never got very far away from you.

Now, I compare that with having run a Federal department, very large, 110,000 employees in 75 foreign countries. We regulated a whole bunch of things. These regulatory enterprises can be so big and the diversity so enormous around the country that what happens is exactly what your report points out. It just breaks down.

And so when you start comparing State charter versus Federal charter, *et cetera,* I think we have to keep that in mind. I really do. Having run both, I can tell you, a department that regulates on a national basis is always going to fight that battle. That is my observation.

My question, though, deals with kind of a follow-up on this whole issue of risk analysis. How do you figure out that this basketful of assets has value and what is its value and what exposure do you want to take to that risk? I would like to hear your thoughts on that. Is this something where you would suggest that our regulatory framework have kind of a pre-approval feature to it, because once the investments are made, the horse has pretty well galloped out of the barn, if you know what I am saying. I would just like to hear your thoughts about that.

Mr. DODARO. Yes. Clearly, the risk management failed at several levels in this situation. It failed at an institution level. It failed at an industry level. It failed at the national level and at an international level. I think the breadth in which this moved across the globe, I think really surprised a lot of people.

At the request of Senator Reed, in his capacity as a Chair of one of the subcommittees of this Committee, we are looking at risk management practices going forward and I will ask Ms. Williams to give you a little bit of an outline on what he has asked us to do, and we will be reporting on that shortly.

But this is an area that I think is really in need of attention going forward. This is the role that we would see the systemic risk regulatory playing, to monitor the developments and to make that decision. And I think you are going to have to rely on the regulators to make the decision as to whether to intervene or not. There is the possibility perhaps of allowing pilots to go forward without it being system-wide. There are other cases where you may want to be watching it, monitoring it for a while very closely. But this risk management that we have in mind needs to be an active risk manager, not over-reactive, but not under-reactive, as well.

Orice?

Ms. WILLIAMS. Basically, what we are going to do on this engagement, we are looking at risk management oversight. We are specifically interested in what the Federal regulators do when they look at risk management at an institution, how they actually go about examining that particular aspect of a financial institution, and then we are looking at how the regulators identify risk that they are going to focus on in an examination, because they do risk-based examinations, to see how often risk management bubbled up in the past several years up to the current point. And then finally, we are looking at the resources that are dedicated to the examination function across the banking regulators, as well as the SEC.

Senator JOHANNS. One other thing I wanted to ask you about as you start to look at this is the whole issue of offloading risk, and maybe there is no solution to that, but it seemed to me this system got created in such a way that the premium for me as the broker was to write the loan at all costs, whatever I could do to get that person to sign on the dotted line, then it is packaged and it is sold off and the risk goes to somebody else and somebody else or whatever.

I would really like to hear your thoughts on how to deal with that, because—and maybe that gets back to the issue of valuation again. But to me, that seems to be an important element as we think about what we want to do with the regulatory system.

Mr. HILLMAN. When you go back a decade or more, the process that depository institutions typically followed in funding mortgages is they would have their own underwriters review the competency of individuals to pay those loans and they would go through a detailed process before making a decision to provide a loan to an individual. Once that decision was made, they would hold that risk or hold that loan on their books themselves.

Today, most oftentimes that is not the case. The case is a model of originate to distribute, where institutions are making decisions and receiving a fee for that service and passing that risk on to others. This originate to distribute model is one of the reasons why we have resulted in the crisis that we are in today and some say that additional attention is going to be needed in the future to help to ensure that at least some responsibilities are being held by each of the individual parties along the way to ensure the appropriateness of decisionmaking at each of those levels.

Senator JOHANNS. Can I often one last piece to this? That piece would be the thought of rating the risk. Is that an appropriate governmental function? For example, if my bank wants to go out and originate junk in the hopes of marketing it, we should call it that. If, on the other hand, they are following a model of caution and due diligence and doing the very best they can to make sure that those loans are going to be repaid, that should be viewed differently.

But the important thing is, how do we let the consumer know that? How do I, Mike Johanns, going in to make my deposit, how do I know that those practices have been employed, so if I buy their stock or invest my money in that stock or whatever, I am an informed consumer? These are complicated issues, but I think that is what we are trying to get to here, is to protect the consumer.

Mr. DODARO. I think basically the answer to that question, Senator, I think involves safeguards at various levels. You need to have the regulators in the examination be clear that the institutions are following due diligence, good practices; second, there is proper disclosure; and then third, there is education, and then a consumer protection safeguard in place.

So it is a very important question. It runs—the threat of it runs through all these various areas that we are talking about. I don't think there is one solution to it, but it is something that needs to be looked at on a comprehensive basis because it is pivotal to the decisionmaking that takes place within all these various levels of institutions and products.

Senator JOHANNS. We have run out of time, but my final thought, Mr. Chairman, is this. If we don't figure this piece out, the mechanism won't make a bit of difference. We can create this. We can put it under the Fed. We can do whatever, whatever, but if you don't solve that piece of it, then they are almost guaranteed to fail as a regulator and we will be back to reports like you just wrote.

Mr. DODARO. Yes, and basically, that is why we set out those characteristics, because if you address all the characteristics, we believe you will get at this issue. This isn't just the question of moving boxes around and solving a problem. It is not anywhere near that simple.

Senator JOHANNS. I went over my time, so thank you.

Chairman DODD. No, you didn't, Senator. You just made a very, very valuable point to me, because if there is that common denominator, as Mr. Dodaro just described that thread, I believe it is consumer protection. I think we have operated for far too long, over the last number of years, where there has been a notion that consumer protection was antithetical to economic growth, that if you were talking consumer protection, you were creating hurdles, barriers to economic growth.

And the painful lesson we have all learned in these last number of months, several years now, is that when consumer protection is foremost in your minds, what happens to that investor, what happens to that customer who walks in, if you are guarding and watching out for them, that you can avoid the very problems we got into.

We didn't watch out, that is we, the regulators, the Government itself, was not watching out for what happened to that purchaser of that mortgage. We were assuming somehow that the system was taking care of them, and they weren't, and so they got cheated in the process. When you abandon the consumer in your analysis of all of this, you put economic growth at risk, and I think your question is right at the heart of it.

We just move boxes around here and create different structures and make it look more simple, but without providing that kind of protection, coming back to the notion that protecting the consumer is absolutely essential for economic growth and the avoidance of the very situation we find ourselves in today, I think is an excellent point. Thank you for it.

Senator Warner?

Senator WARNER. Thank you, Mr. Chairman.

Mr. Dodaro, nice to see you again and, again, compliments on initiating this report and listing it as a top priority for the Congress to take on and the country to take on.

I want to follow up on Senator Johanns' point. One of the areas that has been suggested—and I do not know if you all have weighed in—is if you are originator of one of these mortgages or one of these loans, you keep a stake in the game, that you cannot sell off 100 percent of that risk.

Have you taken a position or do you have a comment on that "stake in the game" notion?

Mr. DODARO. Now, we have not looked at that particular issue, Senator.

Senator WARNER. Mr. Chairman, that is one way, if you are not taking the whole—selling off 100 percent of the risk, as Mr. Hillman mentioned earlier. A decade ago the bank, the originator of the loan, would keep that loan on its books and have a long-term obligation. As they have been securitized and sliced and diced, that connection and bond between the lender and the lendee has disappeared. And one proposal is reconnection and making sure that if you originate, you keep some skin in the game.

Chairman DODD. Absolutely.

Senator WARNER. But let me also follow up on, I think, your appropriate point about protecting the consumer, and it is kind of, again, from a—I keep coming back to, you know, this kind of way we approach this. My concern is, Mr. Chairman, that we clearly need to do a better job of protecting the consumer, but I think we have operated on the premise that transparency and disclosure alone would be enough to protect the consumer. And it seems like we have had two contradictory policy goals. On one level, we want to protect the consumer. On the other level, as we push out these more challenging mortgages or credit cards, the population that we are dealing with are oftentimes the least financially literate.

So what I question, even with more focus on financial literacy programs, is whether disclosure alone is going to get us there and, you know, will there need to be some type of restrictions—again, I come back to my bright lines—on certain products that if you are not, for example, a qualified investor—I spent 20 years in the venture capital business. You know, to invest in my venture capital funds, which were high risk, you had to be a qualified investor.

Do we need to have, in addition to—if we are going to truly protect the consumer, in addition to disclosure and transportation, are we going to need actually some bright-line prohibitions?

Mr. DODARO. I definitely think that the systemic regulator that we are talking about would fulfill that function, or at least that could be one of the functions they fulfill, is to assess the risk level, and there have to be tolerances put in place and balances and decisions made on a case-by-case basis as to whether the risk—you know, assuming you have these clear goals of consumer protection as one of your goals, along with, you know, allowing innovation and capital formation. But, I mean, all those things have to be balanced. But I think you definitely need that in place.

I agree with what you are saying, that, you know, disclosure, transparency alone are not going to be enough. I think you need to have it sort of from one end to the other. One is the regulators need to be protecting the consumers as well as allowing for innovation, all the way through transparency, disclosure, down to educating people more to make them more financially literate.

Senator WARNER. I had a family member who I warned time and again do not get into this adjustable rate mortgage. All the warnings in the world, all the transparency in the world, would not have precluded her from taking a bad long-term action. I was able to bail her out, but now we are looking to a national Uncle Sam bailing everybody out because at some point people with information may still not be making good financial judgments here.

Mr. DODARO. I agree completely.

Senator WARNER. So there has to be some protection component.

Mr. DODARO. Right.

Senator WARNER. I know our time is getting short, but one last question. We have spent a lot of time, again, about all these new financial tools and the over-financial engineering that is taking place. How do we make sure that the regulators stay abreast of these tools and have the skills and the technology and the competency to make sure that they actually understand these new products as they emerge?

Mr. DODARO. Well, I clearly think—and I will ask Ms. Williams to comment on this because she has been doing a lot of our work on these instruments. But, first, clearly the goal has to be set for them to do that. And I think if the Congress sets a statutory—as part of the regulatory goal, an expectation that occur, that is there, I think they need to be given then the authorities to be able to hire the necessary people and compensate them appropriately for doing that. And I do think they would have the capability to be able to do it.

There is no doubt in my mind that you have some very talented people in the regulatory system right now that, given the proper goals and expectations, can, you know, develop in that area. It will not be easy because of the ingenuity of many of the market participants, but I think it is achievable.

Orice, do you have anything?

Ms. WILLIAMS. The only thing that I would add is that this is an area that the regulators are always going to be at a disadvantage in dealing with because the markets are always looking to come up with new and innovative products. But I think one of the things that would really help—and we tried to speak to this with our principal, focused on having, you know, a flexible, nimble process for regulators to be able to adjust, is to get beyond the type of product and the label that is attached to a particular product and really be able to focus on the risk that that product may pose to the system and making that the focus and the driver for whether or not products need to be brought under a regulatory umbrella.

Senator WARNER. So actually making a risk assessment of the product, and then if the assessment was the product was too risky, then perhaps saying some universes of consumers might not be eligible to——

Ms. WILLIAMS. Or that it needs to be, you know, regulated or looked at from a regulatory perspective and not just focus specifically on it meets this statutory definition so, therefore, it falls out of a regulatory jurisdiction versus it poses this particular risk to the system, therefore, it needs to be subject to some level of regulation and oversight.

Senator WARNER. We had that situation last week in the Madoff hearing where we had both SEC and FINRA here, and, you know, asked very much suddenly, you know, on broker-dealers, if somebody says they were an investment adviser and FINRA is looking, they are going to suddenly stop and not turn over that information. These regulatory lines clearly in that case might have precluded exposing a real financial scam.

Ms. WILLIAMS. Exactly. And one example, we have worked looking at credit default swaps, and that is another example of a product that meets a definition and, therefore, there is——

Senator WARNER. No examination beyond meeting the definition.

Ms. WILLIAMS. Exactly.

Senator WARNER. Amen. Thank you very much.

Ms. WILLIAMS. You are welcome.

Senator Akaka.

[Presiding.] Thank you very much, Senator Warner.

Mr. Dodaro, it is good to see you again, and our panel. I am so glad that we have a new team that is addressing the problems that we are facing immediately. And I think you know the history of the so-called Financial Literacy and Education Commission. That is chaired by the Secretary of Treasury, and it has a mission that has really not been carried out. And I think that is an answer to some of the problems that have been mentioned here.

Previously, I heard about protecting the consumers. Well before the current economic crisis that we are facing at this time, financial regulatory systems were failing—failing to adequately protect working families from predatory practices and exploitation. And this Commission was really put in place to try to prepare strategies that would deal with the problems that people in the country would have.

I would tell you that one of the huge problems that this country has is that this country is financially illiterate. And so these financial literacy programs fill that void, and we need to really, I feel, try to bring that back to life and to help the causes here.

Families have been pushed into mortgage products with associated risks and costs that they could not afford. And instead of utilizing affordable, low-cost financial services found at regulated banks and credit unions, too many working families have been exploited by the high cost of fringe financial service providers such as payday lenders and check cashers. I would tell you—and I am sure it is not only in Hawaii—that you find offices like these outside of our bases, and so our military personnel really suffer on this.

So my question to you, Mr. Dodaro, is: How do we create a regulatory structure that better protects working families against predatory practices?

Mr. DODARO. I will ask Rick to elaborate on the Financial Literacy Commission, Senator Akaka, but first, it is a pleasure to see you again as well.

We have studied the Financial Literacy Commission. We have also studied issues relating to information being provided to our military families to educate them. Ms. Williams was involved in that, and we can provide that information for the record as well.

But I think, clearly, the issue first has to be a clear articulation of consumer protection being a clear goal of the regulatory system, to have it organized properly, resourced properly, and there needs to be continual congressional oversight. I think this is an area that the whole financial regulatory system needs to have some ongoing oversight activities. Even if the Congress makes the determination that the system is going to be modernized and a new system is put in place, the idea that that would operate effectively from day one without continual refinement and oversight I think is an unrealistic goal.

And so I would say there needs to be a proper transition and it needs to be followed through on oversight. But let me have Rick talk about the Financial Literacy Commission, because I could not agree with you more about its importance.

Senator AKAKA. Thank you.

Mr. HILLMAN. We recently completed a report assessing the Financial Literacy Commission at the Department of Treasury. Exactly as you have said, this Commission was established to help to promote financial literacy on a nationwide level. It brought together over 20 departments and agencies who had financial literacy programs with the hope of consolidating those efforts and distributing those out to the nations in need. What we have found, however, though, is that the Commission itself is well understaffed and unable to achieve the mission which it was set up to accomplish.

For example, one of the activities that the Commission undertook was to ask each of these agencies to determine the extent to which they had any overlap or duplication in the individual financial literacy initiatives that they had undertaken. And due to a lack of resources, they asked each of the agencies to themselves make that assessment as opposed to having some sort of expert assessment done by an outside party.

That internal assessment came up with very limited suggestions as to how the financial literacy programs could be improved, and we made a recommendation that they seek additional expertise to assess the effectiveness of those programs.

Regarding the notion on the military bases, we have done significant work and we have work ongoing now that is looking at the extent to which sales of financial products to the military, particularly egregious insurance products, are continuing to cause havoc on bases. Sadly, we are finding that that continues to be the case.

One of the major limitations associated with the oversight of payday lenders and other types of establishments that you mentioned in your State that is rampant across all States has to do with the fact that those types of associations that fall outside of the reach of a financial services regulator are under the regulatory authority of the Federal Trade Commission. The Federal Trade Commission is largely an enforcement agency, not an oversight agency. It is a small organization with significant responsibilities, and currently configured, it is simply unable to achieve the level of oversight that most would like to have.

Senator AKAKA. Yes, and I also understand that the Commission, as you said, has been understaffed. Also, they are having problems trying to come to some consensus among themselves, the 20 Federal agencies, and simply because they have different missions and perspectives. But I hope that we can look at these missions and perspectives as a means of bringing a solution to this particular problem. And part of the mission, of course, is education, and this is one thing that we really need to press across the country. And I feel that if more of the citizens of this country were better educated financially, some of the problems we are facing now may not have been as large as this.

But I think we need to, Mr. Dodaro, work on this Commission to make it more effective and to use its efforts to deal with financial literacy in the country.

Mr. DODARO. I agree, Mr. Chairman, and we would be happy to follow up on our report and provide a follow-up activity report on how well they have implemented the recommendations to the Committee.

Senator AKAKA. Well, let me thank you for your January 2009 report, and I have seen parts of it, and your report states that:

> New and more complex products raise challenges for regulators in addressing financial literacy. Without sufficient financial literacy, individuals will not be able to effectively evaluate credit and investing opportunities or be able to cope with difficult economic situations.

And we agree with that.

My question to you is: How can we ensure that in a new regulatory structure financial literacy is effectively addressed?

Mr. DODARO. I think in the characteristics that we point out in our January report, Senator, we point out a couple things, characteristics that are pivotal to this issue. One is clear articulation in statute of a regulatory goal. So this needs to be clearly articulated. Someone has to be given the responsibility for doing it, proper resources, proper accountability back to the Congress, and I think that there needs to just be follow-up.

This is not a hugely difficult task in the sense if we make a priority and then we apply the proper resources and we ensure people are following through on this initiative. Plus I think this is one that if there is work to be done with our education system, there needs to be an integrated fashion, you know, put in place to be able to do this.

One of the things that I almost did rather than come to GAO many, many years ago is I had an idea to start a class to be taught in high schools on this very issue at that point in time because I think it is very important. It has got to start early with people and be built into the education system, and then it has to be reinforced on a more sophisticated level as people take on additional responsibilities and begin working and making larger purchases going forward.

Senator AKAKA. Well, I want to thank our witnesses today for appearing here, and I apologize for Chairman Dodd, who was called away. That is why he is not here. And I want to thank you again for your responses.

The hearing record will remain open for additional statements and questions, and, again, I thank you for your responses and look forward to having you in hearings in the future.

This hearing is adjourned.

[Whereupon, at 5:36 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

STATEMENT OF SENATOR CHARLES SCHUMER

First, I'd like to thank Chairman Dodd for holding the first of what I'm sure will be many hearings on financial regulatory reform. For decades, America generally, and New York in particular, have been the financial capitals of the world. Our markets have been the deepest, most liquid and safest. Our dominant position was built not only on our talent, ingenuity and expertise, but also on a foundation of strong but efficient regulation, and a reputation for fairness, that demonstrated to investors that they would be protected from fraud and financial recklessness here. The events of past 24 months have destroyed our reputation as the system has been gripped by a financial crisis that resulted from years of regulatory neglect at all levels.

Eight years of the Bush Administration's one-sided, laissez-faire, deregulatory ideology have helped cripple our financial system, and an outdated and overmatched regulatory system in this country compounded their failure. Even former Federal Reserve Chairman Alan Greenspan, once an ardent defender of deregulation and the free market, recently acknowledged that there was a "flaw" in his belief that markets could and would regulate themselves. I hope that we've learned that as appealing as deregulation may seem in good times, the price we ultimately pay will be far higher than had we exercised the good judgment and restraint imposed by responsible regulation.

Designing a regulatory system is a complicated and difficult task. Regulation must strike a delicate balance—providing a sense of safety and security for investors, without snuffing out the flame of entrepreneurial vigor and financial innovation that drives economic growth.

It's easy, and even tempting, to go to the ideological extremes on either end of the spectrum. But threading this needle correctly is an essential component of restoring confidence and long-term stability to the financial system.

For many years, the United States had struck that balance very well. However, new factors, including technology, globalization, and industry consolidation and evolution have left our regulatory infrastructure too far behind the reality of today's global financial system.

Where does this leave us? Well, it leaves us needing significant reform. As we go forward, I believe there are a number of clear principles that we must adhere to. I've discussed these principles before, but I think they're worth repeating now as we begin the discussion of regulatory reform under a new Administration.

1.) *We must focus on controlling systemic risk and ensuring stability.*

In increasingly complex markets, even the most sophisticated financial institutions don't always understand the risks their decisions involve. Smaller institutions like some hedge funds and private equity firms, can also create systemic risk in today's world and cannot escape regulation, particularly when it comes to transparency. We need regulation that looks at risk systemically and above all, we need to ensure that whatever may happen to any individual financial actor, we can be confident that the financial system itself will remain strong and stable.

2.) *We need to look closely at unifying and simplifying our regulatory structure.*

In this era of global markets and global actors, we cannot maintain the older model of separate businesses with separate regulators. Right now there are too many regulators at the Federal level with overlapping authority. This creates a regulatory "race to the bottom" as less responsible firms are able to play the regulators off one another in their efforts to operate with as little oversight and as few restrictions as possible.

3.) *It is clear that we must figure out how to regulate currently unregulated parts of the financial markets and opaque and complex financial instruments.*

There are too many vital players and products in the financial markets that operate beyond the scope of Federal regulators, yet have the ability to put the system at risk. We must create an effective regulatory framework for those actors and for more exotic financial instruments like complex derivatives and even the relatively plain vanilla credit-default swaps, which have grown into a multi-trillion dollar part of the financial system.

4.) *We must recognize that a global financial world requires global solutions.*

In this era of global finance, while we have international markets, we still have national regulations. The danger is that there is often a rush to the place where regulation is lightest and least effective. This may be our toughest challenge.

5.) *Increased transparency must be a central goal.*

We must continue to emphasize transparency among all market participants. The ability of investors, lenders and especially regulators to evaluate the quality of holdings and borrowings is essential for restoring confidence.

A complete overhaul of this nation's financial regulatory system will be difficult, complex and time consuming. I look forward to working with President Obama, and under the leadership of Chairman Dodd to advance this process so that as we begin to recover from the current financial crisis in the coming months, we have a system in place to prevent its repetition.

PREPARED STATEMENT OF PAUL A. VOLCKER

CHAIRMAN, STEERING COMMITTEE OF THE GROUP OF 30

FEBRUARY 4, 2009

Mr. Chairman and Members of the Senate Banking Committee:

I appreciate your invitation to discuss the recent Report on Financial Reform issued by the "Group of 30". I remind you that the Group is international, bringing together members with broad financial experience from both the private and public sectors and drawn from both highly developed and emerging economies. While certainly relevant to the United States, most of the recommendations are generally applicable among globally active financial markets.

I understand that the text of the Report has been distributed to you and your staff and will be included in the Committee record. Accordingly, my statement will be short.

What is evident is that we meet at a time of acute distress in financial markets with strongly adverse effects on the economy more broadly. There is a clear need for early and effective governmental programs both to support economic activity and to ease the flow of credit. It is also evident that fundamental changes and reform of the financial system will be required to assure that strong, competitive and innovative private financial markets can in the future again support economic growth without risk of a systemic financial breakdown.

It is that latter challenge to which the G–30 Report is addressed. I understand that President Obama and his administration will soon place before you a specific program for dealing with the banking crisis. Such emergency measures are not the subject of our Report. However, I do believe that the implementation of the more immediate measures will be facilitated by an agreed sense of the essential elements of a reformed financial system.

In that respect, the basic thrust of the G–30 Report is to distinguish among the basic functions of any financial system. First, there is a need for strong and stable institutions serving the needs of individuals, businesses, governments, and others for a safe and sound repository of funds, as a reliable source of credit, and for a robust financial infrastructure able to withstand and diffuse shocks and volatility. I think of this as the service-oriented part of the financial system dealing with customer relationships. It is characterized mainly by commercial banks that have long been supported and protected by deposit insurance, access to Federal Reserve credit, and other elements of the Federal safety net.

What has become apparent during this period of crisis is increasing concentration in banking and the importance of official support for systemically important institutions at risk of failure. What is apparent is that a sudden breakdown or discontinuity in the functioning of such institutions risks widespread repercussions on markets, on closely interconnected financial institutions, and on the broader economy.

The design of any financial system raises large questions about the appropriate criteria for, and the ways and means of, providing official support for these systemically important institutions.

In common ground with virtually all official and private analysts, the Report calls for "particularly close regulation and supervision, meeting high and common international standards" for institutions deemed systemically critical. It also explicitly calls for restrictions on "proprietary activities that present particularly high risks and serious conflicts of interest" deemed inconsistent with the primary responsibilities of those institutions. Of relevance in the light of recent efforts of some commercial enterprises to recast financial affiliates as bank holding companies, the Report strongly urges continuing past U.S. practice of prohibiting ownership or control of Government-insured, deposit-taking institutions by non-financial firms.

Secondly, the Report implicitly assumes that, while regulated banking institutions will be dominant providers of financial services, a variety of capital market institutions will remain active. Organized markets and private pools of capital will be engaging in trading, transformation of credit instruments, and developing derivatives and hedging strategies, and other innovative activities, potentially adding to market efficiency and flexibility.

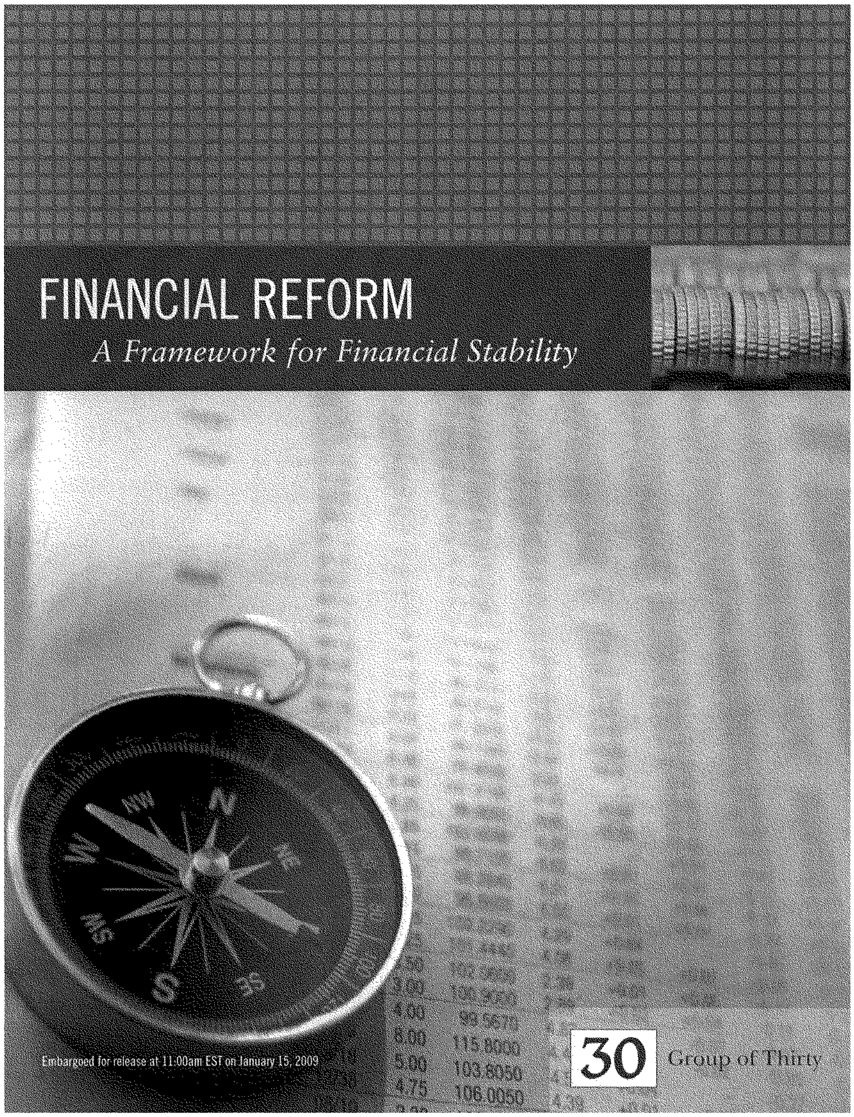
These institutions do not directly serve the general public and individually are less likely to be of systemic significance. Nonetheless, experience strongly points to the need for greater transparency. Specifically beyond some minimum size, registration of hedge and equity funds, should be required, and if substantial use of borrowed funds takes place, an appropriate regulator should be able to require periodic reporting and appropriate disclosure. Furthermore, in those exceptional cases when size, leverage, or other characteristics pose potential systemic concerns, the regulator should be able to establish appropriate standards for capital, liquidity and risk management.

The Report does not deal with important and sensitive questions of the appropriate administrative arrangements for the regulatory and supervisory functions. These are in any case likely to be influenced by particular national traditions and concerns. What is emphasized is that the quality and effectiveness of prudential regulation and supervision must be improved. Insulation from political and private special interests is a key, along with adequate and highly competent staffing. That implies adequate funding.

The precise role and extent of the central bank with respect to regulation and supervision is not defined, and is likely to vary country by country. There is, however, a strong consensus that central banks should accept a continuing role in promoting and maintaining financial stability, not just in times of crisis, but in anticipating and dealing with points of vulnerability and risk.

The Report deals with many more specific issues cutting across all institutions and financial markets. These include institutional and regulatory standards for governance and risk management, an appropriate accounting framework (including common international standards), reform of credit rating agencies, and appropriate disclosure and transparency standards for derivatives and securitized credits. Specifically, the Report calls for ending the hybrid private/public nature of the two very large Government-sponsored mortgage enterprises in the United States. Under the pressure of financial crisis, they have not been able to serve either their public purposes or private stockholders successfully. To the extent the Government wishes to provide support for the residential mortgage market, it should do so by means of clearly designated Government agencies.

Finally, I want to emphasize that success in the reform effort, in the context of global markets and global institutions, will require consistency in approach among countries participating significantly in international markets. There are established fora for working toward such coordination. I trust the forthcoming G–20 meeting, bringing together leaders of so many relevant nations, can provide impetus for thoughtful and lasting reform.


FINANCIAL REFORM
A Framework for Financial Stability
Embargoed for release at 11:00am EST on January 15, 2009
30 Group of Thirty

About the Authors

The views expressed in this paper are those of the Working Group on Financial Reform and do not necessarily represent the views of all of the individual members of the Group of Thirty.

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FINANCIAL REFORM

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ACRONYMS AND ABBREVIATIONS

CCP	Central counterparty [clearing]
CDO	Collateralized debt obligation
CDS	Credit default swap
CLO	Collateralized loan obligation
CRMPG	Counterparty Risk Management Policy Group
FDIC	Federal Deposit Insurance Corporation
FVA	Fair value accounting
GSE	Government-Sponsored Enterprise
NAV	Net asset value
NRSROs	Nationally Recognized Securities Ratings Organizations
OTC	Over-the-counter
SEC	Securities and Exchange Commission
SIV	Structured Investment Vehicle
TARP	Troubled Asset Relief Program

FOREWORD

In July 2008, the Group of Thirty (G30) launched a project on financial reform under the leadership of a Steering Committee chaired by Paul A. Volcker, with Tommaso Padoa-Schioppa and Arminio Fraga Neto as its Vice Chairmen. They were supported by other G30 members who participated in an informal working group. All members (apart from those with current and prospective national official responsibilities) have had the opportunity to review and discuss preliminary drafts.

The Report is the responsibility of the Steering Committee and reflects broad areas of agreement among the participating G30 members, who participated in their individual capacities. The Report does not reflect the official views of those in policymaking positions or in leadership roles in the private sector. Where there are substantial differences in emphasis and substance, they are noted in the text.

The G30 undertook this project as the global financial crisis entered its second year. The analysis has been informed by the extreme events later in 2008, which rocked the very foundation of the established financial system and which led to unprecedented and massive government intervention both in the United States and in many other countries to contain a spreading financial panic.

The Report does not address the need for these or possible further emergency actions. Difficult questions of weaning markets and financial institutions from official life support are sure to arise. While the analysis and recommendations deal in some instances with the need for legislation, regulation, and supervision, the Report is not directed toward questions about the appropriate focus and nature of national administrative arrangements. These are, in any event, influenced by the particular constitutional, legal, and administrative traditions of individual nations and regional arrangements.

The Report, rather, focuses on how the financial system might reasonably be organized once the present crisis has passed, to better assure a reasonable degree of stability. Policymakers, central bankers, and financial regulators will necessarily remain focused on dealing with immediate threats to the effective functioning of markets. However, in taking what are in effect emergency measures, a consensus on the desirable and lasting elements of a reformed system can be useful, and even necessary, to speed restoration of confidence in sturdy, competitive, and efficient financial arrangements serving both national and international markets. The Report, benefitting from the experience and broad perspective of G30 members, is intended to help inform the needed debate among policymakers and the international financial community on these issues. The Report addresses:

a. The policy issues related to redefining the scope and boundaries of prudential regulation;

b. Reforming the structure of prudential regulation, including the role of central banks, the implications for the workings of "lender-of-last-resort" facilities and other elements of the official "safety net," and the need for greater international coordination;
c. Improving governance, risk management, regulatory policies, and accounting practices and standards; and
d. Improvements in transparency and financial infrastructure arrangements.

Two final notes are in order.

First, this Report is intended to be useful to policymakers in all the countries whose financial systems have been disrupted in this crisis. For this reason, most recommendations are framed in terms that should permit consideration in different countries in a fashion that takes account of particular features of their national systems. However, since this crisis has been rooted in developments within the United States, and given the particular importance of reforms to the U.S. financial system in terms of its size and global impact, several of the issues and recommendations have a direct U.S. focus.

Second, the focus of this Report is on the safety and soundness aspects of financial regulation. There are many other important aspects of financial regulation that are touched upon here only to the extent that they bear on financial stability, including competition policies, customer and investor protection, market practices oversight, and financial fraud and crime prevention. Also, to the extent distinctions are drawn between regulation and supervision, the former encompasses the setting of policies, principles, rules, and standards, while the latter encompasses the judgmental application of those policies and standards to particular institutions.

The key issue posed by the present crisis is crystal clear: How can we restore strong, competitive, innovative financial markets to support global economic growth without once again risking a breakdown in market functioning so severe as to put the world economies at risk?

The search for viable answers to that question needs to begin.

Paul A. Volcker
Chairman of the Trustees
The Group of Thirty

Jacob A. Frenkel
Chairman
The Group of Thirty

ACKNOWLEDGEMENTS

On behalf of the entire Group of Thirty (G30), I would like to express appreciation to those whose time, talent, and energy have driven this project to successful fruition.

In particular, we acknowledge the leadership of the Steering Committee, chaired by Paul Volcker and Vice Chairmen Arminio Fraga Neto and Tommaso Padoa-Schioppa. Their collective understanding of the nature of the financial crisis and insights as to the necessary reforms are invaluable.

Special recognition must also go to those members of the G30 who actively participated in the working group project deliberations and discussions.

Crafting a thoughtful report that addresses many difficult supervisory, regulatory, market, and other matters requires considerable knowledge of the issues and an ability to synthesize the views of numerous individuals. We particularly appreciate the work of Stephen Thieke, who served as principal draftsman of the report, who brought extraordinary experience and accomplishment to that role and to our deliberations.

We would also like to thank a number of experts who advised the Steering Group and participated in our deliberations. In particular, thanks go to Mark Walker, Alan Beller, and Mayree Clark. Several institutions provided valuable in-kind support to the project including: Cleary Gottlieb Steen and Hamilton LLP, Promontory Financial Group, and RiskMetrics.

Thanks also to the editor, Diane Stamm, and the designers, Sarah McPhie and Katie Burgess, for their dedicated efforts and flexibility when working on this project.

Finally, the coordination of this project and the many aspects of report production had their logistical center at the offices of the Group of Thirty. This project could not have been completed without the efforts of Executive Director Stuart Mackintosh, Sviatlana Francis, and Nicole Firment of the Group of Thirty.

Jacob A. Frenkel
Chairman
The Group of Thirty

FINANCIAL REFORM WORKING GROUP

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INTRODUCTION

Market economies require robust and competitive financial systems, national and international, to intermediate between those with financial resources and those with productive and innovative uses for those resources. That intermediation necessarily poses risks—risk with respect to bridging maturity preferences of savers and borrowers and risk with respect to creditworthiness. The process, to be effective, depends on mutual trust—trust based on confidence in the integrity of institutions and the continuity of markets. That confidence, taken for granted in well-functioning financial systems, has been lost in the present crisis, in substantial part due to its recent complexity and opacity.

The costs and economic implications of the present crisis cannot be fully known at this point, but we know they are severe, whether measured in trillions of dollars, in the length and depth of the worldwide recession, or in the simple human terms of unemployment and shattered personal finances. We also know that there is a need for comprehensive reform that addresses the major institutional, market, regulatory, policy, and infrastructure weaknesses that have been exposed.

These include weak credit appraisal and underwriting standards; extreme and sometimes unrealized credit concentrations; misjudged maturity mismatches; wildly excessive use of leverage on and off balance sheets, often imbedded in little-understood financial products; and unwarranted and unsustainable confidence in uninterrupted market liquidity. Gaps in regulatory oversight, accounting, and risk management practices that exaggerated cycles, a flawed system of credit ratings, and weakness in governance also need attention.

To some degree, these factors have been evident in other, less damaging periods of financial crises. Two unique features have worked together to help account for the extent of the current market breakdown. Highly aggressive and unbalanced compensation practices have strongly encouraged risk taking over prudence. At the same time, highly engineered financial instruments, in their complexity, obscured the risk and uncertainties inherent in those instruments, giving rise to false confidence and heavy use of leverage to enhance profits, as asset prices rose. As those asset prices began declining, the risks became apparent, triggering sales of assets. A downward spiral of deleveraging has undermined the stability of even the largest financial institutions at the core of the system, contributing to an economic contraction of global proportions. Authorities in most countries have been stretched to and even beyond the limits of their capacity to restore liquidity and contain the instability.

This Report is organized as follows. Part 1 lays out an overview of a program of reform, the Group of Thirty guiding principles, and core recommendations. Part 2 through Part 5 lay out the reasoning behind and content of 18 specific policy recommendations. Specifically, Part 2 reviews the policy issues related to redefining the boundaries of prudential regulation; Part 3 reviews issues related to the strengthening of prudential regulation, including the role of central banks, and international coordination; Part 4 addresses matters related to improving governance, risk management, regulatory policies, and accounting policies; Part 5 concerns needed improvements in transparency and financial infrastructure, including arrangements for clearing and settling over-the-counter transactions; Part 6 provides a concluding comment; and a full list of the recommendations provided throughout the Report can be found in the Appendix.

PART 1

An Overview of a Program for Reform

Recent market-driven forces, combined with the official responses, have set in motion strong pressures for consolidation within financial systems and wholesale changes in the structure of such systems. The potential for undue concentration, unfair competition, and increasing conflicts of interest will require attention. Massive extensions of the scale and reach of government safety nets protecting the financial system raise practical questions of fair and predictable official intervention, including issues arising from resulting government ownership interest, and, more fundamentally, questions as to the appropriate boundaries and expectations of such interventions by both financial institutions and their customers. The clear implication is that at least the very large and complex banking organizations that now account for so much of the extensions of credit and carry the major responsibility for maintaining the financial infrastructure will need to be held to more rigorous standards of prudential regulation and supervision, with new constraints on the type and scope of their risk-taking activities. Confidence in capital markets will also have to be restored, with more transparent and understandable markets and products.

At the same time, while there can be little doubt about the need for more effective official oversight, care must be taken not to extend the reach of regulations too far or too deeply. The new financial system must not become so entangled in restrictions that it cannot flexibly and efficiently support the process of financial intermediation so essential to economic progress.

A reform program that reflects a sensible balance between these considerations should help bring about:

- A system with clearer boundaries between those institutions and financial activities that require substantial formal prudential regulation for reasons of financial stability and those that do not.
- A system with stronger regulatory incentives for holding large (systemically significant) institutions to the highest standards of governance and risk management.
- A system in which there is more scope for using regulatory policies to mitigate inherent tendencies toward destabilizing excesses in risk taking and risk aversion.
- A system with a more robust failure resolution regime, having the practical capacity to permit orderly closings of large financial institutions and the administration of safety net resources in a manner that reinforces discipline on managers, shareholders, and sophisticated creditors.
- A system in which those responsible for prudential regulation and supervision have a high degree of political and market independence, and the resources necessary to supervise giant institutions and to keep abreast of market innovations.
- A system in which central bank responsibilities for promoting financial stability are supported by adequate authority and capacity.

- A system in which there are stronger incentives to achieve higher levels of risk transparency as regards financial products, markets, and institutions.
- A system in which there is a higher degree of international consistency and coordination as regards regulatory, supervisory, and accounting policies and crisis resolution practices.

GUIDING PRINCIPLES FOR FINANCIAL REFORM

The overall objective of the needed reform of the financial system must be to encourage diverse, competitive, predominantly privately owned and managed institutions and markets, able to efficiently and flexibly meet the needs of global, national, and local businesses, governments, and individuals. That broad objective, whether achieved through the spontaneous forces released by the current crisis or by considered public policy—most likely by a combination of the two—must also encompass assurance that instability in free financial markets not again reach the point of undermining the functioning of national or international economies.

In rebuilding what is now a broken system to meet those needs, certain guiding principles are particularly relevant. The recommendations set out in this report are responsive to these principles.

1. The Public Sector Role in Safeguarding Financial Stability

The inherent volatility of free and open financial markets, and the danger that volatility may occasionally reach crisis proportions threatening economic stability, needs to be recognized in the design of the financial system. The primary aim of prudential regulation should be to maintain the health of the system and contain systemic risk by:

a. Subjecting the largest and most complex banking organizations judged to be systemically important to the highest international standards for ongoing close regulation and supervision.
b. Requiring non-bank financial institutions that are also judged potentially to be of systemic importance to be subject to some form of formal prudential regulation and supervision to assure appropriate standards for capital, liquidity, and risk management.
c. Assuring critical elements of the infrastructure supporting the financial system, including clearing and settlement systems and related legal frameworks, are made sufficiently robust to permit the orderly closing of large, complex financial institutions.
d. Avoiding accounting, regulatory, or other practices that may inadvertently reinforce recurrent tendencies toward excessive exuberance or risk aversion.

2. Fair and Effective Competition

To enhance fair and effective competition, regulatory policies and approaches should, insofar as feasible, treat financial services common to different institutions uniformly by seeking:

a. A balance between the benefits of open and free competition and the potential for unfair competition arising from explicit and implicit government protection, excessive concentration of financial resources, or extensive conflicts of interest.

b. A balance between the protection implicit in access to central bank liquidity support for systemically important institutions and restrictions on risk-prone activities or those that present unmanageable conflicts of interest.

3. Official Oversight and Crisis Response

While the precise arrangements may differ among countries, official oversight and crisis response require building a strong, professionally managed structure of public agencies, with substantial insulation from particular political or private interests by assuring:

a. Central banks, given their traditional role and concerns for financial stability, their financial resources, their responsibilities as "lender-of-last-resort," and their typically professional management and high degree of independence within governments, have an important role in regulatory rules and oversight;

b. In those rare and exceptional instances of crisis when budgetary resources are required or governmental funds are placed at risk, the responsibility lies with the appropriate governmental authorities to authorize such expenditures and to affirm and support central bank decisions.

c. Basic crisis resolution procedures and resources should be available to official agencies to deal with instances of institutional failure so severe as to potentially impair system functioning.

4. International Consistency and Coordination

Effective application of these principles requires a substantial degree of international consistency in approach and coordination by means of:

a. Reviewing and reinforcing existing efforts to achieve common capital, accounting, and reporting standards.

b. Achieving a clear understanding of an appropriate response to failures or near failures of internationally active and systemically important financial institutions.

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5. Governance and Risk Management

The need for high standards of institutional governance and risk management must be recognized, with emphasis on:

a. Engaged and knowledgeable independent boards of directors focused on long-run performance;
b. A corporate culture of governance that demands well-balanced compensation policies and practices and fosters incentives for disciplined risk management, including strong and independent risk management staffs;
c. Regulatory and supervisory policies that reinforce those practices and incentives.

BOX 1 Key Characteristics of "Systemically Significant" Institutions

[illegible]

1. **Size.** [illegible]

2. **Leverage.** [illegible]

3. **Scale of Interconnectedness.** [illegible]

4. **The Systemic Significance of Infrastructure Services.** [illegible]

Throughout these principles, a consistent theme is the importance of containing systemic risk and maintaining close oversight of "systemically important" financial institutions. If the financial industry and markets are to operate, as far as possible, according to the principles of competitive markets, then exits of firms that are unprofitable and ineffective must be accepted. Regulation and supervision cannot and should not pursue an objective of zero failures even among the largest players. The primary aim of prudential regulation is to maintain the health of the system as a whole and contain systemic risk. The appropriate standards for judging regulatory effectiveness are limiting the potential for wildly disruptive institutional failures, managing the process of failures when they occur in a way that reinforces discipline on senior management and shareholders, and containing the market fallout from such failures.

There are general characteristics that together define a financial institution as "potentially systemically significant." These are size, leverage, scale of interconnectedness, and the degree to which the company provides infrastructure services critical to the markets. These characteristics are described more fully in Box 1.

In practice, it is some combination of these characteristics that make for a potential "systemically important" financial institution. While these criteria can be defined in advance in general terms, it would not be sensible or prudent for regulators to define them with statistical precision or inflexibly. Rather, a country's prudential regulator—in cooperation with its central bank in those countries where these roles are separate—should have sufficient authority to set and modify criteria used to make these determinations. The end result should be a basis for identifying firms that are likely to require potential regulatory intervention to manage the process of failure and hence also require more preventative oversight.

The common expression "too big to fail" is both misleading and too facile to reflect the reality of official support for "failing" institutions. In perhaps the most typical scenario, the institution is in fact permitted to fail, in the sense that practically all equity investments are lost. Depositors and often other unsophisticated creditors are protected, but the institution loses its identity by liquidation, merger, or effective public ownership. In some recent instances, support has been provided in a way that not only has protected all types of creditors, but has also let stockholders retain some equity interest with a hope of recovery, thus more accurately fitting the description of "too big to fail."

FOUR CORE RECOMMENDATIONS

The reform proposals described in the body of this report consist of an extensive set of interrelated changes in policies, practices, and market standards. These are best viewed in the context of the following four broadly stated core recommendations, which provide a framework for the overall program of reform:

I. **Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated.** All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight. (Recommendations 1 through 5.)

II. **The quality and effectiveness of prudential regulation and supervision must be improved.** This will require better-resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination. (Recommendations 6 through 8.)

III. **Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity.** Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices (Recommendations 9 through 12.)

IV. **Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.** (Recommendations 13 through 18.)

PART 2

Redefining the Boundaries of Prudential Regulation

CORE RECOMMENDATION I

Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight.

Financial institutions and the system in which they operate develop in response to an ongoing dynamic tension among competitive market forces, innovations that alter those forces, and laws and regulations that constrain choices, influence innovations, and then respond to subsequent market development. While the increased degree of international integration of financial markets has worked to bring about a degree of convergence in key characteristics of national financial systems, there remain a number of significant differences in the financial institutions structures across the economically most-developed and emerging countries and in the nature of official response to failures and market disruptions.

In times of financial crisis, such as we are now experiencing, these differences can have an important bearing on how a crisis unfolds and what type of policy responses are required. Significantly, actions taken by one or more European countries to protect depositors rapidly influenced flows of funds in other national jurisdictions with different banking systems and regulatory authorities. Because of a number of distinguishing institutional characteristics, the current crisis has raised an unusually large number of questions within the United States as to how best to define the boundaries for prudential regulation and supervision.

The U.S. financial system is large, complex, and multifaceted, with characteristics distinguishing it from systems in other major countries. These characteristics, which have led to particular challenges in responding to the current crisis, are: (a) the relative size and importance of capital markets; (b) the relative size and importance (until recently) of stand-alone investments banks; (c) the regional and local nature of much of the deposit banking system; (d) the nature of the regulation of the insurance sector; (e) the size of federal government direct and sponsored involvement in market-based credit intermediation; and (f) the complexity of the structure of U.S. regulation and supervision. (These characteristics are described in more detail in Box 2).

In several important respects, it was problems at firms that were underregulated or unregulated that became a flash point for the spread of the subprime mortgage crisis. At the start of 2008, there were eight very large non-bank U.S. financial firms that should have been regarded as systemically significant; five investment banks, the world's largest insurance company, and two Government-Sponsored Enterprises (GSEs). All of these firms have been radically transformed.

There was also a run on U.S. money market mutual funds, leading to a rushed program of temporary federal insurance, backed by an unprecedented use of the resources of the Treasury's Exchange Stabilization Fund. A series of central bank programs have provided sizeable direct support to the commercial paper funding markets. Finally, with the creation of a large fund authorized by Congress, the Troubled Asset Relief Program (TARP), expanded programs of Federal Deposit Insurance Corporation (FDIC) debt guarantees, and extensive central bank asset market support programs, public sector financial support is being provided to the capital structure of institutions and across a broad range of markets.

BOX 2 The U.S. Financial System

The following describes 5 particular characteristics of the U.S. financial system that distinguish it from other systems.

1. **The relative size and importance of capital-market-based credit intermediation channels.** [illegible]

2. **The (until very recently) size and relative importance of stand-alone investment banks, as distinct from commercial banks, in the market-based credit intermediation process.** [illegible]

3. **The local and regional nature of the deposit-based banking system in the United States.** [illegible]

4. **The absence of national-level regulation of the insurance segment of the U.S. financial system.** [illegible]

5. **The size of direct and sponsored federal government involvement in market-based housing finance channels.** [illegible]

In response to these crisis-driven events and regulatory interventions, the United States is moving rapidly to a financial system in which a small number of exceptionally large bank holding companies are at the core of the system. These firms are, and presumably will continue to be, characterized by a scale and complexity that market participants and Administrations will regard as both too big and too interconnected to be allowed to default on creditor obligations or disappear. Indeed, potential failure would be likely to require extensive government intervention and government assistance, with few if any domestic institutions capable of acquiring them in their entirety.

These core institutions are gaining even larger dominant positions in terms of credit and capital market activities, large-scale corporate banking, nationwide deposit taking, and many other segments of the corporate and retail financial business. If permitted by law and regulation, these firms will likely become integrated across business lines and geographies, will maintain a presence as operators of private pools of capital, will dominate the core of the OTC derivative markets, and will step into any void created by the truncation of the GSEs in terms of various forms of housing finance.

These developments are widely viewed as portending a further round of extensive consolidation in the U.S. banking system. How fast and far that proceeds will depend not only on economic and market developments, but also on how government programs deliberately or otherwise encourage mergers and on how statutory limits on deposit concentration and certain functions are administered or modified.

Plainly, these developments pose public policy issues, including questions of excessive concentration, competitive fairness, moral hazard, and conflicts of interest, which are not new. In the past, they have been dealt with in a piecemeal and poorly coordinated fashion. The rush of recent events and the scale of structural changes that have been set in motion add to both the complexity and urgency of developing more appropriate policies.

In sum, market forces and crisis-driven actions have moved the United States perhaps beyond a point of no return, toward a financial system with a much greater concentration of financial resources and influence in a small number of extremely large and complex banking organizations. In other major countries, concentration in a relatively few institutions has been more common. However, the changes forced by this financial crisis, toward further consolidation in national banking systems and renewed importance of the banking sector relative to non-bank financial and capital market sectors, are of a different magnitude.

The events of 2008 underscore the importance of redefining the boundaries of the official "safety net" and of prudential regulation, strengthening the effectiveness and streamlining the structure of financial regulation, and reassessing the role of central banks and the effectiveness of the tools available to them.

1. Prudential Regulation and Supervision of Banking Organizations

No matter how robust failure management mechanisms are, markets are likely to presume that the largest regulated financial institutions will, to some extent, be protected against the full force of market discipline with the potential consequence of encouraging excessive risk taking—the essence of moral hazard. To compensate for this, and to keep the probability of potential failure of such institutions to acceptably low levels, existing regulatory standards and supervisory approaches will need to be upgraded. The necessary corollary is increased emphasis on the quality and level of regulatory and supervisory resources.

Recent experience in the United States and elsewhere has demonstrated instances in which unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise and its ability to meets its responsibilities to its clients, counterparties, and investors.

These activities, and the "originate-to-distribute" model, which facilitated selling and re-selling highly engineered packages of consolidated loans, are for the most part of relatively recent origin. In essence, these activities all step away from the general concept of relationship banking, resting on individual customer service, toward a more impersonal capital markets transaction-oriented financial system. What is at issue is the extent to which these approaches can sensibly be combined in a single institution, and particularly in those highly protected banking institutions at the core of the financial system.

Almost inevitably, the complexity of much proprietary capital market activity, and the perceived need for confidentiality of such activities, limits transparency for investors and creditors alike. In concept, the risks involved might be reduced by limiting leverage and attaching high capital standards and exceptionally close supervision.

Some members of the G30 feel such an approach could be sufficient to deal with these risks. In practice, any approach must recognize that the extent of such risks, potential volatility, and the conflicts of interests will be difficult to measure and control. Experience demonstrates that under stress, capital and credit resources will be diverted to cover losses, weakening protection of client interests. Complex and unavoidable conflicts of interest among clients and investors can be acute. Moreover, to the extent that these proprietary activities are carried out by firms supervised by government and protected from the full force of potential failure, there is a strong element of unfair competition with "free-standing" institutions. In the last analysis, there is a more intangible aspect highlighted by recent experience. Is it really possible, with all the complexities, risks, and potential conflicts, that even the most dedicated board of directors and top management can understand and maintain control over such a diverse and complex mix of activities?

These questions are related to the issue of whether prudential regulation and supervision should follow functional or consolidated lines: should primary supervision of trading and securities activities, hedge funds, investment management, and other elements of a large banking organization be the responsibility of security or market authorities to facilitate competitive equality, or should a single regulator take responsibility for prudential supervision of an entire diversified banking organization or other institutions of systemic importance? If the consolidation of oversight takes place in an institution apart from the central bank, the "last resort" funder for troubled institutions, what principles can be established to encourage appropriate relationships among the various agencies and with the treasury or finance ministry that carry broad governmental responsibilities?

Setting out a reasonable and desirable approach toward these organizational and regulatory challenges lies at the heart of fashioning the new financial system. The following recommendations suggest such an approach.

Recommendation 1:

a. In all countries, the activities of government-insured, deposit-taking institutions should be subject to prudential regulation and supervision by a single regulator (that is, consolidated supervision). The largest and most complex banking organizations should be subject to particularly close regulation and supervision, meeting high and common international standards.

b. Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Participation in packaging and sale of collective debt instruments should require the retention of a meaningful part of the credit risk.

c. In general, government-insured deposit-taking institutions should not be owned and controlled by unregulated non-financial organizations, and strict limits should be imposed on dealings among such banking institutions and partial non-bank owners.

d. To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries.

2. Consolidated Supervision of Non-Bank Financial Institutions

Recent experience in dealing with troubled but systemically significant non-bank financial institutions in some countries points to the need for consolidated regulation and supervision of such institutions.

Recommendation 2:

a. For those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established.
b. An appropriate prudential regulator should be designated for those large investment banks and broker-dealers that are not organized as bank holding companies.

3. Money Market Mutual Funds and Supervision

The widespread run on money market mutual funds has underscored the dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk. These have been compounded by provision of transaction account services, with withdrawals on demand at par, mimicking the services of regulated commercial banks. A regulatory distinction should be drawn between those services that are most appropriately housed in regulated and supervised banks, particularly the right to withdraw funds on demand at par, and those that can reasonably be provided by mutual funds focused on short-term fixed-rate credit instruments.

Recommendation 3:

a. Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.
b. Those institutions remaining as money market mutual funds should only offer a conservative investment option with modest upside potential at relatively low risk. The vehicles should be clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds, with no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV. Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US$1.00 per share.

4. Oversight of Private Pools of Capital

The issue of the appropriate prudential regulatory treatment of private pools of capital—more specifically, hedge funds—has been considered by policymakers numerous times since the collapse of Long Term Capital Management in 1998. The generally prevailing view has been to continue to rely on a combination of: (a) enhanced market discipline, (b) indirect oversight via close scrutiny of the regulated intermediaries they use for financing and operating services, and (c) moral suasion to encourage the spread of improved risk management and compliance practices. In some jurisdictions, such as the U.K., this has been supplemented by formal regulatory oversight of the local managers—but not the funds themselves—and more formal arrangements to develop best practices standards, which have been encouraged by its recently created Hedge Funds Standards Board.

Taken together, these measures have had some degree of success, in terms of bringing about improvements in hedge fund risk management and funding practices, and improved counterparty risk management practices. Nonetheless, volatility has been greater than anticipated, with instances of strongly adverse consequences for sponsoring institutions, including some of systemic importance.

The question, going forward, is whether experience warrants a continuation of the largely unregulated status of hedge funds, and if not, the extent of such regulation. Several indications point toward limited and flexible official regulation. The need for greater transparency supports the introduction of formal authority to register and track those funds, in terms of size, use of leverage, risk styles, and other important variables. This authority should be associated with the jurisdictions in which the fund managers conduct a majority of their business. Second, efforts to achieve continuous improvement in market and counterparty discipline would be enhanced by formal regulatory authority relative to the funds and managers. Third, the increased emphasis on financial stability in the mandates of prudential regulators and central banks points to the need for greater, more systemic access to information crucial to understanding the potential for growing risk imbalances in the system. Finally, there can be no assurances—especially if this sector continues to grow in relative importance—that the largest, most complex funds might not become a future source of significant systemic risk.

While less pressing, similar considerations may be relevant for large private equity funds operating on the basis of substantial borrowing. In contrast, venture capital funds, dealing by their nature with small companies and providing essential capital and managerial support for entrepreneurial innovation, need to be free of inhibiting oversight.

Recommendation 4:

a. Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator. There should be some minimum size and venture capital exemptions from such registration requirement.

b. The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management. Since introduction of even a modest system of registration and regulation can create a false impression of lower investment risk, disclosure, and suitability standards will have to be reevaluated.
c. For funds above a size judged to be potentially systemically significant, the prudential regulator should have authority to establish appropriate standards for capital, liquidity, and risk management.
d. For these purposes, the jurisdiction of the appropriate prudential regulator should be based on the primary business location of the manager of such funds, regardless of the legal domicile of the funds themselves. Given the global nature of the markets in which such managers and funds operate, it is imperative that a regulatory framework be applied on an internationally consistent basis.

5. Government-Sponsored Enterprises

The hybrid business model of the housing finance Government-Sponsored Enterprises (GSEs), in which they are both profit-seeking private companies and agents of government policy, has been shown to be unworkable over time and particularly in the midst of crises. The sense of an implicit government backing facilitated a degree of leverage and risk taking that proved unsustainable. The specialized regulatory oversight was both inadequate and too susceptible to political pressure. This was compounded by misaligned incentives in bank capital rules for banks to take on oversized exposures to these GSEs. The competition from private market firms further induced the GSEs to expand into higher risk-taking activities and lower underwriting standards in the interests of maintaining a dominant market position. Then, in the face of the fall of housing market prices, the GSEs had lost the capacity to provide strong support for the mortgage market, which was their public mandate. In the end, the government had no choice but to intervene directly.

Two important financial policy lessons are: (a) the crucial importance of clearly separating government financial support from private profit seeking; and (b) the need for any chosen level of government support to be explicit and properly accounted for. These lessons are relevant for other industries and other countries.

Recommendation 5:

a. For the United States, the policy resolution of the appropriate role of GSEs in mortgage finance should be based on a clear separation of the functions of private sector mortgage finance risk intermediation from government sector guarantees or insurance of mortgage credit risk.
b. Governmental entities providing support for the mortgage market by means of market purchases should have explicit statutory backing and financial support. Hybrids of

private ownership with government sponsorship should be avoided. In time, existing GSE mortgage purchasing and portfolio activities should be spun off to private sector entities, with the government, if it desires, maintaining a capacity to intervene in the market through a wholly owned public institution.

PART 3

The Structure of Prudential Regulation and International Coordination

CORE RECOMMENDATION II

The quality and effectiveness of prudential regulation and supervision must be improved. This will require better-resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination.

6. Regulatory Structure

The recent G30 report, *The Structure of Financial Supervision*, presents in some detail the characteristics of four different approaches to the organization of financial regulation and supervision. The four approaches are: institutional, functional, integrated, and twin peaks. These different approaches are described in detail in Box 3.

The conceptual pros and cons of each approach are set out in the earlier report and will not be repeated here. The direction of change is clear—that is, to some variant of either the twin-peaks (regulation by objective) or integrated approach. Either approach, and a number of variants on them, is compatible with the large, bank-centered structures that are emerging within most countries.

BOX 3 The Structure of Financial Supervision

[illegible]

1. **The institutional approach** [illegible] and Mexico.
2. **The functional approach** [illegible]

   [illegible]
3. **The integrated approach** [illegible] as in Germany, Japan, and the United Kingdom.
4. **The twin peaks approach** [illegible]

To a significant extent, the choice of which regulatory structural model to employ has to reflect a balancing of country-specific preferences, with appropriate weight to its founding political principles such as, in the United States, the principles of checks and balances, and a mix of Federal and State authority. There is, therefore, no single correct answer to the question of what is the optimal structure for organizing financial regulation and supervision. There is, however, an emerging consensus around a number of key points, including: (a) the need to substantially simplify and consolidate overly complex structures; (b) the emphasis on clarifying and stressing guiding principles of regulation rather than a rules-based approach to regulation; (c) the importance for much greater levels of international cooperation and coordination on such matters as accounting standards, listing standards, licenses to operate as regulated firms, supervisory oversight mechanisms, and, most important, prudential capital and liquidity standards; (d) the importance of regulatory arrangements having the flexibility to adapt to new types of institutions, instruments, and markets; and (e) the need to ensure the political and market independence of national regulatory authorities. Finally, there is a growing appreciation of the importance of ensuring that central bank responsibility for promoting financial stability is supported by adequate authority and capacity.

Regardless of how regulatory agencies are reorganized, prudential supervisors have a common need to better ensure that financial institutions adequately prepare for and respond to periods of financial stress. That role requires a renewed emphasis on the complex nature of judgments about the stability of large banking organizations. The caliber, quality, and integrity of people required to meet these challenges points to the need for more substantial efforts to attract, develop, and retain individuals fully capable of engaging senior private sector counterparts.

Recommendation 6:

a. Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination.
b. In all cases, countries should explicitly reaffirm the insulation of national regulatory authorities from political and market pressures and reassess the needs for improving the quality and adequacy of resources available to such authorities.

7. Role of the Central Bank

A central policy issue in regulatory reorganization is how to strike the right balance between the role of the central bank and that of other national regulators. National governments must decide precisely where to strike that balance. What is important is to do so in a fashion that properly enables the central bank to fulfill its main policy missions. Beyond the central mission of monetary policy, central banks normally have a role in managing and supporting payments systems, in providing liquidity to banks in times of stress, and more broadly in maintaining financial stability.

Recent events provide impetus for recognizing a financial stability role for central banks. That carries with it a need for adequate authority and the tools to carry out this mission. Broader authority to collect information helpful to understanding potential threats to stability is but one element of this. Another is how best to combat the development of financial excesses before they build into full-fledged crises. More countercyclical regulatory and supervisory policies are one such tool. Consideration of asset market developments in setting monetary policies has been a controversial but important debate.

To the extent that excessive use of leverage is a recurring significant contribution to potential financial instability, central banks may consider the value of employing countercyclical tools that work directly to avoid excesses. Some form of broad-based collateral requirements or margin-setting authority, including authority to set minimum initial and maintenance margin requirements across a broad range of financial asset markets and instruments in which leverage is typically employed, is a possibility. As with any formal rulemaking authority, over time, market practices and innovations will develop to exploit gaps and weaknesses. Any rule that forces market participants to hold more collateral than they would voluntarily creates some costs. These, however, are not reasons to abandon consideration of expanding the tools available to temper extreme financial excesses that potentially create far greater costs.

An important element of post-crisis reform is to consider which crisis management actions and innovations developed by central banks should usefully remain part of policymakers' toolkits and which should be strictly limited or eliminated entirely. The point is that broadly extending the safety net may actually encourage risk taking to the point of facilitating future excesses and carry central banks into areas more appropriately reserved for political authorities.

Recommendation 7:

a. Where not already the case, central banks should accept a role in promoting and maintaining financial stability. The expectation should be that concerns for financial stability are relevant not just in times of financial crisis, but also in times of rapid credit expansion and increased use of leverage that may lead to crises.
b. In countries where the central bank is not the prudential regulator, the central bank should have: (i) a strong role on the governing body of the prudential and markets regulator(s); (ii) a formal review role with respect to proposed changes in key prudential policies, especially capital and liquidity policies and margin arrangements; and (iii) a supervisory role in regard to the largest systemically significant firms, and critical payment and clearing systems.

c. A sharp distinction should be maintained between those regulated banking organizations with normal access to central bank liquidity facilities and other types of financial institutions whose access, if any, should be limited to extreme emergency situations of critical systemic importance.
d. Central bank emergency lending authority for highly unusual and exigent circumstances should be preserved, but should include, by law or practice, support by appropriate political authorities for the use of such authority in extending such credit to non-bank institutions.
e. Central bank liquidity support operations should be limited to forms that do not entail lending against or the outright purchase of high-risk assets, or other forms of long-term direct or indirect capital support. In principle, those forms of support are more appropriately provided by directly accountable government entities. In practice, to the extent the central bank is the only entity with the resources and authority to act quickly to provide this form of systemic support, there should be subsequent approval of an appropriate governmental entity with the consequent risk transfer to that entity.

8. International Coordination

There is much that can be done to improve international regulatory and supervisory coordination. Certain specific and needed enhancements can and should move forward within the existing framework of international cooperation. The most pressing and complex of those enhancements relate to making crisis management coordination more effective and operational by agreed protocols. Effective and timely information sharing, including information about large individual institutions operating in a number of jurisdictions, is a start. Greater clarity is required as to which jurisdiction or agency has the responsibility, in terms of managing the failure process, and how the costs of failure and the burdens of financial support, to the extent needed, will be shared. In the current market environment, some of the largest regulated financial institutions have grown to a scale that raises questions as to the capacity of some home country regulators to manage and support the failure resolution process. These concerns warrant early high-level consideration within international policy forums.

Recommendation 8:

a. National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination. The focus of needed enhancements should be to: (i) better coordinate oversight of the largest international banking organizations, with more timely and open information sharing, and greater clarity on home and host responsibilities, including in crisis management; (ii) move beyond coordinated rule making and standard setting to the identification and modification of material national differences in the application and enforcement of such standards; (iii) close regulatory gaps and raise standards, where needed, with respect to offshore banking centers; and (iv) develop the means for joint consideration of systemic risk concerns and the cyclicality implications of regulatory and supervisory policies. The appropriate agencies should strengthen their actions in member countries to promote implementation and enforcement of international standards.

b. Given the recurring importance of excessive leverage as a contributing factor to financial disruptions, and the increasingly complex ways in which leverage can be employed on and off balance sheets, prudential regulators and central banks should collaborate with international agencies in an effort to define leverage and then collect and report data on the degree of leverage and maturity and liquidity mismatches in various national systems and markets.

c. To the extent new international regulatory organizations are ultimately needed, the initial focus should be on developing more formal regional mechanisms, such as in the European Union, but with continued attentiveness to the global dimension of most significant financial markets.

PART 4

Improving Standards for Governance, Risk Management, Capital, and Liquidity

CORE RECOMMENDATION III

Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity. Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.

In a market-based financial system, many stakeholders are involved: shareholders, managers and other employees, clients, regulators, and the public at large. For each stakeholder, costs and benefits and risks and rewards should—as far as possible—be balanced. A prerequisite for this is that incentives should be consistent with the principle that risks should be borne by those who take them. The more this condition is satisfied—and one role of public policy is to help bring this about—the more the risk of systemic instability is reduced. A second prerequisite is that risks must be as transparent as possible to the relevant stakeholders in financial institutions. The more opaque are the risks being taken, the more difficult it is for stakeholders to ascertain if there is reasonable balance between risks and expected rewards.

In looking back at the array of problems encountered during this financial crisis, there are numerous examples of misaligned incentives, of incentives that contribute to instability and cyclicality in financial markets, and of shortcomings in the transparency of risks, in firms, in markets, and in structured products.

The first step toward improving incentives and transparency must be taken at the level of private sector firms central to financial risk intermediation. Further steps can be taken by regulators and by accounting standard setters.

9. Regulatory Standards for Governance and Risk Management

To be effective and sustainable, improvements in governance and risk management must be driven by leadership in private sector firms incorporated into a business culture that promotes discipline and a focus on long-run performance. Direction for that must start at the top, with boards of directors that are engaged and up to the task of overseeing the complexities of modern financial risk management. Complexities cannot be an excuse for poorly prepared and informed boards. In the first instance, senior management has responsibility for providing boards with timely information, and, if necessary, the training necessary to use it. In turn, boards must be populated with sufficient expertise to absorb such information and act on it, if need be with the benefit of independent outside advice. If these criteria cannot be met, the argument for reducing the size and complexity of these organizations becomes relevant.

In terms of specific improvements in firm risk management practices, leading firms in the financial industry have in recent years together assessed their capacity and willingness to cooperate in taking corrective steps to forestall crises. It is less clear how diligent firms and regulators have been in following up on implementation of recommended improvements. It is quite clear that what had been recommended before this most severe of crises was not sufficient to prevent the erosion of discipline at many leading firms. This suggests the need for a more systematic and forceful follow-up on implementation of best practices, by senior management, by boards, and by regulators.

Finally, this crisis has driven home the importance of aligning compensation practices with the incentives and controls in a firm's risk management program. Senior management and boards need to ensure a consistency in that respect, aligning pay with long-run shareholder interest rather than short-term returns that cannot be sustained and entail greater risk. Regulators need to satisfy themselves on this score and factor misaligned incentives into their overall judgments regarding the quality of the firm's risk management capabilities.

Recommendation 9:

Regulatory standards for governance and risk management should be raised, with particular emphasis on:

a. Strengthening boards of directors with greater engagement of independent members having financial industry and risk management expertise;
b. Coordinating board oversight of compensation and risk management policies, with the aim of balancing risk taking with prudence and the long-run interests of and returns to shareholders;
c. Ensuring systematic board-level reviews and exercises aimed at establishing the most important parameters for setting the firm's risk tolerance and evaluating its risk profile relative to those parameters;
d. Ensuring the risk management and auditing functions are fully independent and adequately resourced areas of the firm. The risk management function should report directly to the chief executive officer rather than through the head of another functional area;
e. Conducting periodic reviews of a firm's potential vulnerability to risk arising from credit concentrations, excessive maturity mismatches, excessive leverage, or undue reliance on asset market liquidity;
f. Ensuring that all large firms have the capacity to continuously monitor, within a matter of hours, their largest counterparty credit exposures on an enterprisewide basis and to make that information available, as appropriate, to its senior management, its board, and its prudential regulator and central bank;
g. Ensuring industrywide acceptance of and action on the many specific risk management practice improvements contained in the reports of the Counterparty Risk Management Policy Group (CRMPG) and the Institute of International Finance.

10. Regulatory Capital Standards

The business of banking is inherently cyclical. Movements in asset prices, collateral values, asset quality, capital market transaction volumes, and market liquidity all reflect economic fluctuations with consequences for earnings growth and capital generation. Regulatory policies and practices cannot repeal business cycles. They can, however, be assessed in terms of the impact they have in amplifying institutional behavior during the cycle. In seeking to temper regulatory sources of procyclicality, the objective should be to reinforce the primary aim of prudential regulation—to maintain the health of the system and contain systemic risk.

There are several aspects of prudential regulatory policies in which procyclical features are evident: capital standards, liquidity policies, and reserving practices. These are discussed in this section. Extensive regulatory policy improvement efforts are already under way, under the leadership of the Financial Stability Forum and the Basel Committee on Banking Supervision.

Prudential supervisors have a critical role to play in ensuring that the largest banking organizations adequately prepare for and respond to the ups and downs of cycles. Well-designed and sensibly executed supervisory programs will be an essential element of effective regulatory reform efforts to dampen procyclicality. A starting point for avoiding excessive risk is to support efforts of supervisors to report on and push back against erosion in risk standards and discipline during periods of economic expansion and confidence.

In this same vein, when risks are materializing and extreme pressures mounting, it is even more challenging for supervisors not to overreact to the use of capital, reserve, and liquidity buffers that should have been built up for use in just such circumstances. All this further underscores the importance of these agencies having high-quality resources with the independence to carry out this complex task.

A particularly disturbing aspect of the current crisis is the speed with which large regulated financial institutions moved from being represented as well capitalized with strong liquidity positions to requiring government interventions and sizeable financing support to avoid bankruptcy. To be sure, financial panics can produce conditions that are unmanageable for even very strong financial institutions, as they all require market confidence to function properly. But it is also true that existing international capital standards have lost credibility with market participants. It is critically important that market credibility be reestablished.

The principle of tying capital standards to estimated risk is appropriate only if risk estimation techniques are sound and experience has revealed important limitations that need to be addressed. Consideration should be given to improved methods to identify and account for hidden credit concentrations, unduly optimistic assumptions about market liquidity risk, so called "pipeline" risk in originate-to-distribute business models, and noncontractual exposures, such as those arising from sponsorship of off-balance-sheet vehicles and various types of investment funds.

Even improved techniques for estimating risk will have inherent limitations. Recognizing those limitations, capital standards can be made more practical and less procyclical, by expressing them in terms of wide operating ranges, rather than as minimum point estimates. Such an approach should encourage a buildup of capital during expansion periods, discouraging aggressive share buyback and dividend policies while permitting some reductions in times of stress. Regulators will need to encourage banks to internalize this discipline by requiring capital management policies to be tied to careful analysis of what stress scenarios imply about capital needs.

Recommendation 10:

a. International regulatory capital standards should be enhanced to address tendencies toward procyclicality. Benchmarks for being well capitalized should be raised, given the demonstrable limitations of even the most advanced tools for estimating firmwide risk.

b. These benchmarks should be expressed as a broad range within which capital ratios should be managed, with the expectation that, as part of supervisory guidance, firms will operate in the upper end of such a range in periods when markets are exuberant and tendencies for underestimating and underpricing risk are great.

c. The existing international definitions of capital should be reevaluated, looking toward close alignment on national definitions.

d. Capital and risk disclosure standards should be reevaluated to provide a higher degree of transparency of a firm's risk appetite, its estimated needs for and allocation of economic capital, and its valuation practices.

11. Standards for Liquidity Risk Management

Two interrelated sets of liquidity strains have characterized the current financial crisis. One is the evaporation of active markets for assets apart from government securities with the consequence that price discovery in many markets became unreliable. The other is strains on funding, as reflected in the dislocations in the interbank funding markets and the virtual shutdown of term debt funding markets for even highly rated financial institutions. The extent of these strains suggests that enhanced risk-based capital standards are by themselves not a sufficient basis for ensuring financial stability. Standards are also needed for liquidity risk.

Stronger, more systematic measures need to be taken that build on the framework used for capital standards. A first step in this regard was taken in early 2008 with the Basel Committee's Principles for Sound Liquidity Risk Management.

Recommendation 11:

a. Base-level liquidity standards should incorporate norms for maintaining a sizable diversified mix of long-term funding and an available cushion of highly liquid unencumbered assets. Once such standards are developed, consideration should be given to what is the preferred mix of senior and subordinated debt in bank capital structures.
b. Supervisory guidance for liquidity standards should be based on a more refined analysis of a firm's capacity to maintain ample liquidity under stress conditions, including evaluation of the quality and effectiveness of its liquidity management policies and contingency funding plan.
c. Liquidity disclosure standards, building on the suggested practices in the Basel Committee Principles, should complement the suggested improved disclosure practices for capital and risk profile information.

12. Fair Value Accounting

The current financial crisis has triggered an intense and often frustrating debate concerning the issues raised by strict application of fair value accounting (FVA) rules to the financial statements of regulated financial institutions. In distressed, illiquid, virtually nonfunctioning markets such as have been witnessed, the limitations and unintended consequences of FVA rules have become apparent, seemingly contributing to uncertainties and distress. Some recent interpretative guidance regarding too-rigid application of these rules has been viewed as helpful. But application of that guidance has been uneven across institutions and national regimes and has caused further divergence, rather than convergence, between U.S. and International Accounting Standards, without resolving the core issues.

Apart from the current difficulties in determining market prices, there is an underlying tension between the business purposes served by regulated financial institutions—particularly those in which the basic function is to intermediate credit and liquidity risk by funding illiquid loans by means of demand or short-term deposits—and the interests of investors and creditors to have the best possible current information on the immediate market value of assets and liabilities. That tension has also been reflected historically in different approaches favored by prudential and security regulators.

The direction until recently has been to seek to resolve that tension by forcing as much of the accounting and valuation of all assets and liabilities as possible into an accounting model designed and developed to address market values of liquid tradeable instruments. The extent to which this represents a "forced fit" has become very apparent in the current crisis. One dramatic result has been the ability of distressed institutions to increase their reported earnings by marking to market of certain of their own liabilities as the credit risk on their debt has increased. Another problem is valuations on illiquid assets that sometimes have limited relationship to expected discounted cash flows.

The way forward is not to abandon appropriate consideration of fair value principles but to seek a better principles-based balance between the legitimate needs of investors for useful current financial information and the business model of the regulated financial institutions.

A starting point is to recognize the relevance for sound internal risk management of tracking the best available information on the changes in value of a financial firm's assets and liabilities. Market pricing validated, if possible, by independent appraisal is one important requirement. But it is not necessarily the only one for evaluating risk and profitability in the absence of market liquidity and when the intrinsic value of continuing customer relationship is a relevant consideration.

Another practical consideration is the responsibility of prudential regulators and supervisors to themselves monitor, evaluate, and discipline valuation practices. Their concerns must be to judge the nature and extent of the risks involved and to consider the adequacy of reserve provisions to absorb potential losses, matters that cannot be fully encompassed in marking to market in all circumstances.

In sum, the accounting principles and approaches applicable to regulated financial institutions whose primary purpose is to intermediate credit and liquidity risk needs to be better aligned with the firm's business model. A pure mark-to-market accounting model is generally preferred for trading activities and most elements of market risk. Variations on the current intent-based accounting model applicable to banking organizations are a better place to start for these types of intermediaries. More realistic guidelines for addressing valuation issues for illiquid investments in these types of portfolios—including guidance on how to treat intent-based changes and movements in these instruments between accounts—is also a better starting point for firms with this business model. Rigor in the standards for alternative methods of valuation (including impairments) and for evaluating intent (and ability to carry that intent through) is essential to serve investor needs.

More generally, there can and should be an improved level of disclosure and transparency around regulated firms' risk profiles, risk reporting, and valuation practices. The more flexibility regulated firms and their regulators have to apply appropriate reasonable valuation practices to risk portfolios, the greater is the burden on them to provide full, fair, and timely disclosures of information related to their valuation practices.

Finally, safety and soundness considerations require that regulated firms maintain full and adequate reserves for specific expected credit losses over the life of credit exposures, and general valuation reserves to deal with cyclical and liquidity risks in relevant parts of their portfolios, including derivative portfolios. Tensions in this regard between accounting rules and safe and sound banking practices should be resolved in a way that promotes safety and soundness, with full and complete transparency and disclosure of resulting reserves.

Recommendation 12:

a. Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less-liquid instruments and distressed markets.

b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency. These standards should also be reviewed by, and coordinated with, prudential regulators to ensure application in a fashion consistent with safe and sound operation of such institutions.

c. Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated.

d. As emphasized in the third report of the CRMPG, under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that wholly adequate resources, insulated by fail-safe independent decision-making authority, are at the center of the valuation and price verification process.

PART 5

Improving Transparency and Incentives, and Strengthening the Financial Infrastructure

CORE RECOMMENDATION IV

Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.

13. Restoring Confidence in Securitized Credit Markets

Prior to the current crisis, a meaningful portion of the credit extension process had migrated away from traditional loan origination and retention by individual banks or other financial institutions that have direct knowledge of and relationships with borrowers, to one where financial institutions have relied on each other to originate loans that are then parceled out and shared among a broad group of otherwise unrelated entities. One consequence has been that the loss of confidence experienced during this crisis has extended beyond specific institutions to include a loss of confidence in entire sectors of the world's capital markets.

Prominent in this regard has been the complete drying up of new debt issuance in virtually all segments of the asset-backed securities markets. This has extended well beyond the markets for complex structured collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) to include so-called plain vanilla asset-backed receivables transactions.

The primary factors contributing to this loss of confidence have been the excessive complexity of these instruments and the lack of transparency that has characterized these markets. An additional contributing factor has been flaws exposed in the workings of the "originate-to-distribute" business model followed in the capital market units of virtually all large banking organizations. Those flaws include: (a) an erosion in credit underwriting standards, based on a transaction rather than a relationship and retention approach to credit risk; (b) concentrations of pipeline credit risk, based on overly optimistic assumptions regarding market liquidity and redistribution capabilities; and (c) retention of what turned out to be badly structured and grossly overrated tranches of structured products, in order to drive new deal flow. The extent to which the originate-to-distribute model will survive the present crisis is in question. What is clear is that it should not continue as a major element in finance without a concerted effort to remedy the flawed approaches. Some of the flaws can be addressed in the strengthening of regulatory capital and liquidity standards. Others need to be addressed as part of broader efforts to reduce risk and restore investor confidence in these markets.

The planned 2010 implementation of new international accounting standards for consolidation of various types of off-balance-sheet vehicles may impact securitization markets. Many of those vehicles—particularly so-called Structured Investment Vehicles (SIVs)—were created in part to get around existing accounting rules and regulatory capital standards.

Once these types of vehicles are forced back onto balance sheets and back into regulatory capital calculations, they may be phased out of existence, suggesting they served no sustainable economic purpose other than leveraged arbitrage of those rules.

In contrast to the above, off-balance-sheet trust vehicles that are used to support the issuance of traditional asset-backed securitizations must be viewed differently. Accounting standard setters should give further consideration to the usefulness of these types of trust structures being treated fully as on-balance-sheet items and what this might imply for the future functioning of markets for these types of asset-backed securities. A full discussion of how pending accounting changes are likely to impact the reporting and balance sheet treatment of these types of entities is beyond the scope of this report. (A useful review is provided on pages 38–52 of the CRMPG III report.) To the extent these vehicles also land back on financial institution balance sheets, there needs to be early resolution of the impact this may have on the usefulness of leverage ratios as a regulatory capital metric, and the potential uneven use of that metric across different national regulatory regimes.

Since most of the securitized capital markets have become international in scope, efforts to reopen them using new principles for transparency, risk underwriting, and accounting are best approached on a coordinated basis, particularly between authorities in the United Kingdom and the United States, where most of this activity has been centered.

Recommendation 13:

a. Market Supervision: Extensive innovation in the capital markets and the rapid growth of securitization make it imperative that securitized and other structured product and derivatives markets be held to regulatory, disclosure, and transparency standards at least comparable to those that have historically been applied to the public securities markets. This may require that a broader range of markets be monitored, that there be adequate transparency as to transaction volumes and holdings across all products, and that both credit and leverage elements of each product be thoroughly understood and monitored.
b. Credit Underwriting Standards: The healthy redevelopment of securitized credit markets requires a restoration of market confidence in the adequacy and sustainability of credit underwriting standards. To help achieve this, regulators should require regulated financial institutions to retain a meaningful portion of the credit risk they are packaging into securitized and other structured credit products.
c. Off-Balance-Sheet Vehicles: Pending accounting rule changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement. It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets.

14. Rating Agency Reforms

Numerous issues and questions have been raised about problems arising from the pre-crisis operations of the Nationally Recognized Securities Ratings Organizations (NRSROs), particularly focusing on the ratings attached to complex securitized instruments. They include potential conflicts inherent in the issuer pay business models; limits on rating agency accountability; the usefulness of ratings that only rate credit default probabilities, to the exclusion of many other important risk factors; and excessive regulatory and investor reliance on NRSRO ratings. Issues have also been raised about the need for more competition and for better regulation.

In many financial institutions the number and quality of personnel devoted to credit analysis has failed to keep pace with the increased complexity of individual securities and portfolios of credit instruments. Over time, a focus on profitability within financial institutions has led many investors and intermediaries to "outsource" the screening of credits, and in many cases, the entire credit evaluation function, to the traditional ratings agencies.

Regulatory bodies have also relied on credit ratings from NRSROs as an important input in assessing the adequacy of net capital. In fact, credit ratings have become "hardwired" in a vast spectrum of rules, regulations, and investment guidelines affecting capital requirements, disclosure requirements, portfolio construction, and a host of other activities undertaken by banks, broker-dealers, corporations, and other issuers, pension funds, insurance companies, professional money managers, and other investors.

Unfortunately, however, the economic model that supports the rating agencies is driven not by these users but by issuers who select and pay for the ratings. There are no direct economic consequences for poor credit research or a rating that fails to predict an event of default, because the payer, the issuer, is not harmed in either event. Many issuers are believed to have "shopped" among the traditional providers for higher ratings, lending a perverse negative consequence to regulatory attempts to increase competition.

In addition, the rating agencies are not held legally accountable for the quality of their work. Since there is no contractual relationship between those who rely on ratings (investors) and the providers of ratings, there is no legal recourse. The agencies have, to date, escaped accountability for the quality of their ratings in the courts. In the United States they have successfully argued that their ratings/opinions are subject to protection under the First Amendment.

A model whereby credit research and summary ratings are paid for by investors rather than issuers has been used at times in the past and would be superior to the current model. Some subscription models for credit research and summary ratings have begun to emerge. However, the current models make it difficult for providers to be paid based on value added, both because they have to compete with the "free" ratings provided by the traditional issuers, and because it is difficult for them to discover and monitor how extensively their intellectual property is being deployed. Consideration ought to be given to alternative approaches.

While there has been substantial innovation in the development of structured products rated by the traditional agencies, there has been little innovation in the measurement techniques incorporated in the ratings themselves, including risk measures related to liquidity, volatility, spread risk, and other risk factors relevant to market valuations.

Although many practice changes have been announced and/or proposed by the NRSROs, the European Commission, and the Securities and Exchange Commission (SEC), it is not clear that these changes go far enough to address the underlying incentive problems. The three-part recommendation set out below is intended to address more directly the need to improve the alignment of incentives for the three parties to the rating process—the issuer, the investor, and the rating service provider.

Recommendation 14:

Regulatory policies with regard to NRSROs and the use of ratings should be revised, preferably on an internationally coordinated basis, to achieve the following:

a. Users of risk ratings, most importantly regulated users, should be encouraged to restore or acquire the capacity for independent evaluations of the risk of credit products in which they are investing.
b. Risk ratings issued by the NRSROs should be made more robust, to reflect the risk of potential valuation losses arising not just from default probabilities and loss in the event of default, but also from the full range of potential risk factors (including liquidity and price volatility).
c. Regulators should encourage the development of payment models that improve the alignment of incentives among the providers of risk ratings and their clients and users, and permit users to hold NRSROs accountable for the quality of their work product.

Infrastructure Developments

The events of 2008 have underscored the importance of a strong infrastructure for the financial system—one that keeps pace with the innovations and new markets that are part of modern finance. As Federal Reserve Board Chairman Ben Bernanke has pointed out, there are both "hardware" elements (that is, systems for execution, clearing and settlement, and so forth) and "software" elements (that is, statutory, regulatory, and contractual frameworks) to the infrastructure. Significant weaknesses have been exposed in both these aspects of the system's infrastructure.

The final three recommendations that follow cover three areas for infrastructure improvement: OTC market changes, legal resolution mechanisms for financial institutions, and infrastructure in support of transparency in the markets for structured products.

15. Oversight of Credit Default Swaps (CDS) and Over-the-Counter (OTC) Markets

This crisis has exposed serious shortcomings in the infrastructure in support of the OTC derivatives markets. While some of those shortcomings may be viewed as conduct of business or market integrity issues, several problems have reached a scale that has raised systemic disruption issues. These problems include trade confirmation backlogs, lack of transparency on transaction reporting and pricing, contract closeout procedures, valuation practices and collateral disputes, and direct and indirect counterparty credit issues. Most of these issues either do not arise or are generally well managed within the exchange-based derivative markets.

Under pressure from various regulatory bodies, the leading firms in these markets have been working closely on a comprehensive program to address these infrastructure weaknesses. Prominent within that program are efforts to establish a central counterparty clearing (CCP) arrangement for the credit derivatives market and coordinated efforts to greatly

BOX 4 Regulation of the OTC Derivatives Markets

The following five points outline the nature and scope of proposed regulation of the over-the-counter (OTC) derivatives markets.

1. The appropriate national regulator should have the authority to promulgate rules applicable to market participants to promote sound practices and mitigate systemic risk in relation to credit default swaps (CDS) and other OTC derivatives, including rules regarding sound risk management practices, trade reporting and confirmation standards, appropriate counterparty collateral requirements, contract closeout practices, and other measures needed to achieve market transparency.

2. [illegible] OTC derivatives clearinghouse.

3. A market intermediary in OTC derivatives would be required to be already regulated as a bank or must register with the regulator as a professional intermediary.

4. The regulator should promulgate rules [illegible] reporting of large positions in OTC derivatives and related large counterparty credit exposure by both intermediaries and nonintermediaries.

5. The regulator should promulgate rules with respect to multilateral clearing organizations that clear OTC derivatives transactions other than on a securities or futures exchange to ensure the financial integrity of such clearing organizations and to mitigate systemic risk, promote reliable clearance and settlement, sound risk management practices, and market transparency.

reduce the gross size of outstanding contracts through bilateral compression arrangements. Significant progress has been made on these fronts. Further progress toward standardization and use of CCP mechanisms should be encouraged, if need be with regulatory capital requirements that bear more heavily on instruments that are not cleared through a CCP.

While these efforts may well result in adequate solutions to the most pressing existing problems, the broader policy questions regarding the appropriate regulatory status of these markets remain open. For most of the past 30 years, the markets developed in something of a regulatory vacuum, being regarded legally as neither securities nor futures contracts. Innovations were widespread and the markets grew explosively, suggesting that, beyond serving a valuable risk transfer function, a large speculative element has emerged.

As these markets have grown in complexity and size to dwarf the very cash markets to which they are related, the scale of infrastructure, credit, valuation, and transparency problems have loomed large. Pressure on central banks and other regulators to deal with these problems has grown.

It has long been recognized that the very same economic risk can be taken on or transferred by a combination of securities, futures contracts, or OTC derivatives. Yet, depending on the instrument used, vastly different rules, oversight arrangements, and infrastructure support mechanisms apply. While this may have made public policy sense when the OTC derivatives markets were in their early stages of development, the justification no longer exists. The time has come to harmonize standards and practices across these instrument markets. The time has also come to move beyond moral suasion and enlightened market self-interest to ensure that market practices develop in a timely, healthy, and comprehensive fashion. A possible system of regulation should include the elements listed in Box 4.

Recommendation 15:

a. Much-needed planned improvements to the infrastructure supporting the OTC derivatives markets should be further supported by legislation to establish a formal system of regulation and oversight of such markets.
b. Given the global nature of the market, it is essential that there be a consistent regulatory framework on an international scale, and national regulators should share information and enter into appropriate cooperative arrangements with authorities of other countries responsible for overseeing activities.

16. A Resolution Mechanism for Financial Institutions

Market discipline works best in a system in which failures can happen without being a source of major disruption and contagion. That can only happen with large, complex financial firms if the infrastructure and related market mechanisms that have to operate in the face of failures are robust, transparent, and permit timely but not forced actions on the part of creditors and other counterparties to protect their interest.

In the United States, existing legal mechanisms for managing bank failures, while not perfect, have proven to be workable. The problems have arisen in the context of potential and actual failures of large non-bank financial institutions. Specifically, the intervention to prevent the failure of Bear Sterns, the bankruptcy filings of Lehman Brothers, and other interventions demonstrate that there is a need to establish an effective failure resolution regime for large non-bank financial institutions. Part of that can be addressed by improvements to the infrastructure of the OTC derivatives markets. Part of it can also be addressed by closing the gaps in consolidated prudential oversight of large regulated non-bank financial institutions. But to be fully effective, the legal regimes that operate once failure is triggered should be modified, with a view to placing primary importance on the capacity of the authorities to take actions to protect the health of the system. A related concern is the general framework for handling qualified financial contracts in the United States, which must be reconsidered in light of recent events.

In some countries, a legal framework to provide for the orderly closing of regulated banks is not yet fully in place, let alone a framework for systemically significant non-bank financial institutions. A desirable framework should provide for: (a) continuity of operations and service access for depositors and other clients, (b) appropriate discretion for receivers for managing payment priorities, (c) discretion to impose cost appropriately within the capital structure and on executive management to reduce moral hazard, and (d) appropriate financial flexibility for the regulator/receiver to provide for timely transfer of financial assets and liabilities and prompt access of clients to properly segregated assets and accounts.

A further complication that must be considered—both in the United States and other jurisdictions—relates to a potential failure of a large, leveraged hedge fund or group of related funds, where the funds in question are domiciled in an offshore center. The bankruptcy and governance regimes of such centers may be at odds with the public interest of the countries in whose markets the funds actually operate in terms of containing the impact of failures on the system. Once such funds and managers are brought under a formal regulatory system, the appropriate national regulator should require an analysis of this issue for the largest funds. The regulator should have the authority to require the manager of the funds in question to modify existing legal arrangements to provide for an acceptable legal regime for governance and potential bankruptcy liquidations.

Recommendation 16:

a. In countries where this is not already the case, a legal regime should be established to provide regulators with authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions. In the United States, legislation should establish a process for managing the resolution of failed non-depository financial institutions (including non-bank affiliates within a bank holding company structure) comparable to the process for depository institutions.

b. The regime for non-depository financial institutions should apply only to those few organizations whose failure might reasonably be considered to pose a threat to the financial system and therefore subject to official regulation.

c. A regulatory body having powers comparable to those available for the resolution of banking institutions should be empowered to act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition.

d. The special treatment accorded to various forms of financial contracts under current U.S. law should be examined in light of recent experience, with a view toward resolving claims under these contracts in a manner least disruptive to the financial system.

17. Improving Transparency of Structured Product Markets

Disclosure standards in asset-backed and other structured fixed-income markets need to be reexamined and enhanced. Public interest in ensuring adequate disclosure to the investors in the private or wholesale markets for asset-backed and other structured fixed-income products should be recognized by regulators. At present, information that is likely to be significant is not generally available, and this needs to be addressed.

Once appropriate new disclosure standards have been agreed, this information should be provided in a manner that is comparable and facilitates analysis over time and across transactions. Satisfying this objective will require that information be presented in a more consistent and structured format than is currently the case. At present, financial information for corporate issuers is provided in a substantially structured manner under the content and presentation requirement of generally accepted accounting principles. However, there are no analogous content and presentation requirements for asset-backed and other structured products.

Recommendation 17:

a. The disclosure and dissemination regime for asset-backed and other structured fixed-income financial products (including securities and other financial products) in the public and private markets should be enhanced.

b. The appropriate national regulator should, in conjunction with investors, determine what information is material to investors in these products and should consider enhancing existing rules or adopt new rules that ensure disclosure of that information, for both asset-backed and synthetic structured products.

c. The appropriate national regulator should condition transactions in the private and wholesale markets on satisfaction of appropriate information disclosure standards.

18. Sharing Market Activity and Valuation Information

Public policy considerations have generally supported the importance of competing channels for trading execution in financial markets subject to some basic minimum public market standards. Exchange-based execution mechanisms, and broadly comparable electronic execution facilities, are typically characterized by high degrees of transparency and price discovery. Lesser standards apply in various segments of the over-the-counter markets, in some cases to such a degree that the markets are better described as opaque rather than transparent.

Recommendation 18:

Efforts to restore investor confidence in the workings of these markets suggest a need to revisit evaluations of the costs and benefits of infrastructure investments that would facilitate a much higher level of transparency around activity levels, traded prices, and related valuations. Part of the costs of such changes is the impact on firm-specific concerns regarding the private nature of their market activity. These concerns, and direct investment costs, need to be weighed against the potential benefits of higher levels of market transparency.

PART 6

Concluding Comment

In the year ahead, policymakers will be faced with an extraordinary set of challenges. The financial crisis has yet to fully run its course. Financial markets and institutions have yet to reengage in a healthy process of risk intermediation. Real economies around the world are experiencing sharp contraction, which is likely to lead to additional credit defaults. Governments and central banks are stretching to their limits with programs to stabilize both financial systems and real economies.

Initiatives to address these immediate challenges must take precedence over even the most pressing agendas for financial regulatory reform. Moreover, until the full costs of the current crisis are known—including the financial costs from its economic fallout—there will not be clarity on the extent of needed reforms and a sensible timetable for implementing them and for rolling back of greatly extended safety nets.

The views and recommendations set forth here represent an assessment, at one particular point in the crisis, as to the needed elements of a comprehensive financial reform plan. These suggestions focus primarily on financial stability considerations and do not cover in any detail other potential needed changes in business practice, in market or administrative structure, or in competition policies.

This report should be read in combination with the prior extensive private sector and public sector reform proposals referred to in our report. Policymakers should have an extensive set of proposals for framing the issues involved in the needed comprehensive overhaul of the national and international financial systems and suggesting appropriate reform. These reforms are likely to be more extensive and important than any since the Great Depression.

APPENDIX

LIST OF RECOMMENDATIONS

CORE RECOMMENDATION I

Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight.

Prudential Regulation and Supervision of Banking Organizations

Recommendation 1:

a. In all countries, the activities of government-insured deposit-taking institutions should be subject to prudential regulation and supervision by a single regulator (that is, consolidated supervision). The largest and most complex banking organizations should be subject to particularly close regulation and supervision, meeting high and common international standards.

b. Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Participation in packaging and sale of collective debt instruments should require the retention of a meaningful part of the credit risk.

c. In general, government-insured deposit-taking institutions should not be owned and controlled by unregulated non-financial organizations, and strict limits should be imposed on dealings among such banking institutions and partial non-bank owners.

d. To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries.

Consolidated Supervision of Non-Bank Financial Institutions

Recommendation 2:

a. For those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established.

b. An appropriate prudential regulator should be designated for those large investment banks and broker-dealers that are not organized as bank holding companies.

Money Market Mutual Funds and Supervision
Recommendation 3:

a. Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.
b. Those institutions remaining as money market mutual funds should only offer a conservative investment option with modest upside potential at relatively low risk. The vehicles should be clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds, with no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV. Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US$1.00 per share.

Oversight of Private Pools of Capital
Recommendation 4:

a. Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator. There should be some minimum size and venture capital exemptions from such registration requirement.
b. The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management. Since introduction of even a modest system of registration and regulation can create a false impression of lower investment risk, disclosure, and suitability standards will have to be reevaluated.
c. For funds above a size judged to be potentially systemically significant, the prudential regulator should have authority to establish appropriate standards for capital, liquidity, and risk management.
d. For these purposes, the jurisdiction of the appropriate prudential regulator should be based on the primary business location of the manager of such funds, regardless of the legal domicile of the funds themselves. Given the global nature of the markets in which such managers and funds operate, it is imperative that a regulatory framework be applied on an internationally consistent basis.

Government-Sponsored Enterprises (GSEs)
Recommendation 5:

a. For the United States, the policy resolution of the appropriate role of GSEs in mortgage finance should be based on a clear separation of the functions of private sector mortgage finance risk intermediation from government sector guarantees or insurance of mortgage credit risk.
b. Governmental entities providing support for the mortgage market by means of market purchases should have explicit statutory backing and financial support. Hybrids of private ownership with government sponsorship should be avoided. In time, existing GSE mortgage purchasing and portfolio activities should be spun off to private sector entities, with the government, if it desires, maintaining a capacity to intervene in the market through a wholly owned public institution.

CORE RECOMMENDATION II

The quality and effectiveness of prudential regulation and supervision must be improved. This will require better-resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination.

Regulatory Structure
Recommendation 6:

a. Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination.
b. In all cases, countries should explicitly reaffirm the insulation of national regulatory authorities from political and market pressures and reassess the need for improving the quality and adequacy of resources available to such authorities.

Role of the Central Bank
Recommendation 7:

a. Where not already the case, central banks should accept a role in promoting and maintaining financial stability. The expectation should be that concerns for financial stability are relevant not just in times of financial crisis, but also in times of rapid credit expansion and increased use of leverage that may lead to crises.
b. In countries where the central bank is not the prudential regulator, the central bank should have: (i) a strong role on the governing body of the prudential and markets

regulator(s); (ii) a formal review role with respect to proposed changes in key prudential policies, especially capital and liquidity policies and margin arrangements; and (iii) a supervisory role in regard to the largest systemically significant firms, and critical payment and clearing systems.

c. A sharp distinction should be maintained between those regulated banking organizations with normal access to central bank liquidity facilities and other types of financial institutions whose access, if any, should be limited to extreme emergency situations of critical systemic importance.

d. Central bank emergency lending authority for highly unusual and exigent circumstances should be preserved, but should include, by law or practice, support by appropriate political authorities for the use of such authority in extending such credit to non-bank institutions.

e. Central bank liquidity support operations should be limited to forms that do not entail lending against or the outright purchase of high-risk assets, or other forms of long-term direct or indirect capital support. In principle, those forms of support are more appropriately provided by directly accountable government entities. In practice, to the extent the central bank is the only entity with the resources and authority to act quickly to provide this form of systemic support, there should be subsequent approval of an appropriate governmental entity with the consequent risk transfer to that entity.

International Coordination

Recommendation 8:

a. National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination. The focus of needed enhancements should be to: (i) better coordinate oversight of the largest international banking organizations, with more timely and open information sharing, and greater clarity on home and host responsibilities, including in crisis management; (ii) move beyond coordinated rule making and standard setting to the identification and modification of material national differences in the application and enforcement of such standards; (iii) close regulatory gaps and raise standards, where needed, with respect to offshore banking centers; and (iv) develop the means for joint consideration of systemic risk concerns and the cyclicality implications of regulatory and supervisory policies. The appropriate agencies should strengthen their actions in member countries to promote implementation and enforcement of international standards.

b. Given the recurring importance of excessive leverage as a contributing factor to financial disruptions, and the increasingly complex ways in which leverage can be employed on and off balance sheets, prudential regulators and central banks should collaborate with international agencies in an effort to define leverage and then collect and report data on the degree of leverage and maturity and liquidity mismatches in various national systems and markets.

c. To the extent new international regulatory organizations are ultimately needed, the initial focus should be on developing more formal regional mechanisms, such as in the European Union, but with continued attentiveness to the global dimension of most significant financial markets.

CORE RECOMMENDATION III

Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity. Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.

Regulatory Standards for Governance and Risk Management

Recommendation 9:

Regulatory standards for governance and risk management should be raised, with particular emphasis on:

a. Strengthening boards of directors with greater engagement of independent members having financial industry and risk management expertise;
b. Coordinating board oversight of compensation and risk management policies, with the aim of balancing risk taking with prudence and the long-run interests of and returns to shareholders;
c. Ensuring systematic board-level reviews and exercises aimed at establishing the most important parameters for setting the firm's risk tolerance and evaluating its risk profile relative to those parameters;
d. Ensuring the risk management and auditing functions are fully independent and adequately resourced areas of the firm. The risk management function should report directly to the chief executive officer rather than through the head of another functional area;
e. Conducting periodic reviews of a firm's potential vulnerability to risk arising from credit concentrations, excessive maturity mismatches, excessive leverage, or undue reliance on asset market liquidity;
f. Ensuring that all large firms have the capacity to continuously monitor, within a matter of hours, their largest counterparty credit exposures on an enterprisewide basis and to make that information available, as appropriate, to its senior management, its board, and its prudential regulator and central bank;

g. Ensuring industrywide acceptance of and action on the many specific risk management practice improvements contained in the reports of the Counterparty Risk Management Policy Group (CRMPG) and the Institute of International Finance.

Regulatory Capital Standards

Recommendation 10:

a. International regulatory capital standards should be enhanced to address tendencies toward procyclicality. Benchmarks for being well capitalized should be raised, given the demonstrable limitations of even the most advanced tools for estimating firmwide risk.
b. These benchmarks should be expressed as a broad range within which capital ratios should be managed, with the expectation that, as part of supervisory guidance, firms will operate at the upper end of such a range in periods when markets are exuberant and tendencies for underestimating and underpricing risk are great.
c. The existing international definitions of capital should be reevaluated, looking toward close alignment on national definitions.
d. Capital and risk disclosure standards should be reevaluated to provide a higher degree of transparency of a firm's risk appetite, its estimated needs for and allocation of economic capital, and its valuation practices.

Standards for Liquidity Risk Management

Recommendation 11:

a. Base-level liquidity standards should incorporate norms for maintaining a sizable diversified mix of long-term funding and an available cushion of highly liquid unencumbered assets. Once such standards are developed, consideration should be given to what is the preferred mix of senior and subordinated debt in bank capital structures.
b. Supervisory guidance for liquidity standards should be based on a more refined analysis of a firm's capacity to maintain ample liquidity under stress conditions, including evaluation of the quality and effectiveness of its liquidity management policies and contingency funding plan.
c. Liquidity disclosure standards, building on the suggested practices in the Basel Committee Principles, should complement the suggested improved disclosure practices for capital and risk profile information.

Fair Value Accounting
Recommendation 12:

a. Fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments and distressed markets.
b. The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency. These standards should also be reviewed by, and coordinated with, prudential regulators to ensure application in a fashion consistent with safe and sound operation of such institutions.
c. Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated.
d. As emphasized in the third report of the CRMPG, under any and all standards of accounting and under any and all market conditions, individual financial institutions must ensure that wholly adequate resources, insulated by fail-safe independent decision-making authority, are at the center of the valuation and price verification process.

CORE RECOMMENDATION IV

Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.

Restoring Confidence in Securitized Credit Markets
Recommendation 13:

a. Market Supervision: Extensive innovation in the capital markets and the rapid growth of securitization make it imperative that securitized and other structured product and derivatives markets be held to regulatory, disclosure, and transparency standards at least comparable to those that have historically been applied to the public securities markets. This may require that a broader range of markets be monitored, that there be adequate transparency as to transaction volumes and holdings across all products, and that both credit and leverage elements of each product be thoroughly understood and monitored.

b. Credit Underwriting Standards: The healthy redevelopment of securitized credit markets requires a restoration of market confidence in the adequacy and sustainability of credit underwriting standards. To help achieve this, regulators should require regulated financial institutions to retain a meaningful portion of the credit risk they are packaging into securitized and other structured credit products.
c. Off-Balance-Sheet Vehicles: Pending accounting rule changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement. It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets.

Rating Agency Reforms

Recommendation 14:

Regulatory policies with regard to Nationally Recognized Securities Rating Organizations (NRSROs) and the use of ratings should be revised, preferably on an internationally coordinated basis, to achieve the following:

a. Users of risk ratings, most importantly regulated users, should be encouraged to restore or acquire the capacity for independent evaluations of the risk of credit products in which they are investing.
b. Risk ratings issued by the NRSROs should be made more robust, to reflect the risk of potential valuation losses arising not just from default probabilities and loss in the event of default, but also from the full range of potential risk factors (including liquidity and price volatility).
c. Regulators should encourage the development of payment models that improve the alignment of incentives among the providers of risk ratings and their clients and users, and permit users to hold NRSROs accountable for the quality of their work product.

The Oversight of Credit Default Swaps (CDS) and Over-the-Counter (OTC) Markets

Recommendation 15:

a. Much-needed planned improvements to the infrastructure supporting the OTC derivatives markets should be further supported by legislation to establish a formal system of regulation and oversight of such markets.

b. Given the global nature of the market, it is essential that there be a consistent regulatory framework on an international scale, and national regulators should share information and enter into appropriate cooperative arrangements with authorities of other countries responsible for overseeing activities.

A Resolution Mechanism for Financial Institutions
Recommendation 16:

a. In countries where this is not already the case, a legal regime should be established to provide regulators with authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions. In the United States, legislation should establish a process for managing the resolution of failed non-depository financial institutions (including non-bank affiliates within a bank holding company structure) comparable to the process for depository institutions.
b. The regime for non-depository financial institutions should apply only to those few organizations whose failure might reasonably be considered to pose a threat to the financial system and therefore subject to official regulation.
c. A regulatory body having powers comparable to those available for the resolution of banking institutions should be empowered to act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition.
d. The special treatment accorded to various forms of financial contracts under current U.S. law should be examined in light of recent experience, with a view toward resolving claims under these contracts in a manner least disruptive to the financial system.

Improving Transparency of Structured Product Markets
Recommendation 17:

a. The disclosure and dissemination regime for asset-backed and other structured fixed-income financial products (including securities and other financial products) in the public and private markets should be enhanced.
b. The appropriate national regulator should, in conjunction with investors, determine what information is material to investors in these products and should consider enhancing existing rules or adopt new rules that ensure disclosure of that information, for both asset-backed and synthetic structured products.
c. The appropriate national regulator should condition transactions in the private and wholesale markets on satisfaction of appropriate information disclosure standards.

Sharing Market Activity and Valuation Information

Recommendation 18:

Efforts to restore investor confidence in the workings of these markets suggest a need to revisit evaluations of the costs and benefits of infrastructure investments that would facilitate a much higher level of transparency around activity levels, traded prices, and related valuations. Part of the costs of such changes is the impact on firm-specific concerns regarding the private nature of their market activity. These concerns, and direct investment costs, need to be weighed against the potential benefits of higher levels of market transparency.

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PREPARED STATEMENT OF GENE L. DODARO

ACTING COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

FEBRUARY 4, 2009

United States Government Accountability Office

GAO

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

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FINANCIAL REGULATION

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

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

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GAO-09-349T

Mr. Chairman and Members of the Committee:

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

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

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

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

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

Summary

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. Today, almost a dozen federal regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies share responsibility for overseeing the financial services industry. As the nation finds itself in the midst of one of the worst financial crises ever, it has become apparent that the regulatory system is ill-suited to meet the nation's needs in the 21st century.

Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system.

- First, regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks.
- Second, regulators have had to address problems in financial markets resulting from the activities of large and sometimes less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit

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

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

These significant developments have outpaced a fragmented and outdated regulatory structure, and, as a result, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has significant weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. Our report offers a framework for crafting and evaluating regulatory reform proposals consisting of nine characteristics that should be reflected in any new regulatory system. By applying the elements of the framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

Table 1: Framework for Crafting and Evaluating Regulatory Reform Proposals

Characteristic		Description
✓	Clearly defined regulatory goals	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
✓	Appropriately comprehensive	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
✓	Systemwide focus	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
✓	Flexible and adaptable	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
✓	Efficient and effective	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
✓	Consistent consumer and investor protection	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
✓	Regulators provided with independence, prominence, authority, and accountability	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.
✓	Consistent financial oversight	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
✓	Minimal taxpayer exposure	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO.

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

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

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. In particular, five federal agencies—including the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—and multiple state agencies oversee depository institutions. Securities activities are overseen by the Securities and Exchange Commission and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by the Commodity Futures Trading Commission and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little federal involvement. Other federal regulators also play important roles in the financial regulatory system, such as the Public Company Accounting Oversight Board, which oversees the activities of public accounting firms, and the Federal Trade Commission, which acts as the primary federal agency responsible for enforcing compliance with federal consumer protection laws for financial institutions, such as finance companies, which are not overseen by another financial regulator.

Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s. Changes in the types of financial activities permitted for depository institutions and their affiliates have also shaped the financial regulatory system over time. For example, under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services, but with the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities.

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

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 1.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulators have struggled, and often failed, to mitigate the systemic risks posed by these conglomerates, and to ensure they adequately manage their risks. The portion of firms that conduct activities across the financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.

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

A third development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. In particular, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.

Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.

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

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

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

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

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

As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. As early as 1994, we identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products.[3] Since then, we have described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs.[4] Our report offers a framework for crafting and evaluating regulatory reform proposals; it consists of the following nine characteristics that should be reflected in any new regulatory system. By applying the elements of this framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

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

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

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

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

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

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

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

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

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

Key issues to be addressed:

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

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

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

Key issues to be addressed:

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

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

A regulatory system should focus on risks to the financial system, not just institutions. As noted in our report, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. The collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly, once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

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

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

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

<u>Key issues to be addressed:</u>

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

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

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

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

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

Key issues to be addressed:

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

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

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

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we note in our report, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted in our report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

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

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

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

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

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

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

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

Key issues to be addressed:

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

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

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

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

Key issues to be addressed:

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

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

accountable for meeting regulatory goals.

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

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

In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, in a 2007 report we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.[6] It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct

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

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

Key issues to be addressed:

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

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

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

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

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

Key issues to be addressed:

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

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

[7]GAO-05-61.

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

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

Key issues to be addressed:

- Identify safeguards that are most appropriate to prevent systemic crises while minimizing moral hazard.

- Consider how a financial system can most effectively minimize taxpayer exposure to losses related to financial instability.

Finally, although significant changes may be required to modernize the U.S. financial regulatory system, policymakers should consider carefully how best to implement the changes in such a way that the transition to a new structure does not hamper the functioning of the financial markets, individual financial institutions' ability to conduct their activities, and consumers' ability to access needed services. For example, if the changes require regulators or institutions to make systems changes, file registrations, or other activities that could require extensive time to complete, the changes could be implemented in phases with specific target dates around which the affected entities could formulate plans. In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.[8] Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

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

Contacts

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

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

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

Related GAO Products

High-Risk Series: An Update. GAO-09-271. Washington, D.C.: January 22, 2009.

Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. GAO-09-216. Washington, D.C.: January 8, 2009.

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

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

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

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

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

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

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

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

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

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

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

Financial Derivatives: Actions Needed to Protect the Financial System. GAO/GGD-94-133. Washington, D.C.: May 18, 1994.

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Report to Congressional Addressees

January 2009

FINANCIAL REGULATION

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

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GAO-09-216

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Highlights

Highlights of GAO-09-216, a report to congressional addressees

January 2009

FINANCIAL REGULATION

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

Why GAO Did This Study

The United States and other countries are in the midst of the worst financial crisis in more than 75 years. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.

To help policymakers better understand existing problems with the financial regulatory system and craft and evaluate reform proposals, this report (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have created challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, GAO synthesized existing GAO work and other studies and met with dozens of representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. Twenty-nine regulators, industry associations, and consumer groups also reviewed a draft of this report and provided valuable input that was incorporated as appropriate. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

To view the full product, including the scope and methodology, click on GAO-09-216. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. As the nation finds itself in the midst of one of the worst financial crises ever, the regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. For example, the Federal Reserve System was created in 1913 in response to financial panics and instability around the turn of the century, and much of the remaining structure for bank and securities regulation was created as the result of the Great Depression turmoil of the 1920s and 1930s.

Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system.

- First, regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks. The portion of firms operating as conglomerates that cross financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.
- Second, regulators have had to address problems in financial markets resulting from the activities of large and sometimes less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today's financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors, and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products. Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market developments, and in addressing challenges arising from the global convergence of accounting and auditing standards.
- Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

Highlights of GAO-09-216 (continued)

As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks. As early as 1994, GAO identified the need to examine the federal financial regulatory structure, including the need to address the risks from new unregulated products. Since then, GAO has described various options for Congress to consider, each of which provides potential improvements, as well as some risks and potential costs. This report offers a framework for crafting and evaluating regulatory reform proposals; it consists of the following nine characteristics that should be reflected in any new regulatory system. By applying the elements of this framework, the relative strengths and weaknesses of any reform proposal should be better revealed, and policymakers should be able to focus on identifying trade-offs and balancing competing goals. Similarly, the framework could be used to craft proposals, or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system.

Characteristic		Description
✓	**Clearly defined regulatory goals**	Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated comprehensive and cohesive goals that reflect today's environment.
✓	**Appropriately comprehensive**	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals and should ensure that appropriate determinations are made about how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems, for determining the appropriate level of oversight for financial activities and institutions, including closing gaps that contributed to the current crisis.
✓	**Systemwide focus**	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Given that no regulator is currently tasked with this, key issues include determining how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such responsibilities.
✓	**Flexible and adaptable**	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
✓	**Efficient and effective**	Effective and efficient oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Any changes to the system should be continually focused on improving the effectiveness of the financial regulatory system. Key issues include determining opportunities for consolidation given the large number of overlapping participants now, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.
✓	**Consistent consumer and investor protection**	Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
✓	**Regulators provided with independence, prominence, authority, and accountability**	Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals. With regulators with varying levels of prominence and funding schemes now, key issues include how to appropriately structure and fund agencies to ensure that each one's structure sufficiently achieves these characteristics.
✓	**Consistent financial oversight**	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
✓	**Minimal taxpayer exposure**	A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazard.

Source: GAO.

Contents

Figures

Abbreviations

BFCU	Bureau of Federal Credit Unions
CDO	collateralized debt obligation
CEC	Commodity Exchange Commission
CFTC	Commodity Futures Trading Commission
CSE	Consolidated Supervised Entity
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FHFB	Federal Housing Finance Board
FHLBB	Federal Home Loan Bank Board
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
FTC	Federal Trade Commission
GFA	Grain Futures Administration
GLBA	Gramm-Leach-Bliley Act of 1999
GSE	government-sponsored enterprise
IMF	International Monetary Fund
LTCM	Long Term Capital Management
NAIC	National Association of Insurance Commissioners
NCUA	National Credit Union Administration
NRSRO	nationally recognized statistical rating organization
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OTC	over-the-counter
OTS	Office of Thrift Supervision
PCAOB	Public Company Accounting Oversight Board
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

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United States Government Accountability Office
Washington, DC 20548

January 8, 2009

Congressional Addressees

The United States is in the midst of the worst financial crisis in more than 75 years. In recent months, federal officials have taken unprecedented steps to stem the unraveling of the financial services sector by committing trillions of dollars of taxpayer funds to rescue financial institutions and restore order to credit markets, including the creation of a $700 billion program that has been used so far to inject money into struggling institutions in an attempt to stabilize markets.[1] This current crisis largely stems from defaults on U.S. subprime mortgage loans, many of which were packaged and sold as securities to buyers in the United States and around the world. With financial institutions from many countries participating in these activities, the resulting turmoil has afflicted financial markets globally and has spurred coordinated action by world leaders in an attempt to protect savings and restore the health of the markets. While much of policymakers' attention understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.[2]

The current U.S. regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with the major developments that have occurred in financial markets and products in recent decades. In particular, the current system was not designed to adequately oversee today's large and interconnected financial institutions, whose activities pose new risks to the institutions themselves as well as risk to the broader financial system—called systemic risk, which is the risk that an event could broadly effect the financial system rather than just one or a few institutions. In addition, not all financial activities and institutions fall

[1]For more information about these activities, see GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, GAO-09-161 (Washington, D.C.: Dec. 2, 2008).

[2]Throughout this report, we use the term "financial regulatory system" to refer broadly to both the financial regulatory structure—that is, the number and organization of financial regulatory agencies—as well as other aspects of financial regulation, including agency responsibilities, and mechanisms and authorities available to agencies for fulfilling such responsibilities.

under the direct purview of financial regulators, and market innovations have led to the creation of new and sometimes very complex products that were never envisioned as the current regulatory system developed. In light of the recent turmoil in financial markets, the current financial regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century.

As the administration and Congress continue to take actions to address the immediate financial crisis, determining how to create a regulatory system that reflects new market realities is a key step to reducing the likelihood that the U.S. will experience another financial crisis similar to the current one. As a result, considerable debate is under way over whether and how the current regulatory system should be changed, including calls for consolidating regulatory agencies, broadening certain regulators' authorities, or subjecting certain products or entities to more regulation. For example, in March 2008, the Department of the Treasury (Treasury) proposed significant financial regulatory reforms in its "Blueprint for a Modernized Financial Regulatory Structure," and other federal regulatory officials and industry groups have also put forth reform proposals.[3] Under the Emergency Economic Stabilization Act, Treasury is required to submit to Congress by April 30, 2009, a report with recommendations on "the current state of the financial markets and the regulatory system."[4] As these and other proposals are developed or evaluated, it will be important to carefully consider their advantages and disadvantages and long-term implications.

To help policymakers weigh the various proposals and consider ways in which the current regulatory system could be made more effective and efficient, we prepared this report under the authority of the Comptroller General. Specifically, our report (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have raised challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and

[3]See Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Washington, D.C., March 2008); Financial Services Roundtable, *The Blueprint for U.S. Financial Services Competitiveness* (Washington, D.C., Nov. 7, 2007); Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, "Reducing Systemic Risk in a Dynamic Financial System" (speech, New York, June 9, 2008); and Ben S. Bernanke, Chairman, Federal Reserve, "Reducing Systemic Risk" (speech, Jackson Hole, Wyo., Aug. 22, 2008).

[4]Pub. L. No. 110-343, § 105(c).

others to craft or evaluate potential regulatory reform efforts going forward. This report's primary focus is on discussing how various market developments have revealed gaps and limitations in the existing regulatory system. Although drawing on examples of events from the current crisis, we do not attempt to identify all of the potential weaknesses in the actions of regulators that had authority over the institutions and products involved.

To address these objectives, we synthesized existing GAO work on challenges to the U.S. financial regulatory structure and on criteria for developing and strengthening effective regulatory structures.[5] We also reviewed existing studies, government documents, and other research for illustrations of how current and past financial market events have exposed inadequacies in our existing financial regulatory system and for suggestions for regulatory reform. In a series of forums, we discussed these developments and the elements of a potential framework for an effective regulatory system with groups of financial regulators of banking, securities, futures, insurance, and housing markets; representatives of financial services industry associations and individual financial institutions; and with selected consumer advocacy organizations, academics, and other experts in financial markets issues. The work upon which this report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008. A more extensive discussion of our scope and methodology appears in appendix I.

Background

While providing many benefits to our economy and citizens' lives, financial services activities can also cause harm if left unsupervised. As a result, the United States and many other countries have found that regulating financial markets, institutions, and products is more efficient and effective

[5]For example, see GAO, *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure*, GAO-08-32 (Washington, D.C.: Oct. 12, 2007); and *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004). See Related GAO Products appendix for additional reports.

than leaving the fairness and integrity of these activities to be ensured solely by market participants themselves.

The federal laws related to financial regulation set forth specific authorities and responsibilities for regulators, although these authorities typically do not contain provisions explicitly linking such responsibilities to overall goals of financial regulation. Nevertheless, financial regulation generally has sought to achieve four broad goals:

- *Ensure adequate consumer protections.* Because financial institutions' incentives to maximize profits can in some cases lead to sales of unsuitable or fraudulent financial products, or unfair or deceptive acts or practices, U.S. regulators take steps to address informational disadvantages that consumers and investors may face, ensure consumers and investors have sufficient information to make appropriate decisions, and oversee business conduct and sales practices to prevent fraud and abuse.
- *Ensure the integrity and fairness of markets.* Because some market participants could seek to manipulate markets to obtain unfair gains in a way that is not easily detectable by other participants, U.S. regulators set rules for and monitor markets and their participants to prevent fraud and manipulation, limit problems in asset pricing, and ensure efficient market activity.
- *Monitor the safety and soundness of institutions.* Because markets sometimes lead financial institutions to take on excessive risks that can have significant negative impacts on consumers, investors, and taxpayers, regulators oversee risk-taking activities to promote the safety and soundness of financial institutions.
- *Act to ensure the stability of the overall financial system.* Because shocks to the system or the actions of financial institutions can lead to instability in the broader financial system, regulators act to reduce systemic risk in various ways, such as by providing emergency funding to troubled financial institutions.

Although these goals have traditionally been their primary focus, financial regulators are also often tasked with achieving other goals as they carry out their activities. These can include promoting economic growth, capital formation, and competition in our financial markets. Regulators have also taken actions with an eye toward ensuring the competitiveness of regulated U.S. financial institutions with those in other sectors or with others around the world. In other cases, financial institutions may be required by law or regulation to foster social policy objectives such as fair access to credit and increased home ownership.

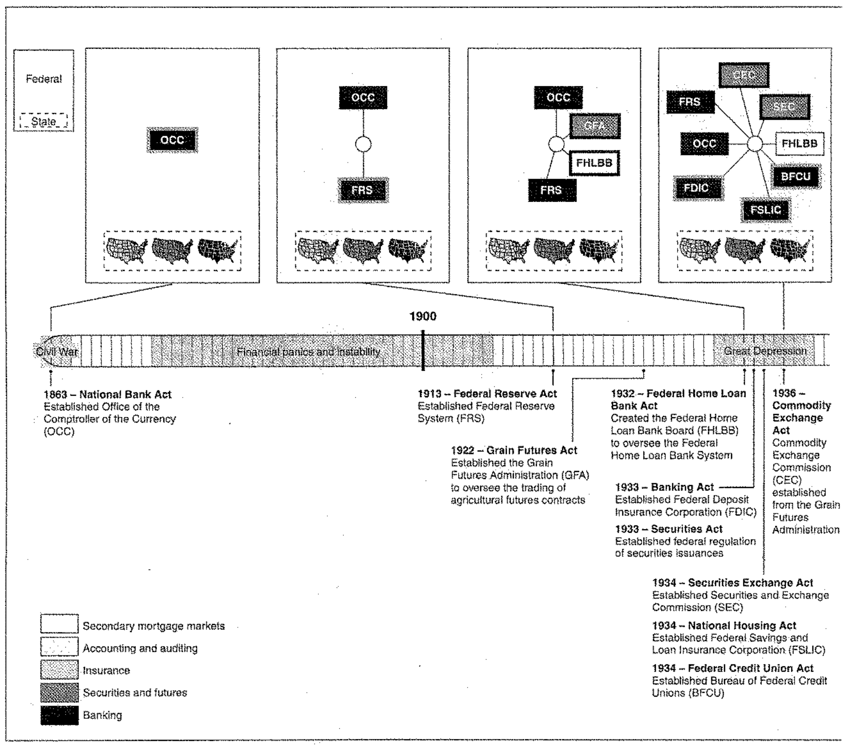
In general, these goals are reflected in statutes, regulations, and administrative actions, such as rulemakings or guidance, by financial institution supervisors. Laws and regulatory agency policies can set a greater priority on some roles and missions than others. Regulators are usually responsible for multiple regulatory goals and often prioritize them differently. For example, state and federal bank regulators generally focus on the safety and soundness of depository institutions; federal securities and futures regulators focus on the integrity of markets, and the adequacy of information provided to investors; and state securities regulators primarily address consumer protection. State insurance regulators focus on the ability of insurance firms to meet their commitments to the insured.

The degrees to which regulators oversee institutions, markets, or products also vary depending upon, among other things, the regulatory approach Congress has fashioned for different sectors of the financial industry. For example, some institutions, such as banks, are subject to comprehensive regulation to ensure their safety and soundness. Among other things, they are subject to examinations and limitations on the types of activities they may conduct. Other institutions conducting financial activities are less regulated, such as by only having to register with regulators or by having less extensive disclosure requirements. Moreover, some markets, such as those for many over-the-counter derivatives markets, as well as activities within those markets, are not subject to oversight regulation at all.

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

As a result of 150 years of changes in financial regulation in the United States, the regulatory system has become complex and fragmented. (See fig. 1.) Our regulatory system has multiple financial regulatory bodies, including five federal and multiple state agencies that oversee depository institutions. Securities activities are overseen by federal and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by a federal regulator and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little federal involvement.

Figure 1: Formation of U.S. Financial Regulatory System (1863-2008)



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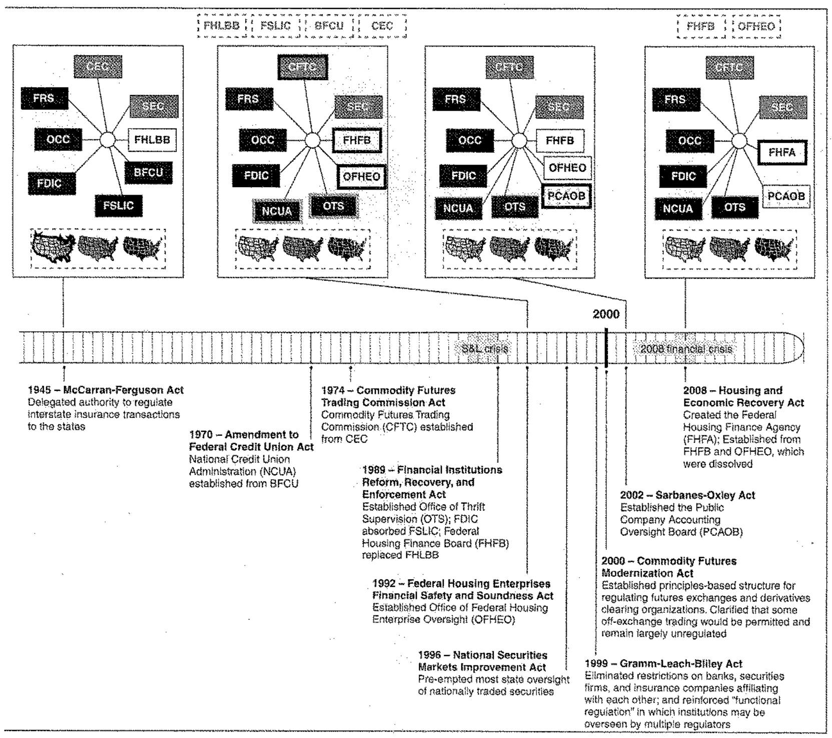


Overall, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations (SRO), and hundreds of state financial regulatory agencies. The following sections describe how regulation evolved in various sectors, including banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets, and other financial institutions. The accounting and auditing environment for financial institutions, and the role of the Gramm-Leach-Bliley Act in financial regulation, are also discussed.

Banking

Since the early days of our nation, banks have allowed citizens to store their savings and used these funds to make loans to spur business development. Until the middle of the 1800s, banks were chartered by states and state regulators supervised their activities, which primarily consisted of taking deposits and issuing currency. However, the existence of multiple currencies issued by different banks, some of which were more highly valued than others, created difficulties for the smooth functioning of economic activity. In an effort to finance the nation's Civil War debt and reduce financial uncertainty, Congress passed the National Bank Act of 1863, which provided for issuance of a single national currency. This act also created the Office of the Comptroller of the Currency (OCC), which was to oversee the national currency and improve banking system efficiency by granting banks national charters to operate and conducting oversight to ensure the sound operations of these banks. As of 2007, of the more than 16,000 depository institutions subject to federal regulation in the United States, OCC was responsible for chartering, regulating, and supervising nearly 1,700 commercial banks with national charters.

In the years surrounding 1900, the United States experienced troubled economic conditions and several financial panics, including various instances of bank runs as depositors attempted to withdraw their funds from banks whose financial conditions had deteriorated. To improve the liquidity of the U.S. banking sector and reduce the potential for such panics and runs, Congress passed the Federal Reserve Act of 1913. This act created the Federal Reserve System, which consists of the Board of Governors of the Federal Reserve System (Federal Reserve), and 12 Federal Reserve Banks, which are congressionally chartered semiprivate entities that undertake a range of actions on behalf of the Federal Reserve, including supervision of banks and bank holding companies, and lending to troubled banks. The Federal Reserve was given responsibility to act as the federal supervisory agency for state-chartered banks—banks authorized to do business under charters issued by states—that are members of the Federal Reserve System.[6] In addition to supervising and

[6]Staff at the Federal Reserve Banks act as supervisors in conjunction with the Board.

regulating bank and financial holding companies and nearly 900 state-chartered banks, the Federal Reserve also develops and implements national monetary policy, and provides financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.

Several significant changes to the U.S. financial regulatory system again were made as a result of the turbulent economic conditions in the late 1920s and 1930s. In response to numerous bank failures resulting in the severe contraction of economic activity of the Great Depression, the Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC), which administers a federal program to insure the deposits of participating banks. Subsequently, FDIC's deposit insurance authority expanded to include thrifts.[7] Additionally, FDIC provides primary federal oversight of any insured state-chartered banks that are not members of the Federal Reserve System, and it serves as the primary federal regulator for over 5,200 state-chartered institutions. Finally, FDIC has backup examination and enforcement authority over all of the institutions it insures in order to mitigate losses to the deposit insurance funds.

Securities

Prior to the 1930s, securities markets were overseen by various state securities regulatory bodies and the securities exchanges themselves. In the aftermath of the stock market crash of 1929, the Securities Exchange Act of 1934 created a new federal agency, the Securities and Exchange Commission (SEC) and gave it authority to register and oversee securities broker-dealers, as well as securities exchanges, to strengthen securities oversight and address inconsistent state securities rules.[8] In addition to regulation by SEC and state agencies, securities markets and the broker-dealers that accept and execute customer orders in these markets

[7] Thrifts, also known as savings and loans, are financial institutions that accept deposits and make loans, particularly for home mortgages. Until 1989, thrift deposits were federally insured by the Federal Savings and Loan Insurance Corporation (FSLIC), which was created by the National Housing Act of 1934. After experiencing solvency problems in connection with the savings and loan crisis of the 1980s, FSLIC was abolished and its insurance function was transferred to FDIC.

[8] The Securities Act of 1933 (1933 Act), 48 Stat. 74. et. seq., assigned federal supervision of securities to the Federal Trade Commission (FTC) by, among other things, requiring that securities offerings subject to the act's registration requirements be registered with the FTC. See 1933 Act, §§ 2, 5, 6 (May 27, 1933). In the 1934 act, Congress replaced the FTC's role by transferring its powers, duties, and functions under the 1933 act to SEC. See Securities Exchange Act of 1934, 48 Stat. 881, §§ 3(a), 210 (June 6, 1934).

continue to be regulated by SROs, including those of the exchanges and the Financial Industry Regulatory Authority, that are funded by the participants in the industry. Among other things, these SROs establish rules and conduct examinations related to market integrity and investor protection. SEC also registers and oversees investment companies and advisers, approves rules for the industry, and conducts examinations of broker-dealers and mutual funds. State securities regulators—represented by the North American Securities Administrators Association—are generally responsible for registering certain securities products and, along with SEC, investigating securities fraud.[9] SEC is also responsible for overseeing the financial reporting and disclosures that companies issuing securities must make under U.S. securities laws. SEC was also authorized to issue and oversee U.S. accounting standards for entities subject to its jurisdiction, but has delegated the creation of accounting standards to a private-sector organization, the Financial Accounting Standards Board, which establishes generally accepted accounting principles.

Thrifts and Credit Unions

The economic turmoil of the 1930s also prompted the creation of federal regulators for other types of depository institutions, including thrifts and credit unions.[10] These institutions previously had been subject to oversight only by state authorities. However, the Home Owners' Loan Act of 1933 empowered the newly created Federal Home Loan Bank Board to charter and regulate federal thrifts, and the Federal Credit Union Act of 1934 created the Bureau of Federal Credit Unions to charter and supervise credit unions.[11] Congress amended the Federal Credit Union Act in 1970 to

[9]The National Securities Markets Improvement Act, Pub. L. No. 104-290 (Oct. 11, 1996), pre-empted state securities registration requirements for all but a subset of small securities products and limited state supervision of broker-dealers, but left intact the right of states to investigate securities fraud.

[10]Credit unions are member-owned financial institutions that generally offer their members services similar to those provided by banks.

[11]Home Owners' Loan Act of 1933, 48 Stat. 128 (June 13, 1933). The administration of the Federal Credit Union Act was originally vested in the Farm Credit Administration (Act of June 26, 1934, 48 Stat. 1216.) Executive Order No. 9148, dated April 27, 1942 (7 F.R. 3145), transferred the functions, powers and duties of the Farm Credit Administration to FDIC. Effective July 29, 1948, the powers, duties and functions transferred to FDIC were transferred to the Federal Security Agency. (Act of June 29, 1948, 62 Stat. 1091.) Reorganization Plan No. 1 of 1953, effective April 11, 1953, abolished the Federal Security Agency and transferred the Bureau of Federal Credit Unions, together with other agencies of the Federal Security Agency, to the Department of Health, Education, and Welfare. (67 Stat. 631, 18 F.R. 2053.).

establish the National Credit Union Administration (NCUA), which is responsible for chartering and supervising over 5,000 federally chartered credit unions, as well as insuring deposits in these and more than 3,000 state-chartered credit unions.[12] Oversight of these state-chartered credit unions is managed by 47 state regulatory agencies, represented by the National Association of State Credit Union Supervisors.[13]

From 1980 to 1990, over 1,000 thrifts failed at a cost of about $100 billion to the federal deposit insurance funds. In response, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Home Loan Bank Board and, among other things, established the Office of Thrift Supervision (OTS) to improve thrift oversight.[14] OTS charters about 750 federal thrifts and oversees these and about 70 state-chartered thrifts, as well as savings and loan holding companies.[15]

Futures

Oversight of the trading of futures contracts, which allow their purchasers to buy or sell a specific quantity of a commodity for delivery in the future, has also changed over the years in response to changes in the marketplace. Under the Grain Futures Act of 1922, the trading of futures contracts was overseen by the Grain Futures Administration, an office within the Department of Agriculture, reflecting the nature of the products for which futures contracts were traded.[16] However, futures contracts were later created for nonagricultural commodities, such as energy products like oil and natural gas, metals such as gold and silver, and financial products such as Treasury bonds and foreign currencies. In 1974,

[12]Public Law 91-206 (Mar. 10, 1970, 84 Stat. 49) created the National Credit Union Administration as an independent agency and transferred all of the functions of the Bureau of Federal Credit Unions to the new administration.

[13]Federally insured state credit unions also are subject to supervision by NCUA.

[14]Pub. L. No. 101-73 § 301 (Aug. 9, 1989).

[15]The five federal depository institution regulators discussed earlier coordinate formally through the Federal Financial Institutions Examination Council, an interagency body that was established in 1979 and is empowered to (1) prescribe uniform principles, standards, and report forms for the federal examination of financial institutions; and (2) make recommendations to promote uniformity in the supervision of financial institutions.

[16]The Grain Futures Act (ch. 369, 42 Stat. 998, Sept. 21, 1922). In 1936 the act was renamed the "Commodity Exchange Act (CEA)," which, among other things, created the Commodity Exchange Commission (CEC), a predecessor agency to the Commodity Futures Trading Commission. 49 Stat. 1491 (June 15, 1936).

a new independent federal agency, the Commodity Futures Trading Commission (CFTC), was created to oversee the trading of futures contracts.[17] Like SEC, CFTC relies on SROs, including the futures exchanges and the National Futures Association, to establish and enforce rules governing member behavior. In 2000, the Commodity Futures Modernization Act of 2000 established a principles-based structure for the regulation of futures exchanges and derivatives clearing organizations, and clarified that some off-exchange derivatives trading—and in particular trading on facilities only accessible to large, sophisticated traders—was permitted and would be largely unregulated or exempt from regulation.[18]

Insurance

Unlike most other financial services, insurance activities traditionally have been regulated at the state level. In 1944, a U.S. Supreme Court decision determined that the insurance industry was subject to interstate commerce laws, which could then have allowed for federal regulation, but Congress passed the McCarran-Ferguson Act in 1945 to explicitly return insurance regulation to the states.[19] As a result, as many as 55 state, territorial, or other local jurisdiction authorities oversee insurance activities in the United States, although state regulations and other activities are often coordinated nationally by the National Association of Insurance Commissioners (NAIC).[20]

[17]Commodity Futures Trading Commission Act, Pub. L. No. 93-463 (Oct. 23, 1974).

[18]A derivative is a financial instrument representing a right or obligation based on the value at a particular time of an underlying asset, reference rate, or index, such as a stock, bond, agricultural or other physical commodity, interest rate, currency exchange rate, or stock index. Derivatives contracts are used by firms around the world to manage market risk—the exposure to the possibility of financial loss caused by adverse changes in the values of assets or liabilities—by transferring it from entities less willing or able to manage it to those more willing and able to do so. Common types of derivatives include futures, options, forwards, and swaps and can be traded through an exchange, known as exchange-traded, or privately, known as over-the counter.

[19]Up until 1944, insurance was not considered interstate commerce and, therefore, was not subject to federal regulation. In *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944) the Supreme Court held that Congress could regulate insurance transactions that truly are interstate. Congress subsequently enacted the McCarran-Ferguson Act (Mar. 9, 1945), ch. 20, 59 Stat. 33, which provides that state laws apply to insurance unless they are specifically pre-empted by Congress. See 15 U.S.C. § 1011.

[20]NAIC is made up of the heads of the insurance departments of 50 states, the District of Columbia, and U.S. territories to provide a forum for the development of uniform policy when uniformity is appropriate.

Secondary Mortgage Markets

The recent financial crisis in the credit and housing markets has prompted the creation of a new, unified federal financial regulatory oversight agency, the Federal Housing Finance Agency (FHFA), to oversee the government-sponsored enterprises (GSE) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.[21] Fannie Mae and Freddie Mac are private, federally chartered companies created by Congress to, among other things, provide liquidity to home mortgage markets by purchasing mortgage loans, thus enabling lenders to make additional loans. The system of 12 Federal Home Loan Banks provides funding to support housing finance and economic development.[22] Until enactment of the Housing and Economic Recovery Act of 2008, Fannie Mae and Freddie Mac had been overseen since 1992 by the Office of Federal Housing Enterprise Oversight (OFHEO), an agency within the Department of Housing and Urban Development, and the Federal Home Loan Banks were subject to supervision by the Federal Housing Finance Board (FHFB), an independent regulatory agency.[23] OFHEO regulated Fannie Mae and Freddie Mac on matters of safety and soundness, while HUD regulated their mission-related activities. FHFB served as the safety and soundness and mission regulator of the Federal Home Loan Banks. In July 2008, the Housing and Economic Recovery Act of 2008 created FHFA to establish more effective and more consistent oversight of the three housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. With respect to Fannie Mae and Freddie Mac, the law gives FHFA such new regulatory authorities as the power to regulate the retained mortgage portfolios, to set more stringent capital standards, and to place a failing entity in receivership. In addition, the law provides FHFA with funding outside the annual appropriations process. The law also combined the regulatory authorities for all the housing GSEs that were previously distributed

[21]Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, title I, subtitle A (July 30, 2008).

[22]The 12 Federal Home Loan Banks form a system of regional cooperatives, each with its own president and board of directors, located in different regions of the country. Their statutory mission is to provide cost-effective funding to members for use in housing, community, and economic development; to provide regional affordable housing programs, which create housing opportunities for low- and moderate-income families; to support housing finance through advances and mortgage programs; and to serve as a reliable source of liquidity for its membership.

[23]OFHEO was created in title XIII of the Housing and Community Development Act (1992), Pub. L. No. 102-550 (Oct. 28, 1992). In 1932, the Federal Home Loan Bank Act created the Federal Home Loan Bank System to provide liquidity to thrifts to make home mortgages. Oversight of these responsibilities was later transferred to the Federal Housing Finance Board.

among OFHEO, FHFB, and the Department of Housing and Urban Development. In September 2008, Fannie Mae and Freddie Mac were placed in conservatorship, with FHFA serving as the conservator under powers provided in the 2008 act. Treasury also created a backstop lending facility for the Federal Home Loan Banks, should they decide to use it. In November 2008, the Federal Reserve announced plans to purchase mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac on the open market.

Gramm-Leach-Bliley

Changes in the types of financial activities permitted for depository institutions and their affiliates have also shaped the financial regulatory system over time. Under the Glass-Steagall provisions of the Banking Act of 1933, financial institutions were prohibited from simultaneously offering commercial and investment banking services. However, in the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress permitted financial institutions to fully engage in both types of activities and, in addition, provided a regulatory process allowing for the approval of new types of financial activity.[24] Under GLBA, qualifying financial institutions are permitted to engage in banking, securities, insurance, and other financial activities. When these activities are conducted within the same bank holding company structure, they remain subject to regulation by "functional regulators," which are the federal authorities having jurisdiction over specific financial products or services, such as SEC or CFTC. As a result, multiple regulators now oversee different business lines within a single institution. For example, broker-dealer activities are generally regulated by SEC even if they are conducted within a large financial conglomerate that is subject to the Bank Holding Company Act, which is administered by the Federal Reserve. The functional regulator approach was intended to provide consistency in regulation, focus regulatory restrictions on the relevant functional area, and avoid the potential need for regulatory agencies to develop expertise in all aspects of financial regulation.

[24]Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (Nov. 12, 1999). Although originally precluded from conducting significant securities underwriting activities, bank holding companies were permitted to conduct more of such activities over the years. For example, in 1987, the Federal Reserve allowed the subsidiaries of bank holding companies to engage in securities underwriting activities up to 5 percent of their revenue. Over time, the Federal Reserve also expanded the types of securities that banks could conduct business in and raised the revenue limit to 10 percent in 1989 and to 25 percent in 1996.

Accounting and Auditing

In addition to the creation of various regulators over time, the accounting and auditing environment for financial institutions and market participants—a key component of financial oversight—has also seen substantial change. In the early 2000s, various companies with publicly traded securities were found to have issued materially misleading financial statements. These companies included Enron and WorldCom, both of which filed for bankruptcy. When the actual financial conditions of these companies became known, their auditors were called into question, and one of the largest, Arthur Andersen, was dissolved after the Department of Justice filed criminal charges related to its audits of Enron. As a result of these and other corporate financial reporting and auditing scandals, the Sarbanes-Oxley Act of 2002 was enacted.[25] Among other things, Sarbanes-Oxley expanded public company reporting and disclosure requirements and established new ethical and corporate responsibility requirements for public company executives, boards of directors, and independent auditors. The act also created a new independent public company audit regulator, the Public Company Accounting Oversight Board, to oversee the activities of public accounting firms. The activities of this board are, in turn, overseen by SEC.

Other Financial Institutions

Some entities that provide financial services are not regulated by any of the existing federal financial regulatory bodies. For example, entities such as mortgage brokers, automobile finance companies, and payday lenders that are not bank subsidiaries or affiliates primarily are subject to state oversight, with the Federal Trade Commission acting as the primary federal agency responsible for enforcing their compliance with federal consumer protection laws.

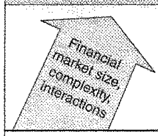
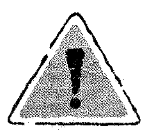
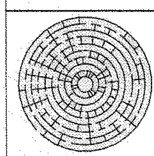
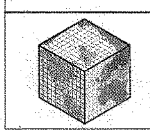
[25] Pub. L. No. 107-204 (July 30, 2002).

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

Several key developments in financial markets and products in the past few decades have significantly challenged the existing financial regulatory structure. (See fig. 2.) First, the last 30 years have seen waves of mergers among financial institutions within and across sectors, such that the United States, while still having large numbers of financial institutions, also has several very large globally active financial conglomerates that engage in a wide range of activities that have become increasingly interconnected. Regulating these large conglomerates has proven challenging, particularly in overseeing their risk management activities on a consolidated basis and in identifying and mitigating the systemic risks they pose. A second development has been the emergence of large and sometimes less-regulated market participants, such as hedge funds and credit rating agencies, which now play key roles in our financial markets. Third, the development of new and complex products and services has challenged regulators' abilities to ensure that institutions are adequately identifying and acting to mitigate risks arising from these new activities and that investors and consumers are adequately informed of the risks. In light of these developments, ensuring that U.S. accounting standards have kept pace has also proved difficult, and the impending transition to conform to international accounting standards is likely to create additional challenges.[26] Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

[26]We include discussion of audit and accounting standards in this report because any new effort to examine the structure of financial regulation in the United States could include consideration of the process for creating and adopting these standards. However, determining whether the oversight of this process should be changed was not part of the scope of this report.

Figure 2: Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System

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

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

Conglomeration and Increased Interconnectedness in Financial Markets Have Created Difficulties for a Regulatory System That Lacks a Systemwide Focus

Overseeing large financial conglomerates that have emerged in recent decades has proven challenging, particularly in regulating their consolidated risk management practices and in identifying and mitigating the systemic risks they pose. These systemically important institutions in many cases have tens of thousands or more customers and extensive financial linkages with each other through loans, derivatives contracts, or trading positions with other financial institutions or businesses. The activities of these large financial institutions, as we have seen by recent events, can pose significant systemic risks to other market participants and the economy as a whole, but the regulatory system was not prepared to adequately anticipate and prevent such risks.

Largely as the result of waves of mergers and consolidations, the number of financial institutions today has declined. However, the remaining institutions are generally larger and more complex, provide more and varied services, offer similar products, and operate in increasingly global markets. Among the most significant of these changes has been the emergence and growth of large financial conglomerates or universal banks that offer a wide range of products that cut across the traditional financial sectors of banking, securities, and insurance. A 2003 IMF study highlighted this emerging trend. Based on a worldwide sample of the top 500 financial services firms in assets, the study found that the percentage of the largest financial institutions in the United States that are conglomerates—financial institutions having substantial operations in more than one of the sectors (banking, securities, and insurance)—increased from 42 percent of the U.S. financial institutions in the sample in 1995 to 62 percent in 2000.[27] This new environment contrasts with that of the past in which banks primarily conducted traditional banking activities such as deposit taking and lending; securities broker-dealers were largely focused on brokerage and underwriting activities; and insurance firms offered a more limited set of insurance products. In a report that analyzed the regulatory structures of various countries, The Group of Thirty noted that the last 25 years have been a period of enormous transformation in the financial services sector, with a marked shift from firms engaging in distinct banking, securities, and insurance businesses to one in which more integrated financial services conglomerates offer a broad range of financial products across the globe. These fundamental changes in the nature of the financial service markets

[27] Gianni De Nicoló, 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).

around the world have exposed the shortcomings of financial regulatory models, some of which have not been adapted to the changes in business structures.[28]

While posing challenges to regulators, these changes have resulted in some benefits in the United States financial services industry. For example, the ability of financial institutions to offer products of varying types increased the options available to consumers for investing their savings and preparing for their retirement. Conglomeration has also made it more convenient for consumers to conduct their financial activities by providing opportunities for one-stop shopping for most or all of their needs, and by promoting the cross-selling of new innovative products of which consumers may otherwise not have been aware.

However, the rise of large financial conglomerates has also posed risks that our current financial regulatory system does not directly address. First, although the activities of these large interconnected financial institutions often cross traditional sector boundaries, financial regulators under the current U.S. regulatory system did not always have full authority or sufficient tools and capabilities to adequately oversee the risks that these financial institutions posed to themselves and other institutions. As we noted in a 2007 report, the activities of the Federal Reserve, SEC, and OTS to conduct consolidated supervision of many of the largest U.S. financial institutions were not as efficient and effective as needed because these agencies were not collaborating more systematically.[29] In addition, the recent market crisis has revealed significant problems with certain aspects of these regulators' oversight of financial conglomerates. For example, some of the top investment banks were subject to voluntary and limited oversight at the holding-company level—the level of the institution that generally managed its overall risks—as part of SEC's Consolidated Supervised Entity (CSE) Program. SEC's program was created in 2004 as a way for global investment bank conglomerates that lack a supervisor

[28]Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (Washington, D.C., 2008). The Group of Thirty, established in 1978, is a private, nonprofit, international body—composed of very senior representatives of the private and public sectors and academia—that consults and publishes papers on international economic and monetary affairs.

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

under law to voluntarily submit to regulation.[30] This supervision, which could include SEC examinations of the parent companies' and affiliates' operations and monitoring of their capital levels, enabled the CSEs to qualify for alternative capital rules in exchange for consenting to supervision at the holding company level. Being subject to consolidated supervision was perceived as necessary for these financial institutions to continue operating in Europe under changes implemented by the European Union in 2005.[31]

However, according to a September 2008 report by SEC's Inspector General, this supervisory program failed to effectively oversee these institutions for several reasons, including the lack of an effective mechanism for ensuring that these entities maintained sufficient capital. In comparison to commercial bank conglomerates, these investment banks were holding much less capital in relation to the activities exposing them to financial risk. For example, at the end of 2007, the five largest investment banks had assets to equity capital leverage ratios of between 26 and 34 to 1—meaning that for every dollar of capital capable of absorbing losses, these institutions held between $26 and $34 of assets subject to loss. In contrast, the largest commercial bank conglomerates, which were subject to different regulatory capital requirements, tended to be significantly less leveraged, with the average leverage ratio of the top five largest U.S. bank conglomerates at the end of 2007 only about 13 to 1. Moreover, because the program SEC used to oversee these investment bank conglomerates was voluntary, it had no authority to compel these institutions to address any problems that may have been identified. Instead, SEC's only means for coercing an institution to take corrective actions was to disqualify an institution from CSE status. SEC also lacked the ability to provide emergency funding for these investment bank conglomerates in a similar way that the Federal Reserve could for commercial banks. As a result, these CSE firms, whose activities resulted in their being significant and systemically important participants with vast interconnections with other financial institutions, were more vulnerable to market disruptions that could create risks to the overall financial system,

[30]Under the CSE program, which SEC initiated pursuant to its capitalization requirements for broker-dealers, SEC instituted a system for supervising large broker-dealers at the holding company level. See 69 *Fed. Reg.* 34428 (June 21, 2004). Previously, SEC had focused its broker-dealer net capital regulations only upon the firms themselves, not their holding companies or other subsidiaries.

[31]69 *Fed. Reg.* 34428 at n. 9.

but not all were subject to full and consistent oversight by a supervisor with adequate authority and resources. For example, one of the ways that the bankruptcy filing of Lehman Brothers affected other institutions was that 25 money market fund advisers had to act to protect their investors against losses arising from their investments in that company's debt, with at least one of these funds having to be liquidated and distributed to its investors.

Collapse of the Investment Bank Model

Until 2008, the largest U.S. investment banks all generally had similar structures that were characterized by a publicly traded holding company with a U.S. broker-dealer subsidiary. Each of these firms typically had a large number of affiliates, including certain special-purpose U.S.-regulated banks, banking and securities subsidiaries regulated in foreign jurisdictions, and unregulated subsidiaries in the United States and abroad, including those used for over-the-counter derivatives transactions. Each of these firms was also involved with mortgage activities to varying degrees, including originating loans, purchasing loans from others, and creating mortgage-backed securities sold to investors. However, unlike their commercial bank counterparts that had access to large, relatively stable deposit bases to fund part of their operations, investment banks were more dependent on short-term wholesale funding markets, such as the repurchase or "repo" market that involves placing securities (i.e., U.S. Treasury bonds) with another party in exchange for cash for a short time and agreeing to buy back the securities at the end of that period. As their mortgage-related losses increased in the recent turmoil, these institutions encountered increasing difficulties in obtaining sufficient funding in these wholesale credit markets. Although in March 2008, the Federal Reserve extended to the remaining institutions funding that had previously only been available to banks, investors' doubts about the viability of these investment banks resulted in each of the top five firms either filing for bankruptcy, being sold to other institutions, or converting themselves into bank or financial holding companies.

Following the sale of Bear Stearns to JPMorgan Chase, the Lehman bankruptcy filing, and the sale of Merrill Lynch to Bank of America, the remaining CSEs opted to become bank holding companies subject to Federal Reserve oversight. SEC suspended its CSE program and the Chairman stated that "the last six months have made it abundantly clear that voluntary regulation does not work."[32]

Recent events have also highlighted difficulties faced by the Federal Reserve and OTS in their roles in overseeing risk management at large financial and thrift holding companies, respectively. In June 2008 testimony, a Federal Reserve official acknowledged such supervisory lessons, noting that under the current U.S. regulatory structure consisting of multiple supervisory agencies, challenges can arise in assessing risk profiles of large, complex financial institutions operating across financial sectors, particularly given the growth in the use of sophisticated financial products that can generate risks across various legal entities. He also noted that recent events have highlighted the importance of enterprisewide risk management, noting that supervisors need to understand risks across a consolidated entity and assess the risk management tools being applied across the financial institution.[33] Our own work had raised concerns over the adequacy of supervision of these large financial conglomerates. For example, one of the large entities that OTS oversaw was the insurance conglomerate AIG, which was subject to a government takeover necessitated by financial difficulties the firm experienced as the result of OTC derivatives activities related to mortgages. In a 2007 report, we expressed concerns over the appropriateness of having OTS oversee diverse global financial institutions

[32]SEC Press Release (2008-230), *Chairman Cox Announces End of Consolidated Supervised Entities Program* (Sept. 26, 2008).

[33]Senate Committee on Banking, Housing, and Urban Affairs, *Condition of the Banking System*, 110th Cong., 2nd sess., June 5, 2008 (testimony of Federal Reserve Vice Chairman Donald L. Kohn).

given the size of the agency relative to the institutions for which it was responsible.[34] We had also noted that although OTS oversaw a number of holding companies that are primarily in the insurance business, including AIG, it had only one specialist in this area as of March 2007.[35] An OTS official noted, however, that functional regulation established by Gramm-Leach-Bliley avoided the need for regulatory agencies to develop expertise in all aspects of financial regulation.

Second, the emergence of these large institutions with financial obligations with thousands of other entities has revealed that the existing U.S. regulatory system is not well-equipped for identifying and addressing risks across the financial system as a whole. In the current environment, with multiple regulators primarily responsible for just individual institutions or markets, no one regulator is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. For example, multiple factors contributed to the subprime mortgage crisis, and many market participants played a role in these events, including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others. The collective activities of these entities, rather than one particular institution, likely all contributed to the overall market collapse. In particular, the securitization process created incentives throughout the chain of participants to emphasize loan volume over loan quality, which likely contributed to the problem as lenders sold loans on the secondary market, passing risks on to investors. Similarly, once financial institutions began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events. Ad hoc actions by the Department of the Treasury, the Federal Reserve, other members of the President's Working Group on Financial Markets, and FDIC were aimed at helping to mitigate the fallout once events began to unfold.[36] However, even given this ad hoc coordination, our past work has repeatedly identified limitations of the current U.S. federal regulatory structure to adequately coordinate and share information to monitor risks across markets or "functional" areas to

[34]GAO-07-154.

[35]AIG is subject to OTS supervision as a savings and loan holding company because of its control of a thrift. See, e.g., 12 U.S.C. § 1467a(a)(1)(D), (H).

[36]The President's Working Group on Financial Markets consists of the Secretary of the Treasury, and the Chairmen of the Federal Reserve, SEC, and CFTC.

identify potential systemic crises.[37] Whether a greater focus on systemwide risks would have fully prevented the recent financial crises is unclear, but it is reasonable to conclude that such a mechanism would have had better prospects of identifying the breadth of the problem earlier and been better positioned to stem or soften the extent of the market fallout.

Existing Regulatory System Failed to Adequately Address Problems Associated with Less-Regulated Entities That Played Significant Roles in the U.S. Financial System

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

Activities of Nonbank Mortgage Lenders Played a Significant Role in Mortgage Crisis but Were Not Adequately Addressed by Existing Regulatory System

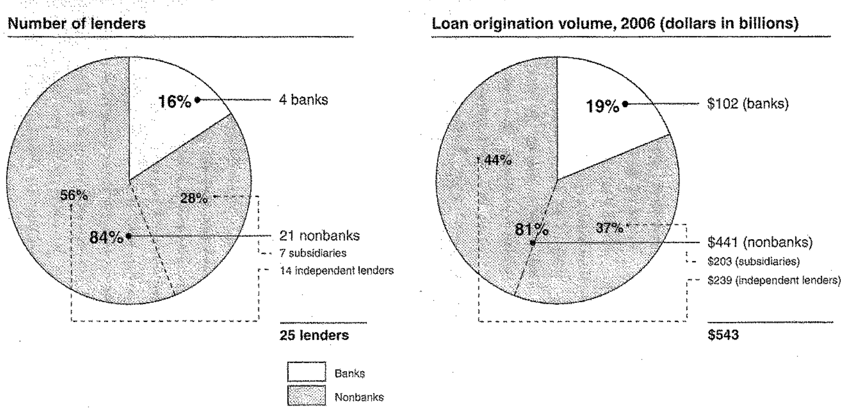
The role of nonbank mortgage lenders in the recent financial collapse provides an example of a gap in our financial regulatory system resulting from activities of institutions that were generally subject to little or no direct oversight by federal regulators.[38] The significant participation by these nonbank lenders in the subprime mortgage market—which targeted products with riskier features to borrowers with limited or poor credit history—contributed to a dramatic loosening in underwriting standards leading up to the crisis. In recent years, nonbank lenders came to represent a large share of the consumer lending market, including for subprime mortgages. Specifically, as shown in figure 3, of the top 25 originators of subprime and other nonprime loans in 2006 (which accounted for more than 90 percent of the dollar volume of all such

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

[38] For the purposes of this report, nonbank lenders are those that are not banks, thrifts, or credit unions. Such entities include independent mortgage lenders, subsidiaries of national banks, subsidiaries of thrifts, and nonbank mortgage lending subsidiaries of holding companies. Although we include operating subsidiaries of national banks in the category of nonbanks, they are subject to the same federal requirements and OCC supervision and examination as their parent bank, according to an OCC official.

originations), all but 4 were nonbank lenders, accounting for 81 percent of origination by dollar volume.[39]

Figure 3: Status of Top 25 Subprime and Nonprime Mortgage Lenders (2006)



Source: GAO.

Although these lenders were subject to certain federal consumer protection and fair lending laws, they were generally not subject to the same routine monitoring and oversight by federal agencies that their bank counterparts were. From 2003 to 2006, subprime lending grew from about 9 percent to 24 percent of mortgage originations (excluding home equity loans), and Alt-A lending (nonprime loans considered less risky than subprime) grew from about 2 percent to almost 16 percent, according to data from the trade publication *Inside Mortgage Finance*. The resulting sharp rise in defaults and foreclosures that occurred as subprime and other homeowners were unable to make mortgage payments led to the collapse of the subprime mortgage market and set off a series of events that led to today's financial turmoil.

[39] Of the 21 nonbank lenders, 7 were subsidiaries of national banks, thrifts, or holding companies.

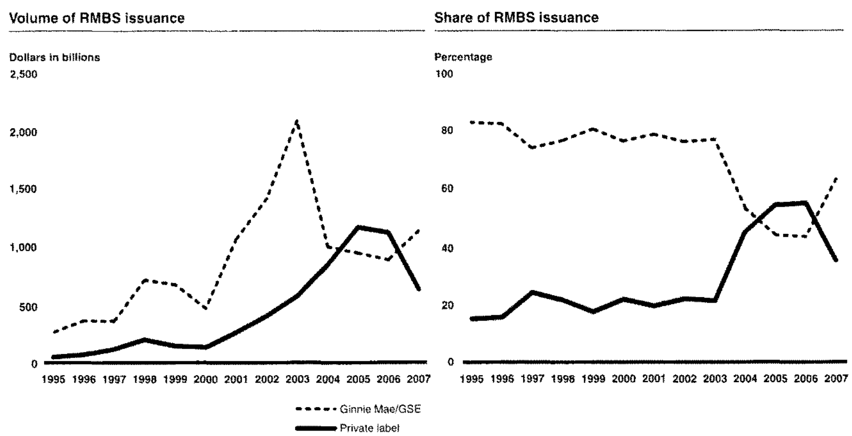
In previous reports, we noted concerns that existed about some of these less-regulated nonbank lenders and recommended that federal regulators actively monitor their activities.[40] For example, in a 2004 report, we reported that some of these nonbank lenders had been the targets of notable federal and state enforcement actions involving abusive lending. As a result, we recommended to Congress that the Federal Reserve should be given a greater role in monitoring the activities of some nonbank mortgage lenders that are subsidiaries of bank holding companies that the Federal Reserve regulates. Only recently, in the wake of the subprime mortgage crisis, the Federal Reserve began a pilot program in conjunction with OTS and the Conference of State Bank Supervisors to monitor the activities of nonbank subsidiaries of holding companies, with the states conducting examinations of independent state-licensed lenders. Nevertheless, other nonbank lenders continue to operate under less rigorous federal oversight and remain an example of the risks posed by less-regulated institutions in our financial regulatory system.

The increased role in recent years of investment banks securitizing and selling mortgage loans to investors further illustrates gaps in the regulatory system resulting from less-regulated institutions. Until recently, GSEs Fannie Mae and Freddie Mac were responsible for the vast majority of mortgage loan securitization. The securitization of loans that did not meet the GSEs' congressionally imposed loan limits or regulator-approved quality standards—such as jumbo loans that exceeded maximum loan limits and subprime loans—was undertaken by investment firms that were subject to little or no standards to ensure safe and sound practices in connection with the purchase or securitization of loans. As the volume of subprime lending grew dramatically from around 2003 through 2006, investment firms took over the substantial share of the mortgage securitization market. As shown in figure 4, this channel of mortgage funding—known as the private label mortgage-backed securities market—grew rapidly and in 2005 surpassed the combined market share of the GSEs and Ginnie Mae—a government corporation that guarantees mortgage-backed securities. As the volume of subprime loans increased, a rapidly growing share was packaged into private label securities, reaching

[40]GAO, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, GAO-04-280 (Washington, D.C.: Jan. 30, 2004); *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, GAO-06-1021 (Washington, D.C.: Sept. 19, 2006); and *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, GAO-08-78R (Washington, D.C.: Oct. 16, 2007).

75 percent in 2006, according to the Federal Reserve Bank of San Francisco.

Figure 4: Growth in Proportion of Private Label Securitization in the Mortgage-Backed Securities Market, in Dollars and Percentage of Dollar Volume (1995-2007)



Source: GAO analysis of data from Inside Mortgage Finance.

As shown in figure 4, this growth allowed private label securities to become approximately 55 percent of all mortgage-backed security issuance by 2005. This development serves as yet another example of how a less-regulated part of the market, private label securitization, played a significant role in fostering risky subprime mortgage lending, exposing a gap in the financial regulatory structure.

The role of mortgage brokers in the sale of mortgage products in recent years has also been a key focus of attention of policymakers. In past work, we noted that the role of mortgage brokers grew in the years leading up to the current crisis. By one estimate, the number of brokerages rose from about 30,000 firms in 2000 to 53,000 firms in 2004. In 2005, brokers accounted for about 60 percent of originations in the subprime market (compared with about 25 percent in the prime market).[41] In 2008, in the wake of the subprime mortgage crisis, Congress enacted the Secure and Fair Enforcement for Mortgage Licensing Act, as part of the Housing and Economic Recovery Act, to require enhanced licensing and registration of mortgage brokers.[42]

Activities of Hedge Funds Can Pose Systemic Risks Not Recognized by Regulatory System

Hedge funds, which are professionally managed investment funds for institutional and wealthy investors, have become significant participants in many important financial markets. For example, hedge funds often assume risks that other more regulated institutions are unwilling or unable to assume, and therefore generally are recognized as benefiting markets by enhancing liquidity, promoting market efficiency, spurring financial innovation, and helping to reallocate financial risk. But hedge funds receive less-direct oversight than other major market participants such as mutual funds, another type of investment fund that manages pools of assets on behalf of investors.[43] Hedge funds generally are structured and operated in a manner that enables them to qualify for exemptions from certain federal securities laws and regulations.[44] Because their participants are presumed to be sophisticated and therefore not require the full protection offered by the securities laws, hedge funds have not generally been subject to direct regulation. Therefore, hedge funds are not subject to regulatory capital requirements, are not restricted by regulation in their choice of investment strategies, and are not limited by regulation in their use of leverage. By soliciting participation in their funds from only certain large institutions and wealthy individuals and refraining from advertising to the general public, hedge funds are not required to meet the registration and disclosure requirements of the Securities Act of 1933 or the Securities Exchange Act of 1934, such as providing their investors with detailed prospectuses on the activities that their fund will undertake using

[41]GAO-08-78R.

[42]"Secure and Fair Enforcement for Mortgage Licensing Act of 2008" or "S.A.F.E. Mortgage Licensing Act of 2008", Pub. L. No. 110-289, title V.

[43]Although there is no statutory definition of hedge funds, the term is commonly used to describe pooled investment vehicles directed by professional managers that often engage in active trading of various types of assets such as securities and derivatives.

[44]See GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*, GAO-08-200 (Washington, D.C.: Jan. 24, 2008), 9.

investors' proceeds.[45] Hedge fund managers that trade on futures exchanges and that have U.S. investors are required to register with CFTC and are subject to periodic reporting, recordkeeping, and disclosure requirements of their futures activities, unless they notify the Commission that they qualify for an exemption from registration.[46]

The activities of many, but not all, hedge funds have recently become subject to greater oversight from SEC, although the rule requiring certain hedge fund advisers to register as investment advisers was recently vacated by a federal appeals court. In December 2004, SEC amended its rules to require certain hedge fund advisers that had been exempt from registering with SEC as investment advisers under its "private adviser" exemption to register as investment advisers.[47] In August 2006, SEC estimated that over 2,500 hedge fund advisers were registered with the agency, although what percentage of all hedge fund advisers active in the United States that this represents is not known. Registered hedge fund advisers are subject to the same requirements as all other registered investment advisers, including providing current information to both SEC and investors about their business practices and disciplinary history, maintaining required books and records, and being subject to periodic SEC examinations. Some questions exist over the extent of SEC's authority over these funds. In June 2006, the U.S. Court of Appeals for the

[45]Under the Securities Act of 1933, a public offering or sale of securities must be registered with SEC, unless otherwise exempted. In order to exempt an offering or sale of hedge fund shares (ownership interests) to investors from registration under the Securities Act of 1933, most hedge funds restrict their sales to accredited investors in compliance with the safe harbor requirements of Rule 506 of Regulation D. See 15 U.S.C. § 77d and § 77e; 17 C.F.R. § 230.506 (2007). Such investors must meet certain wealth and income thresholds. In addition, hedge funds typically limit the number of investors to fewer than 500, so as not to fall within the purview of Section 12(g) of the Securities Exchange Act of 1934, which requires the registration of any class of equity securities (other than exempted securities) held of record by 500 or more persons. 15 U.S.C. § 78l(g).

[46]The registration and regulatory requirements applicable to Commodity Pool Operators and Commodity Trading Advisors are subject to various exceptions and exemptions contained in CFTC regulations. See, e.g., 17 C.F.R. Secs. 4.5 (exclusion from definition of CPO for pools subject to other types of regulation such as supervision as an insured depository institution, registration under the Investment Company Act of 1940, or state regulation as an insurance company), 4.7 (exemptions from disclosure requirements for CPOs and CTAs offering or selling interests to qualified eligible persons or directing or guiding their accounts), 4.12(b) (disclosure exemption for CPOs operating pools offered and sold pursuant to the 1933 Securities Act or an exemption from the Act), 4.13 (exemption from CPO registration), 4.14 (exemption from CTA registration).

[47]69 *Fed. Reg.* 72054 (Dec. 10, 2004).

District of Columbia overturned SEC's amended rule, concluding that the rule was arbitrary because it departed, without reasonable justification, from SEC's long-standing interpretation of the term "client" in the private adviser exemption as referring to the hedge fund itself, and not to the individual investors in the fund.[48] However, according to SEC, most hedge fund advisers that previously registered have chosen to retain their registered status as of April 2007.

Although many hedge fund advisers are now subject to some SEC oversight, some financial regulators and market participants remain concerned that hedge funds' activities can create systemic risk by threatening the soundness of other regulated entities and asset markets. Hedge funds have important connections to the financial markets, including significant business relationships with the largest regulated commercial banks and broker-dealers. They act as trading counterparties with many of these institutions and constitute in many markets a significant portion of trading activity, from stocks to distressed debt and credit derivatives.[49]

The far-reaching consequences of potential hedge fund failures first became apparent in 1998. The hedge fund Long Term Capital Management (LTCM) experienced large losses related to the considerable positions—estimated to be as large as $100 billion—it had taken in various sovereign debt and other markets, and regulators coordinated with market participants to prevent a disorderly collapse that could have led to financial problems among LTCM's lenders and counterparties and potentially to the rest of the financial system.[50] No taxpayer funds were

[48]See *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). In Goldstein, the petitioner challenged an SEC regulation under the Investment Adviser's Act that defined "client" to include hedge fund investors and, therefore, prevented hedge fund advisers from qualifying for an exemption from registration for investment advisers with fewer than 15 clients. See *Goldstein*, 451 F.3d at 874-76. The Court of Appeals vacated the SEC's regulation. While hedge fund advisers may be exempt from registration, the anti-fraud provisions of the Advisers Act apply to all investment advisers, whether or not they are required to register under the Advisers Act. See Goldstein, 451 F.3d at 876. In August 2007, SEC adopted a final rule under the Investment Advisers Act (rule 206(4)-8 which prohibits advisers from (1) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (2) otherwise defrauding these investors. 72 *Fed. Reg.* 44756 (Aug. 9, 2007)).

[49]A counterparty is the opposite party in a bilateral agreement, contract, or transaction.

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

used as part of this effort; instead, the various large financial institutions with large exposures to this hedge fund agreed to provide additional funding of $3.6 billion until the fund could be dissolved in an orderly way. Since LTCM, other hedge funds have experienced near collapses or failures, including two funds owned by Bear Stearns, but these events have not had as significant impact on the broader financial markets as LTCM.

Also, since LTCM's near collapse, investors, creditors, and counterparties have increased their efforts to impose market discipline on hedge funds. According to regulators and market participants, creditors and counterparties have been conducting more extensive due diligence and monitoring risk exposures to their hedge fund clients. In addition, hedge fund advisers have improved disclosure and become more transparent about their operations, including their risk-management practices. However, we reported in 2008 that some regulators continue to be concerned that the counterparty credit risk created when regulated financial institutions transact with hedge funds can be a primary channel for potentially creating systemic risk.[51]

Credit Rating Agency Activities Also Illustrate the Failure of the Regulatory System to Address Risks Posed by Less-Regulated Entities

Similar to hedge funds, credit rating agencies have come to play a critical role in financial markets, but until recently they received little regulatory oversight. While not acting as direct participants in financial markets, credit ratings are widely used by investors for distinguishing the creditworthiness of bonds and other securities. Additionally, credit ratings are used in local, federal, and international laws and regulations as a benchmark for permissible investments by banks, pension funds, and other institutional investors. Leading up to the recent crisis, some investors had come to rely heavily on ratings in lieu of conducting independent assessments on the quality of assets. This overreliance on credit ratings of subprime mortgage-backed securities and other structured credit products contributed to the recent turmoil in financial markets. As these securities started to incur losses, it became clear that their ratings did not adequately reflect the risk that these products ultimately posed. According to the trade publication *Inside B&C Lending*, the three major credit rating agencies have each downgraded more than half of the subprime mortgage-backed securities they originally rated between 2005 and 2007.

[51]See GAO-08-200. Counterparty credit risk is the risk that a loss will be incurred if a counterparty to a transaction does not fulfill its financial obligations in a timely manner.

However, despite the critical nature of these rating agencies in our financial system, the existing regulatory system failed to adequately foresee and manage their role in recent events. Until recently, credit rating agencies received little direct oversight and thus faced no explicit requirements to provide information to investors about how to understand and appropriately use ratings, or to provide data on the accuracy of their ratings over time that would allow investors to assess their quality. In addition, concerns have been raised over whether the way in which credit rating agencies are compensated by the issuers of the securities that they rate affects the quality of the ratings awarded. In a July 2008 report, SEC noted multiple weaknesses in the management of these conflicts of interest, including instances where analysts expressed concerns over fees and other business interests when issuing ratings and reviewing ratings criteria.[52] However, until 2006, no legislation had established statutory regulatory authority or disclosure requirements over credit rating agencies.[53] Then, to improve the quality of ratings in response to events such as the failures of Enron and Worldcom—which highlighted the limitations of credit ratings in identifying companies' financial strength—Congress passed the Credit Rating Agency Reform Act of 2006, which established limited SEC oversight, requiring their registration and certain recordkeeping and reporting requirements.[54]

[52]SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (Washington, D.C., July 8, 2008).

[53]Previously, SEC regulations referred to credit ratings by "nationally recognized statistical rating organizations," or NRSROs, but this designation was not established or defined in statute. SEC staff identified credit rating agencies as NRSROs through a no-action letter process in which they determine whether a rating agency had achieved broad market acceptance for its ratings.

[54]Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (Sept. 29, 2006). Under the act, a credit rating agency seeking to be treated as an NRSRO must apply for, and be granted, registration with SEC, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. In addition, the act provides the SEC with rulemaking authority to prescribe: the form of the application (including requiring the furnishing of additional information); the records an NRSRO must make and retain; the financial reports an NRSRO must furnish to SEC on a periodic basis; the specific procedures an NRSRO must implement to manage the handling of material nonpublic information; the conflicts of interest an NRSRO must manage or avoid altogether; and the practices that an NRSRO must not engage in if SEC determines they are unfair, coercive, or abusive. The act expressly prohibits SEC from regulating the rating agencies' methodologies or the substance of their ratings. Pub. L. No. 109-291 § 4(a). SEC adopted rules implementing the act in June 2007. 72 *Fed. Reg.* 33564 (June 18, 2007).

Since the financial crisis began, regulators have taken steps to address the important role of rating agencies in the financial system. In December 2008, in response to the subprime mortgage crisis and resulting credit market strains, SEC adopted final rule amendments and proposed new rule amendments that would impose additional requirements on nationally recognized statistical rating organizations in order to address concerns raised about the policies and procedures for, transparency of, and potential conflicts of interest relating to ratings. Determining the most appropriate government role in overseeing credit rating activities is difficult. For example, SEC has expressed concerns that too much government intervention—such as regulatory requirements of credit ratings for certain investments or examining the underlying methodology of ratings—would unintentionally provide an unofficial "seal of approval" on the ratings and therefore be counterproductive to reducing overreliance on ratings. Whatever the solution, it is clear that the current regulatory system did not properly recognize and address the risks associated with the important role these entities played.

Regulatory System Failed to Identify Risks Associated with Special-Purpose Entities

The use by financial institutions of special-purpose entities provides another example of how less-regulated aspects of financial markets came to play increasingly important roles in recent years, creating challenges for regulators in overseeing risks at their regulated institutions. Many financial institutions created and transferred assets to these entities as part of securitizations for mortgages or to hold other assets and produce fee income for the institution that created it—known as the sponsor. For example, after new capital requirements were adopted in the late 1980s, some large banks began creating these entities to hold assets for which they would have been required to hold more capital against if the assets were held within their institutions. As a result, these entities are also known as off-balance sheet entities because they generally are structured in such a way that their assets and liabilities are not required to be consolidated and reported as part of the overall balance sheet of the sponsoring financial institution that created them. The amount of assets accumulated in these entities resulted in them becoming significant market participants in the last few years. For example, one large commercial bank reported that its off-balance sheet entities totaled more than $1 trillion in assets at the end of 2007.

Some of these off-balance sheet entities were structured in a way that left them vulnerable to market disruptions. For example, some financial institutions created entities known as asset-backed commercial paper conduits that would purchase various assets, including mortgage-related securities, financial institution debt, and receivables from industrial

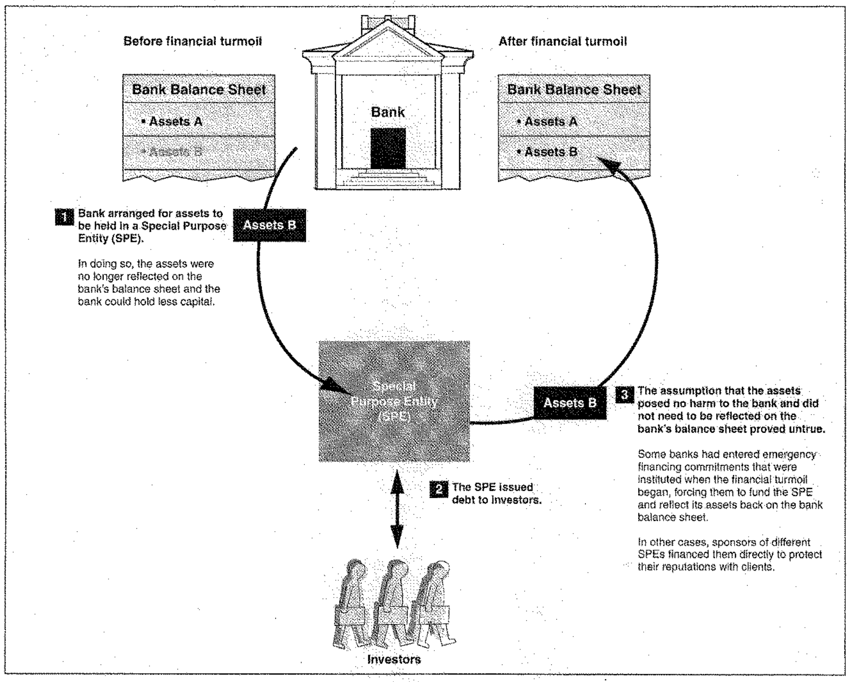
Credit Ratings and the Financial Crisis

Traditionally, products receiving the highest credit ratings, such as AAA, were a small set of corporate and sovereign bonds that were deemed to be the safest and most stable debt investments. However, credit rating agencies assigned similarly high credit ratings to many of the newer mortgage-related products even though these products did not have the same characteristics as previously highly rated securities. As a result of these ratings, institutions were able to successfully market many of these products, including to other financial firms and institutional investors in the United States and around the world. Ratings were seen to provide a common measure of credit risk across all debt products, allowing structured credit products that lacked an active secondary market to be valued against similarly rated products with available prices. Starting in mid-2007, increasing defaults on residential mortgages, particularly those for subprime borrowers, led to a widespread, rapid, and severe series of downgrades by rating agencies on subprime-related structured credit products. These downgrades undermined confidence in the quality of ratings on these and related products. Along with increasing defaults, the uncertainty over credit ratings led to a sharp repricing of assets across the financial system and contributed to large writedowns in the market value of assets by banks and other financial institutions. This contributed to the unwillingness of many market participants to transact with each other due to concerns over the actual value of assets and the financial condition of other financial institutions.

businesses. To obtain the funds to purchase these assets, these special-purpose vehicles often borrowed using shorter-term instruments, such as commercial paper and medium-term notes. The difference between the interest paid to the commercial paper or note holders and the income earned on the entity's assets produced fee and other income for the sponsoring institution. However, these structures carried the risk that the entity would find it difficult or costly to renew its debt financing under less-favorable market conditions.

Although structured as off-balance sheet entities, when the turmoil in the markets began in 2007, many financial institutions that had created these entities had to take back the loans and securities in certain types of these off-balance sheet entities. (See fig. 5.)

Figure 5: Example of an Off-Balance Sheet Entity



Source: GAO.

In general, banks stepped in to finance the assets held by these entities when they were unable to refinance their expiring debt due to market concerns over the quality of the assets. In some cases, off-balance sheet entities relied on emergency financing commitments that many sponsoring banks had extended to these entities. In other cases, financial institutions supported troubled off-balance sheet entities to protect their reputations with clients even when no explicit requirement to do so existed. This, in turn, contributed to the reluctance of banks to lend as they had to fund additional troubled assets on their balance sheets. Thus, although the use of these entities seemingly had removed the risk of these assets from these institutions, their inability to obtain financing resulted in the ownership, risks, and losses of these entities' assets coming back into many of the sponsoring financial institutions.

According to a 2008 IMF study, financial institutions' use of off-balance sheet entities made it difficult for regulators, as well as investors, to fully understand the associated risks of such activities. In response to these developments, regulators and others have begun to reassess the appropriateness of the regulatory and accounting treatment for these entities. In January 2008, SEC asked the Financial Accounting Standards Board (FASB), which establishes U.S. financial accounting and reporting standards, to consider further improvements to the accounting and disclosure for off-balance sheet transactions involving securitization. FASB and the International Accounting Standards Board both have initiated projects to improve the criteria for determining when financial assets and related liabilities that institutions transfer to special-purpose entities should be included on the institutions' own balance sheets—known as consolidation—and to enhance related disclosures. As part of this effort, FASB issued proposed standards that would eliminate a widely used accounting exception for off-balance sheet entities, introduce a new accounting model for determining whether special-purpose entities should be consolidated that is less reliant on mathematical calculations and more closely aligned with international standards, and require additional disclosures about institutions' involvement with certain special-purpose entities. On December 18, 2008, the International Accounting Standards Board also issued a proposed standard on consolidation of special-purpose entities and related risk disclosures. In addition, in April 2008, the Basel Committee on Banking Supervision announced new measures to capture off-balance sheet exposures more effectively.

Nevertheless, this serves as another example of the failure of the existing regulatory system to recognize the problems with less-regulated entities and take steps to address them before they escalate. Existing accounting and disclosure standards had not required banks to extensively disclose their holdings in off-balance sheet entities and allowed for very low capital requirements. As a March 2008 study by the President's Working Group on Financial Markets noted, before the recent market turmoil, supervisory authorities did not insist on appropriate disclosures of firms' potential exposure to off-balance sheet entities.

New and Complex Financial Products and Services Also Revealed Limitations in the Regulatory Structure

Another development that has revealed limitations in the current regulatory structure has been the proliferation of more complex financial products. Although posing challenges, these new products also have provided certain benefits to financial markets and consumers. For example, the creation of securitized products such as mortgage-backed securities increased the liquidity of credit markets by providing additional funds to lenders and a wider range of investment returns to investors with excess funds. Other useful product innovations included OTC derivatives, such as currency options, which provide a purchaser the right to buy a specified quantity of a currency at some future date, and interest rate swaps, which allow one party to exchange a stream of fixed interest rate payments for a stream of variable interest rate payments. These products help market participants hedge their risks or stabilize their cash flows. Alternative mortgage products, such as interest-only loans, originally were used by a limited subset of the population, mainly wealthy borrowers, to obtain more convenient financing for home purchases. Despite these advantages, the complexity and expanded use of new products has made it difficult for the current regulatory system to oversee risk management at institutions and adequately protect individual consumers and investors.

New Complex Securitized Products Have Created Difficulties for Institutions and Regulators in Valuing and Assessing Their Risks

Collateralized debt obligations (CDO) are one of the new products that proliferated and created challenges for financial institutions and regulators. In a basic CDO, a group of loans or debt securities are pooled and securities are then issued in different tranches that vary in risk and return depending on how the underlying cash flows produced by the pooled assets are allocated. If some of the underlying assets defaulted, the more junior tranches—and thus riskier ones—would absorb these losses first before the more senior, less-risky tranches. Purchasers of these CDO securities included insurance companies, mutual funds, commercial and investment banks, and pension funds. Many CDOs in recent years largely consisted of mortgage-backed securities, including subprime mortgage-backed securities.

Although CDOs have existed since the 1980s, recent changes in the underlying asset mix of these products led to increased risk that was poorly understood by the financial institutions involved in these investments. CDOs had consisted of simple securities like corporate bonds or loans, but more recently have included subprime mortgage-backed securities, and in some cases even lower-rated classes of other equally complex CDOs. Some of these CDOs included investments in 100 or more asset-backed securities, each of which had its own large pool of loans and specific payment structures.[55] A large share of the total value of the securities issued were rated AA or AAA—designating them as very safe investments and unlikely to default—by the credit rating agencies. In part because of their seemingly high returns in light of their rated risk, demand for these new CDOs grew rapidly and on a large scale. Between 2004 and 2007, nearly all adjustable-rate subprime mortgages were packaged into mortgage-backed securities, a large portion of which were structured into CDOs.

As housing prices in the United States softened in the last 2 years, default and foreclosure rates on the mortgages underlying many CDOs rose and the credit rating agencies downgraded many CDO ratings, causing investors to become unwilling to purchase these products in the same quantities or at the prices previously paid. Many financial institutions, including large commercial and investment banks, struggled to realize the size of their exposure to subprime credit risk. Many of these institutions appeared to have underestimated the amount of risk and potential losses that they could face from creating and investing in these products. Reductions in the value of subprime-backed CDOs have contributed to reported losses by financial institutions totaling more than $750 billion globally, as of September 2008, according to the International Monetary Fund, which estimates that total losses on global holdings of U.S. loans and securities could reach $1.4 trillion.

Several factors could explain why institutions—and regulators—did not effectively monitor and limit the risk that CDOs represented. Products like CDOs have risk characteristics that differ from traditional investments. First, the variation and complexity of the CDO structures and the underlying assets they contain often make estimating potential losses and determining accurate values for these products more difficult than for traditional securities. Second, although aggregating multiple assets into these structures can diversify and thus reduce the overall risk of the securities issued from them, their exposure to the overall housing market downturn made investors reluctant to purchase even the safest tranches, which produced large valuation losses for the holders of even the highest-

[55]CDO cash flows also can be affected by other contract terms, such as detailed provisions that divert payments from the junior classes to the more senior classes when certain conditions are met, such as if the portfolio value or interest proceeds fall below a certain level.

rated CDO securities.[56] Finally, Federal Reserve staff noted that an additional reason these securities performed worse than expected was that rating agencies and investors did not believe that housing prices could have fallen as significantly as they have.

The lack of historical performance data for these new instruments also presented challenges in estimating the potential value of these securities. For example, the Senior Supervisors Group—a body comprising senior financial supervisors from France, Germany, Switzerland, the United Kingdom, and the United States—reported that some financial institutions substituted price and other data associated with traditional corporate debt in their loss estimation models for similarly rated CDO debt, which did not have sufficient historical data.[57] As a report by a group of senior representatives of financial regulators and institutions has noted, the absence of historical information on the performance of CDOs created uncertainty around the standard risk-management tools used by financial institutions.[58] Further, structured products such as CDOs may lack an active and liquid market, as in the recent period of market stress, forcing participants to look for other sources of valuation information when market prices are not readily available. For instance, market participants often turned to internal models and other methods to value these products, which raised concerns about the consistency and accuracy of the resulting valuation information.

Growth in OTC Derivatives Markets, Which Feature Complex Products That Are Not Regulated, Raised Regulator Concerns about Systemic Risk and Weak Market Infrastructure

The rapid growth in OTC derivatives—or derivatives contracts that are traded outside of regulated exchanges—is another example of how the emergence of large markets for increasingly complex products has challenged our financial regulatory system. OTC derivatives, which began trading in the 1980s, have developed into markets with an estimated notional value—which is the amount underlying a financial derivatives contract—of about $596 trillion, as of December 2007, according to the

[56]For more information, see The Joint Forum, Bank for International Settlements, *Credit Risk Transfer: Developments from 2005 to 2007* (Basel, Switzerland, April 2008).

[57]See the Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (New York, Mar. 6, 2008).

[58]See the Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (Basel, Switzerland, Apr. 7, 2008). The Financial Stability Forum promotes international financial stability through information exchange and international cooperation in financial supervision and surveillance. It is composed of senior representatives of national financial authorities and various international financial organizations and the European Central Bank.

Bank for International Settlements.[59] OTC derivatives transactions are generally not subject to regulation by SEC, CFTC, or any other U.S. financial regulator and in particular are not subject to similar disclosure and other requirements that are in place for most securities and exchange-traded futures products. Institutions that conduct derivatives transactions may be subject to oversight of their lines of business by their regulators. For example, commercial banks that deal in OTC derivatives are subject to full examinations by their respective regulators. On the other hand, investment banks generally conducted their OTC derivatives activities in affiliates or subsidiaries that traditionally—since most OTC derivatives are not securities—were not subject to direct oversight by SEC, although SEC did review how the largest investment banks that were subject to its CSE program were managing the risk of such activities.

Although OTC derivatives and their markets are not directly regulated, the risk exposures that these products created among regulated financial institutions can be sometimes large enough to raise systemic risk concerns among regulators. For example, Bear Stearns, the investment bank that experienced financial difficulties as the result of its mortgage-backed securities activities, was also one of the largest OTC derivatives dealers. According to regulators, one of the primary reasons the Federal Reserve, which otherwise had no regulatory authority over this securities firm, facilitated the sale of Bear Stearns rather than let it go bankrupt was to avoid a potentially large systemic problem because of the firm's large OTC derivatives obligations. More than a decade ago, we reported that the large financial interconnections between derivatives dealers posed risk to the financial system and recommended that Congress and financial regulators take action to ensure that the largest firms participating in the OTC derivatives markets be subject to similar regulatory oversight and requirements.[60]

[59]The notional amount is the amount upon which payments between parties to certain types of derivatives contracts are based. When this amount is not exchanged, it is not a measure of the amount at risk in a transaction. According to the Bank for International Settlements, the amount at risk, as measured by the gross market value of OTC derivatives outstanding, was $15 trillion, as of December 2007, or about 2 percent of the notional/contract amount. (The gross market value is the cost that would be incurred if the outstanding contracts were replaced at prevailing market prices.)

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

The market for one type of OTC derivative—credit default swaps—had grown so large that regulators became concerned about its potential to create systemic risks to regulated financial institutions. Credit default swaps are contracts that act as a type of insurance, or a way to hedge risks, against default or another type of credit event associated with a security such as a corporate bond. One party in the contract—the seller of protection—agrees, in return for a periodic fee, to compensate the other party—the protection buyer—if the bond or other underlying entity defaults or another specified credit event occurs. In recent years, the size of the market for credit default swaps (in terms of the notional amount of outstanding contracts) has increased almost tenfold from just over $6 trillion in 2004 to almost $58 trillion at the end of 2007, according to the Bank for International Settlements.

As this market has grown, regulators increasingly have become concerned about the adequacy of the infrastructure in place for clearing and settling these contracts, especially the ability to quickly resolve contracts in the event of a large market participant failure. For example, in September 2008, concerns over the effects that a potential bankruptcy of AIG—which was a large seller of credit default swaps—would have on this firm's swap counterparties contributed to a decision by the Federal Reserve to lend the firm up to $85 billion.[61] The Federal Reserve expressed concern at the time that a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. As with other OTC derivatives, credit default swaps are not regulated as products, but many of the large U.S. and internationally regulated financial institutions act as dealers. Despite the credit default market's rapid growth, as recently as 2005 the processing of transactions was still paper-based and decentralized. Regulators have put forth efforts over the years to strengthen clearing and settlement mechanisms. For example, in September 2005, the Federal Reserve Bank of New York began working with dealers and market participants to strengthen arrangements for clearing and settling these swap transactions. Regulators began focusing on reducing a large backlog of unconfirmed trades, which can inhibit market participants' ability to manage their risks if errors are not found quickly or if uncertainty exists about how other institutions would

[61]Subsequently, the Federal Reserve agreed to loan AIG up to an additional $38 billion. In November 2008, the Federal Reserve and U.S. Treasury restructured these lending arrangements with a new financial support package totaling over $150 billion.

be affected by the failure of a firm with which they hold credit default swap contracts. Regulators continue to monitor dealers' progress on these efforts to reduce operational risk arising from these products, and recently have begun holding discussions with the largest credit derivatives dealers and other entities, including certain exchanges, regarding the need to establish a centralized clearing facility, which could reduce the risk of any one dealer's failure to the overall system. In November 2008, the President's Working Group on Financial Markets announced policy objectives to guide efforts to address challenges associated with OTC derivatives, including recommendations to enhance the market infrastructure for credit default swaps. However, as of December 2008, no such entity had begun operations.

New Complex Products Have Also Created Challenges for Regulators in Ensuring Adequate Investor and Consumer Protection

The regulations requiring that investors receive adequate information about the risks of financial assets being marketed to them are also being challenged by the development of some of these new and complex products. For some of the new products that have been created, market participants sometimes had difficulty obtaining clear and accurate information on the value of these assets, their risks, and other key information. In some cases, investors did not perform needed due diligence to fully understand the risks associated with their investment. In other cases, investors have claimed they were misled by broker-dealers about the advantages and disadvantages of products. For example, investors for municipal governments in Australia have accused Lehman Brothers of misleading them regarding the risks of CDOs. As another example, the treasurer of Orange County who oversaw investments leading to the county's 1994 bankruptcy claimed to have relied on the advice of a large securities firm for his decision to pursue leveraged investments in complex structured products. Finally, a number of financial institutions—including Bank of America, Wachovia, Merrill Lynch, and UBS—have recently settled SEC allegations that these institutions misled investors in selling auction-rate securities, which are bonds for which the interest rates are regularly reset through auctions. In one case, Bank of America, in October 2008, reached a settlement in principle in response to SEC charges that it made misrepresentations to thousands of businesses, charities, and institutional investors when it told them that the products were safe and highly liquid cash and money market alternative investments.

Similarly, the introduction and expansion of increasingly complicated retail products to new and broader consumer populations has also raised challenges for regulators in ensuring that consumers are adequately protected. Consumers face growing difficulty in understanding the relative advantages and disadvantages of products such as mortgages and credit cards with new and increasingly complicated features, in part because of limitations on the part of regulatory agencies to improve consumer disclosures and financial literacy. For example, in the last few years many borrowers likely did not understand the risks associated with taking out their loans, especially in the event that housing prices would not continue to increase at the rate at which they had been in recent years. In particular, a significant majority of subprime borrowers from 2003 to 2006 took out adjustable-rate mortgages whose interest rates were fixed for the first 2 or 3 years but then adjusted to often much higher interest rates and correspondingly higher mortgage payments. In addition, many borrowers took out loans with interest-only features that resulted in significant increases in mortgage payments later in the loan. The combination of reduced underwriting standards and a slowdown in house price appreciation led many borrowers to default on their mortgages.

Alternative mortgage products such as interest-only or payment option loans, which allow borrowers to defer repayment of principal and possibly part of the interest for the first few years of the loan, grew in popularity and expanded greatly in recent years. From 2003 through 2005, originations of these types of mortgage products grew threefold, from less than 10 percent of residential mortgage originations to about 30 percent. For many years, lenders had primarily marketed these products to wealthy and financially sophisticated borrowers as financial management tools. However, lenders increasingly marketed alternative mortgage products as affordability products that enabled a wider spectrum of borrowers to purchase homes they might not have been able to afford using a conventional fixed-rate mortgage. Lenders also increased the variety of such products offered after interest rates rose and adjustable rate mortgages became less attractive to borrowers.

In past work, we found that most of the disclosures for alternative mortgage products that we reviewed did not always fully or effectively explain the risks associated with these products and lacked information on some important loan features.[62] Some evidence suggests more generally that existing mortgage disclosures were inadequate, a problem that is likely to grow with the increased complexity of products. A 2007 Federal Trade Commission report found that both prime and subprime borrowers

[62]See GAO-06-1021.

failed to understand key loan terms when viewing current disclosures.[63] In addition, some market observers have been critical of regulators' oversight of these products and whether products with such complex features were appropriate for some of the borrowers to which they were marketed. For example, some were critical of the Federal Reserve for not acting more quickly to use its authority under the 1994 Home Ownership and Equity Protection Act to prohibit unfair or deceptive acts or practices in the mortgage market. Although the Federal Reserve took steps in 2001 to ban some practices, such as engaging in a pattern or practice of refinancing certain high-cost loans when it is not in the borrower's interest, it did not act again until 2008, when it banned additional products and practices, such as certain loans with limited documentation. In a 2007 testimony, a Federal Reserve official noted that writing such rules is difficult, particularly since determinations of unfairness or deception depend heavily on the facts of an individual case.[64]

Efforts by regulators to respond to the increased risks associated with new mortgage products also have sometimes been slowed in part because of the need for five federal regulators to coordinate their response. In late 2005, regulators began crafting regulatory guidance to strengthen lending practices and improve disclosures for loans that start with relatively low payments but leave borrowers vulnerable to much higher ones later. The regulators completed their first set of such standards in September 2006, with respect to the disclosure of risks associated with nontraditional mortgage products, and a second set, applicable to subprime mortgage loans, in June 2007.[65] Some industry observers and consumer advocacy groups have criticized the length of time it took for regulators to issue these changes, noting that the second set of guidance was released well after many subprime lenders had already gone out of business.

[63]Federal Trade Commission, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms: A Bureau of Economics Staff Report.* (Washington D.C.: June 2007).

[64]House of Representatives Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Subprime Mortgages*, 110th Cong. 2nd sess., Mar. 27, 2007 (testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Federal Reserve).

[65]71 *Fed. Reg.* 58609 (Oct. 4, 2006) "Interagency Guidance on Nontraditional Mortgage Product Risks"; 72 *Fed. Reg.* 37569 (Jul. 10, 2007) "Statement on Subprime Mortgage Lending".

As variations in the types of credit card products and terms have proliferated, consumers also have faced difficulty understanding the rates and terms of their credit card accounts. Credit card rate and fee disclosures have not always been effective at clearly conveying associated charges and fees, creating challenges to informed financial decision making. Although credit card issuers are required to provide cardholders with information aimed at facilitating informed use of credit, these disclosures have serious weaknesses that likely reduce consumers' ability to understand the costs of using credit cards. Because the pricing of credit cards is not generally subject to federal regulation, these disclosures are the primary federal consumer protection mechanism against inaccurate and unfair credit card practices. However, we reported in 2006 that the disclosures in materials provided by four of the largest credit card issuers were too complicated for many consumers to understand. Following our report, Federal Reserve staff began using consumer testing to involve them to a greater extent in the preparation of potentially new and revised disclosures, and in May 2007, issued proposed changes to credit card disclosure requirements. Nonetheless, the Federal Reserve recognizes the challenge of presenting the information that consumers may need to understand the costs of their cards in a clear way, given the increasingly complicated terms of credit card products.[66] In December 2008, the Federal Reserve, OTS, and NCUA finalized rules to ban various unfair credit card practices, such as allocating payments in a way that unfairly maximizes interest charges.

The expansion of new and more complex products also raises challenges for regulators in addressing financial literacy. We have also noted in past work that even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters.[67] In response to increasing evidence that many Americans are lacking in financial literacy, the federal government has taken steps to expand financial education efforts. However, attempts by the Financial Literacy and Education Commission to coordinate federal financial literacy efforts have sometimes proven difficult due, in part, to the need to reach consensus among its 20 participating federal agencies, which have different missions and perspectives. Moreover, the commission's staff and

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

[67]See GAO-04-280.

funding resources are relatively small, and it has no legal authority to require agencies to redirect their resources or take other actions.[68]

Increased Complexity and Other Factors Have Challenged Accounting Standard Setters and Regulators

As new and increasingly complex financial products have become more common, FASB and SEC have also faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.[69] The development and widespread use of increasingly complex financial products has heightened the importance of having effective accounting and financial reporting requirements that provide interested parties with information that can help them identify and assess risk. As the pace of financial innovation increased in the last 30 years, accounting and financial reporting requirements have also had to keep pace, with 72 percent of the current 163 standards having been issued since 1980—some of which were revisions and amendments to recently established standards, which evidences the challenge of establishing accounting and financial reporting requirements that respond to needs created by financial innovation.

As a result of the growth in complex financial instruments and a desire to improve the usefulness of financial information about them, U.S. standard setters and regulators currently are dealing with accounting and auditing challenges associated with recently developed standards related to valuing financial instruments and special-purpose entities. Over the last year, owners and issuers of financial instruments have expressed concerns about implementing the new fair value accounting standard, which requires that financial assets and liabilities be recorded at fair or market value. SEC and FASB have recently issued clarifications of measuring fair value when there is not an active market for the financial instrument.[70] In addition, market participants raised concerns about the availability of

[68]See GAO, *Financial Literacy and Education Commission: Further Progress Needed to Ensure an Effective National Strategy*, GAO-07-100 (Washington, D.C.: Dec. 4, 2006).

[69]FASB issues generally accepted accounting principles for financial statements prepared by nongovernmental entities in the United States. SEC issues financial reporting and disclosure requirements for U.S. publicly traded companies and recognizes the standards issued by FASB as "generally accepted" within the United States. SEC oversees FASB's standard-setting activities.

[70]FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (Oct. 10, 2008); and SEC Press Release No. 2008-234, *SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting* (Sept. 30, 2008).

useful accounting and financial reporting information to assess the risks posed by special-purpose entities. Under current accounting rules, publicly traded companies that create qualifying special-purpose entities are allowed to move qualifying assets and liabilities associated with certain complex financial instruments off the issuing company's balance sheets, which results in virtually no accounting and financial reporting information being available about the entities' activities. Due to the accounting and financial reporting treatment for these special-purpose entities, as the subprime crisis worsened, banks initially refused to negotiate loans with homeowners because banks were concerned that the accounting and financial reporting requirements would have the banks put the assets and liabilities back onto their balance sheets. In response to questions regarding modification of loans in special-purpose entities, the SEC's Chief Accountant issued a letter that concluded his office would not object to loans being modified pursuant to specific screening criteria. In response to these concerns, FASB expedited its standards-setting process in order to reduce the amount of time before the issuance of a new accounting standard that would effectively eliminate qualified special-purpose entities.[71]

Standard setters and regulators also face new challenges in dealing with global convergence of accounting and auditing standards. The rapid integration of the world's capital markets has made establishing a single set of effective accounting and financial reporting standards increasingly relevant. FASB and SEC have acknowledged the need to address the convergence of U.S. and international accounting standards, and SEC has proposed having U.S. public companies use International Financial Reporting Standards by 2014. As the globalization of accounting standards moves forward, U.S. standard setters and regulators need to anticipate and manage the challenges posed by their development and implementation, such as how to apply certain standards in unique legal and regulatory environment frameworks in the United States as well as in certain unique industry niches. Ensuring that auditing standards applicable to U.S. public companies continue to provide the financial markets with the important

[71]On September 15, 2008, FASB issued an exposure draft, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, for a 30-day comment period that closed on October 15, 2008. On December 11, 2008, FASB issued FASB Staff Position (FSP) FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. This document requires additional disclosures about transfers of financial assets and variable interests in qualifying special purpose entities. It also requires public enterprises to provide additional disclosures about their involvement with variable interest entities.

and independent assurances associated with existing U.S. auditing standards will also prove challenging to the Public Company Accounting Oversight Board.

Globalization Will Further Challenge the Existing U.S. Regulatory System

Just as global accounting and auditing standards are converging, financial markets around the world are becoming increasingly interlinked and global in nature, requiring U.S. regulators to work with each other and other countries to effectively adapt. To effectively oversee large financial services firms that have operations in many countries, regulators from various countries must coordinate regulation and supervision of financial services across national borders and must communicate regularly. Although financial regulators have effectively coordinated in a number of ways to accommodate some changes, the current fragmented regulatory structure has complicated some of these efforts.

For example, the current U.S. regulatory system complicates the ability of financial regulators to convey a single U.S. position in international discussions, such as those related to the Basel Accords process for developing international capital standards. Each federal regulator involved in these efforts oversees a different set of institutions and represents an important regulatory perspective, which has made reaching consensus on some issues more difficult than others. Although U.S. regulators generally agree on the broad underlying principles at the core of Basel II, including increased risk sensitivity of capital requirements and capital neutrality, in a 2004 report we noted that although regulators communicated and coordinated, they sometimes had difficulty agreeing on certain aspects of the process.[72] As we reported, in November 2003, members of the House Financial Services Committee warned in a letter to the bank regulatory agencies that the discord surrounding Basel II had weakened the negotiating position of the United States and resulted in an agreement that was less than favorable to U.S. financial institutions.[73] International officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making. However, regulatory officials told us that the final outcome of the Basel II negotiations was better than it would have been with a single U.S. representative because of the agencies' varying perspectives and expertise. In particular, one regulator noted that, in light of the magnitude

[72]GAO-05-61.

[73]Letter from Representative Michael Oxley et al. to Chairman Alan Greenspan et al., Nov. 3, 2003.

of recent losses at banks and the failure of banks and rating agencies to predict such losses, the additional safeguards built into how U.S. regulators adopted Basel II are an example of how more than one regulatory perspective can improve policymaking.

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

The U.S. regulatory system is a fragmented and complex system of federal and state regulators—put into place over the past 150 years—that has not kept pace with the major developments that have occurred in financial markets and products in recent decades. In 2008, the United States finds itself in the midst of one of the worst financial crises ever, with instability threatening global financial markets and the broader economy. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, attention has also turned to the need to consider significant reforms to the financial regulatory system to keep pace with existing and anticipated challenges in financial regulation.

While the current U.S. system has many features that could be preserved, the significant limitations of the system, if not addressed, will likely fail to prevent future crises that could be as harmful as or worse than those that have occurred in the past. Making changes that better position regulators to oversee firms and products that pose risks to the financial system and consumers and to adapt to new products and participants as these arise would seem essential to ensuring that our financial services sector continues to serve our nation's needs as effectively as possible.

We have conducted extensive work in recent decades reviewing the impacts of market developments and overseeing the effectiveness of financial regulators' activities. In particular, we have helped Congress address financial crises dating back to the savings and loan and LTCM crises, and more recently over the past few years have issued several reports citing the need to modernize the U.S. financial regulatory structure. In this report, consistent with our past work, we are not proposing the form and structure of what a new financial regulatory system should look like. Instead, we are providing a framework, consisting of the following nine elements, that Congress and others can use to evaluate or craft proposals for financial regulatory reform. By applying the elements of this framework to proposals, the relative strengths and weaknesses of each one should be better revealed. Similarly, the framework we present could be used to craft a proposal or to identify aspects to be added to existing proposals to make them more effective and appropriate for addressing the limitations of the current system. The nine elements could be addressed in a variety of ways, but each is critically important in establishing the most effective and efficient financial regulatory system possible.

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

A critical first step to modernizing the regulatory system and enhancing its ability to meet the challenges of a dynamic financial services industry is to clearly define regulatory goals and objectives. In the background of this report, we identify four broad goals of financial regulation that regulators have generally sought to achieve. These include ensuring adequate consumer protections, ensuring the integrity and fairness of markets, monitoring the safety and soundness of institutions, and acting to ensure the stability of the overall financial system. However, these goals are not always explicitly set in the federal statutes and regulations that govern these regulators. Having specific goals clearly articulated in legislation could serve to better focus regulators on achieving their missions with greater certainty and purpose, and provide continuity over time.

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

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

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

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

Key issues to be addressed:

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

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

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

Key issues to be addressed:

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

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

A regulatory system should focus on risks to the financial system, not just institutions. As noted earlier, with multiple regulators primarily responsible for individual institutions or markets, none of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry. As we noted earlier in the report, the collective activities of a number of entities—including mortgage brokers, real estate professionals, lenders, borrowers, securities underwriters, investors, rating agencies and others—likely all contributed to the recent market crisis, but no one regulator had the necessary scope of oversight to identify the risks to the broader financial system. Similarly, once firms began to fail and the full extent of the financial crisis began to become clear, no formal mechanism existed to monitor market trends and potentially stop or help mitigate the fallout from these events.

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

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

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

Key issues to be addressed:

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.
- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.

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

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

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

Key issues to be addressed:

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

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

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

With that said, recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability. As we noted earlier, efforts by regulators to respond to the increased risks associated with new mortgage products were sometimes slowed in part because of the need for five federal regulators to coordinate their response. The Chairman of the Federal Reserve has similarly noted that the different regulatory and supervisory regimes for lending institutions and mortgage brokers made monitoring such institutions difficult for both regulators and investors. Similarly, we noted earlier in the report that the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

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

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

Organizing agencies around regulatory goals as opposed to the existing sector-based regulation may be one way to improve the effectiveness of the system, especially given some of the market developments discussed earlier. Whatever the approach, policymakers should seek to minimize conflict in regulatory goals across regulators, or provide for efficient mechanisms to coordinate in cases where goals inevitably overlap. For example, in some cases, the safety and soundness of an individual institution may have implications for systemic risk, or addressing an unfair or deceptive act or practice at a financial institution may have implications on the institution's safety and soundness by increasing reputational risk. If a regulatory system assigns these goals to different regulators, it will be important to establish mechanisms for them to coordinate.

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

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

Key issues to be addressed:

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

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

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

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

Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer

protections, including suitability requirements and disclosures across the financial services industry.

- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how products are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.

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

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

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

In considering authority, agencies must have the necessary enforcement and other tools to effectively implement their missions to achieve regulatory goals. For example, as noted earlier, in a 2007 report we expressed concerns over the appropriateness of having OTS oversee diverse global financial firms given the size of the agency relative to the institutions for which it was responsible.[74] It is important for a regulatory system to ensure that agencies are provided with adequate resources and expertise to conduct their work effectively. A regulatory system should also include adequate checks and balances to ensure the appropriate use of agency authorities. With respect to accountability, policymakers may also want to consider different governance structures at agencies—the current system includes a combination of agency heads and independent boards or commissions—and how to ensure that agencies are recognized for successes and held accountable for failures to act in accordance with regulatory goals.

Key issues to be addressed:

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

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

A regulatory system should ensure that similar institutions, products, and services posing similar risks are subject to consistent regulation, oversight, and transparency. Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very

[74]GAO-07-154.

different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.

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

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

Key issues to be addressed:

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

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

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

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

Key issues to be addressed:

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

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

In addition, our past work has identified certain critical factors that should be addressed to ensure that any large-scale transitions among government agencies are implemented successfully.[75] Although all of these factors are likely important for a successful transformation for the financial regulatory system, Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.

Comments from Agencies and Other Organizations, and Our Evaluation

We provided the opportunity to review and comment on a draft of this report to representatives of 29 agencies and other organizations, including federal and state financial regulatory agencies, consumer advocacy groups, and financial service industry trade associations. A complete list of organizations that reviewed the draft is included in appendix II. All reviewers provided valuable input that was used in finalizing this report. In general, reviewers commented that the report represented a high-quality and thorough review of issues related to regulatory reform. We made changes throughout the report to increase its precision and clarity and to provide additional detail. For example, the Federal Reserve provided comments indicating that our report should emphasize that the traditional goals of regulation that we described in the background section are incomplete unless their ultimate purpose is considered, which is to promote the long-term growth, stability, and welfare of the United States. As a result, we expanded the discussion of our framework element concerning the need to have clearly defined regulatory goals to emphasize

[75] See GAO, *Homeland Security: Critical Design and Implementation Issues*, GAO-02-957T. (Washington, D.C.: July 17, 2002).

that policymakers will need to ensure that such regulation is balanced with other national goals, including facilitating capital raising and fostering innovation.

In addition, we received formal written responses from the American Bankers Association, the American Council of Life Insurers, the Conference of State Bank Supervisors, Consumers Union, the Credit Union National Association, the Federal Deposit Insurance Corporation, the Mortgage Bankers Association, and the National Association of Federal Credit Unions, and a joint letter from the Center for Responsible Lending, the National Consumer Law Center, and U.S. PIRG; all formal written responses are included as appendixes to this report.

Among the letters we received, various commenters raised additional issues regarding consumer protection and risky products. For example, in a joint letter, the Center for Responsible Lending, the National Consumer Law Center, and the U.S. PIRG noted that the best way to avoid systemic risk is to address problems that exist at the level of individual consumer transactions, before they pose a threat to the system as a whole. They also noted that although most of the subprime lending was done by nonbank lenders, overly aggressive practices for other loan types and among other lenders also contributed to the current crisis. In addition, they noted that to effectively protect consumers, the regulatory system must prohibit unsustainable lending and that disclosures and financial literacy are not enough. The letter from FDIC agreed that effective reform of the U.S. financial regulatory system would help avoid a recurrence of the economic and financial problems we are now experiencing. It also noted that irresponsible lending practices were not consistent with sound banking practices. FDIC's letter also notes that the regulatory structure collectively permitted excessive levels of leverage in the nonbank financial system and that statutory mandates that address consumer protection and aggressive lending practices and leverage among firms would be equally important for improving regulation as would changing regulatory structure. In a letter from Consumers Union, that group urged that consumer protection be given equal priority as safety and soundness and that regulators act more promptly to address emerging risks rather than waiting until a problem has become national in scope. The letter indicates that Consumers Union supports an independent federal consumer protection agency for financial services and the ability of states to also develop and enforce consumer protections. We made changes in response to many of these comments. For example, we enhanced our discussion of weaknesses in regulators' efforts to oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system, and we made changes to the framework to emphasize the importance of consumer protection.

Several of the letters addressed issues regarding potential consolidation of regulatory agencies and the role of federal and state regulation. The letter from the American Bankers Association said that the current system of bank regulation and oversight has many advantages and that any reform efforts should build on those advantages. The letter also noted that there are benefits to having multiple federal regulators, as well as a dual banking system. The letter from the Conference of State Bank Supervisors agreed with our report that the U.S. regulatory system is complex and clearly has gaps, but cautioned that consolidating regulation and making decisions that could indirectly result in greater industry consolidation could exacerbate problems. The letter also indicates concern that our report does not fully acknowledge the importance of creating an environment that promotes a diverse industry to serve the nation's diverse communities and prevents concentration of economic power in a handful of institutions. Our report does discuss the benefits of state regulation of financial institutions, but we did not address the various types of state institutions because we focused mainly on the federal role over our markets. In the past, our work has acknowledged the dual banking system has benefits and that concentration in markets can have disadvantages. The Conference of State Bank Supervisors letter also notes that state efforts to respond to consumer abuses were stymied by federal pre-emption and that a regulatory structure should preserve checks and balances, avoid concentrations of power, and be more locally responsive. In response to this letter, we also added information about the enactment of the Secure and Fair Enforcement for Mortgage Licensing Act, as part of the Housing and Economic Recovery Act, which requires enhanced licensing and registration of mortgage brokers.

The letter from the National Association of Federal Credit Unions urged that an independent regulator for credit unions be retained because of the distinctive characteristics of federal credit unions. A letter from the Credit Union National Association also strongly opposes combining the credit union regulator or its insurance function with another agency. The letter from the Mortgage Bankers Association urges that a federal standard for mortgage lending be developed to provide greater uniformity than the currently diffuse set of state laws. They also supported consideration of federal regulation of independent mortgage bankers and mortgage brokers as a way of improving uniformity and effectiveness of the regulation of these entities. A letter from the American Council of Life Insurers noted that the lack of a federal insurance regulatory office provides for uneven consumer protections and policy availability nationwide and hampers the country's ability to negotiate internationally on insurance industry issues, and urged that we include a discussion of the need to consider a greater federal role in the regulation of insurance. As a result, in the section where we discuss the need for efficient and effective regulation we noted that harmonizing insurance regulation across states has been difficult, and that Congress could consider the advantages and disadvantages of providing a federal charter option for insurance and creating a federal insurance regulatory entity.

We are sending copies of this report to interested congressional committees and members. In addition, we are sending copies to the federal financial regulatory agencies and associations representing state financial regulators, financial industry participants, and consumers, as well as to the President and Vice President, the President-Elect and Vice President-Elect, and other interested parties. The report also is available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix XII.

Gene L. Dodaro
Acting Comptroller General of the United States

List of Congressional Addressees

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

The Honorable Joseph I. Lieberman
Chairman
The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

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

The Honorable Edolphus Towns
Chairman
The Honorable Darrell E. Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

The Honorable Richard J. Durbin
The Honorable Tim Johnson
The Honorable Jack Reed
United States Senate

The Honorable Judy Biggert
The Honorable Paul E. Kanjorski
The Honorable Carolyn B. Maloney
The Honorable José E. Serrano
House of Representatives

Appendix I: Scope and Methodology

Our report objectives were to (1) describe the origins of the current financial regulatory system, (2) describe various market developments and changes that have raised challenges for the current system, and (3) present an evaluation framework that can be used by Congress and others to craft or evaluate potential regulatory reform efforts going forward.

To address all of these objectives, we synthesized existing GAO work on challenges to the U.S. financial regulatory structure and on criteria for developing and strengthening effective regulatory structures. These reports are referenced in footnotes in this report and noted in the Related GAO Products appendix. In particular, we relied extensively on our recent body of work examining the financial regulatory structure, culminating in reports issued in 2004 and 2007.[1] We also reviewed existing studies, government documents, and other research for illustrations of how current and past financial market events have revealed limitations in our existing regulatory system and suggestions for regulatory reform.

In addition, to gather input on challenges with the existing system and important considerations in evaluating reforms, we interviewed several key individuals with broad and substantial knowledge about the U.S. financial regulatory system—including a former Chairman of the Board of Governors of the Federal Reserve System (Federal Reserve), a former high-level executive at a major investment bank that had also served in various regulatory agencies, and an international financial organization official that also served in various regulatory agencies. We selected these individuals from a group of notable officials, academics, legal scholars, and others we identified as part of this and other GAO work, including a 2007 expert panel on financial regulatory structure. We selected individuals to interview in an effort to gather government, industry, and academic perspectives, including on international issues. In some cases, due largely to the market turmoil at the time of our study, we were unable to or chose not to reach out to certain individuals, but took steps to ensure that we selected other individuals that would meet our criteria.

To develop the evaluation framework, we also convened a series of three forums in which we gathered comments on a preliminary draft of our framework from a wide range of representatives of federal and state

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

financial regulatory agencies, financial industry associations and institutions, and consumer advocacy organizations. In particular, at a forum held on August 19, 2008, we gathered comments from representatives of financial industry associations and institutions, including the American Bankers Association, the American Council of Life Insurers, The Clearing House, Columbia Bank, the Independent Community Bankers of America, The Financial Services Roundtable, Fulton Financial Corporation, the Futures Industry Association, the Managed Funds Association, the Mortgage Bankers Association, the National Association of Federal Credit Unions, the Securities Industry and Financial Markets Association, and the U.S. Chamber of Commerce. We worked closely with representatives at the American Bankers Association—which hosted the forum at its Washington, D.C., headquarters—to identify a comprehensive and representative group of industry associations and institutions.

At a forum held on August 27, 2008, we gathered comments from representatives of consumer advocacy organizations, including the Center for Responsible Lending, the Consumer Federation of America, the Consumers Union, the National Consumer Law Center, and the U.S. PIRG. We invited a comprehensive list of consumer advocacy organization representatives—compiled based on extensive dealings with these groups from current and past work—to participate in this forum and hosted it at GAO headquarters in Washington, D.C.

At a forum held on August 28, 2008, we gathered comments from representatives of federal and state banking, securities, futures, insurance and housing regulatory oversight agencies, including the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Department of the Treasury, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Federal Reserve, the Financial Industry Regulatory Authority, the National Association of Insurance Commissioners, the National Credit Union Administration, the North American Securities Administrators Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Public Company Accounting Oversight Board, and the Securities and Exchange Commission. We worked closely with officials at the Federal Reserve—which hosted the forum at its Washington, D.C., headquarters—to identify a comprehensive and representative group of federal and state financial regulatory agencies.

We conducted this work from April 2008 to December 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Agencies and Other Organizations That Reviewed the Draft Report

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

Appendix III: Comments from the American Bankers Association

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December 19, 2008

Ms. Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The American Bankers Association[1] (ABA) appreciates the opportunity to provide comments in connection with the Government Accountability Office's (GAO) draft report entitled, *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, which we understand is to be published in January, 2009. The purpose of the report is to identify existing problems with the financial regulatory system and craft a framework to assist in the evaluation of reform proposals.

We believe that any review of the current regulatory system should begin with the recognition that banks have been and continue to be the primary institutions for saving, lending, and financing economic growth in our nation's communities. Banks are also the leading players in the payments system and the only institutions that can be found participating in every stage of the payments system. Held to high standards of financial strength and integrity of operations, banks are well-poised to be engines of economic recovery and continued economic growth and development thereafter.

Our customers include people and families from all walks of life and involve businesses of all sizes. The innovation and the diversity of the banking industry enable us to meet changing customer needs and interests. Through these efforts in recent decades more people have gained access to a wider array of banking products—and at lower costs—than ever before, and better than anywhere else in the world.

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1 The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.6 trillion in assets and employ over 2 million men and women.

We support a regulatory program that fosters a climate in which we can build on these accomplishments and continue our progress in providing more and better services to more people and businesses at lower costs. With that in mind, we offer the following observations about ways in which changes to the current system could achieve these objectives.

The central objective of regulatory reform efforts should be to enhance banks' ability to meet the needs of their customers. This objective has several facets. First, regulation needs to foster safe and sound operations. Second, it must provide appropriate consumer protections. Third, it needs to promote competition. And fourth, it must foster innovation and facilitate banks' ability to meet changing customer needs. These facets, while distinct, are wholly compatible. A financial institution will best be able to achieve its business objectives by responsibly managing its risks; by providing a full range of products and services to all customers who can responsibly manage *their* risks; and by competing against others based on price, product quality, reputation, and other customer interests, not by undermining standards of integrity. We believe it is incumbent upon policy makers to create the legal framework that supports these goals.

Any regulatory reform effort must focus on solving the problems that caused the current market turmoil. This necessarily entails identifying what those problems are so that responses can be tailored accordingly. A business model that combines activities that are financial in nature and thereby draws from a diversified revenue mix has shown to be a solution to, and not a part of, the current problems. Thus reform efforts should facilitate banks offering a broad range of financial products and services. Conversely, reform efforts should be careful not merely to impose new regulations on the banking sector, which did not cause the crisis and which continues to provide credit; rather it should remove unnecessary regulations that impede sound lending and efficient operations.

The current system of bank regulation and oversight has many advantages, and we believe any reform efforts should build on those advantages. As the recent rush by non-bank actors to obtain bank charters has demonstrated, bank regulation and supervision has proven to be the most durable method to minimize risks to safety and soundness. Moreover, it provides a useful check against any one regulator neglecting its duties, becoming too calcified for an ever-changing financial marketplace, growing overly bureaucratic and ineffective, or otherwise imposing regulatory conditions inconsistent with the ability of financial firms to serve their customers. Thus, the ABA supports the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and the Office of Thrift Supervision with regard to their diverse supervision and oversight responsibilities within the U.S. banking system.

Just as there is a benefit in having multiple federal regulators, so too is there a benefit in having a dual banking system. States have for years operated as incubators for new products and services, such as NOW accounts and adjustable rate mortgages. The dual banking system has proven vital to the continued evolution of the U.S. banking. Close coordination between federal bank regulators and state banking commissioners within the Federal Financial Institutions Examination Council (FFIEC) as well as during joint bank examinations is a dynamic element of the dual banking system, resulting in a system of complementary supervision.

Recent economic turmoil has drawn attention to the need for a regulator with explicit jurisdiction to manage systemic risk. The primary responsibility of systemic risk regulation should be protecting the economy from major shocks and working with bank supervisors to avoid pro-cyclical directives within the supervisory process. The systemic risk regulator would gather information, monitor exposures throughout the system and take action in concert with domestic and international supervisors to minimize risks to the economy. For maximum effectiveness and ease of implementation, systemic risk regulation should rely on existing regulatory structures and restrict its oversight to a limited number of large market participants, both bank and non-bank.

There clearly is a need for better supervision and regulation of many non-bank actors, such as mortgage banks and brokers that are not affiliated with an insured depository institution. Consumer confidence in the financial sector as a whole suffers when non-bank actors offer bank-like services while operating under substandard or non-existent guidelines for safety and soundness. Lesser-regulated companies and individuals participating in bank-like activities or offering bank-like products and services should be subject to bank-like regulation and capital requirements. Regulatory reform should tackle these issues and bring appropriate oversight to inadequately or ineffectively regulated financial products and services.

This should be done within the context of agencies that have the authority and responsibility to supervise all aspects of an institution's activities. Safety and soundness issues and consumer protection are closely linked for banks and should be supervised as such. Treating consumers unfairly is inconsistent with safe and sound operations; so, too, is attempting to insulate consumers from any risk. Well-run institutions keep both facets in mind, and their regulators should as well. This argues in favor of continuing to place responsibility for both consumer protection and safety and soundness with the banking agencies.

It also should be done in a manner that preserves the independence of the Federal Reserve Board (Board) and keeps the Board's primary focus on the conduct of monetary policy. Any expansion of the Board's authority to serve as the systemic risk regulator should be made only if such authority would not create conflicts of interest for the Board or otherwise compromise its ability to carry out its responsibilities for monetary policy.

Any regulatory restructuring effort must recognize the benefits of charter choice. A robust banking sector requires participants of all sizes and business models, including community banks, development banks, and niche-focused financial institutions as well as regional, national, and international banks. Federal and state bank charter alternatives, a broad range of business models, as well as choice of ownership structure (encompassing S corporations, limited liability corporations, mutual ownership, and other forms of publicly-traded and privately-held banks) promotes responsiveness to changing customer needs, consumer preferences, and economic conditions. Only a diverse, well-regulated banking system can bring sustainable increases in homeownership and community development that are essential to economic recovery.

This diversity is not well-served by a system that treats any financial institution as if it were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole. Clear actions strengthening the competitive position of all banks are needed to address and ameliorate the negative effect on the majority of financial institutions when a select few are designated as too big to fail. Moreover, financial regulators should develop a program to identify, monitor, and respond effectively to market developments arising to the perception of an institution as too big or too complex to fail—particularly in times of financial stress. The ad hoc approach used in the resolution of Lehman Brothers and Bear Sterns is inadequate. Specific authorities and programs must be developed to manage the orderly transition or resolution of any systemically significant financial institution, bank or non-bank.

Any reform effort also must address issues in our accounting rules that create a pro-cyclical downward drag on the financial sector and the economy as a whole. Accounting should be a reflection of economic reality, not a driver. Reforms to accounting standards should make the standard setting process accountable to the market and implement standards that consider the real-world effects of the rules. Rules governing loan-loss reserves and fair value accounting should minimize pro-cyclical effects that reinforce economic highs and lows. A reformed accounting system would recognize that functioning accounting rules are essential to minimizing systemic risk and fostering economic growth

Thank you for the opportunity to comment on this proposal. Should you have any questions, please contact the undersigned at 202-663-5333 or ddepierr@aba.com.

Sincerely,

Denyette DePierro

Appendix IV: Comments from the American Council of Life Insurers

ACLI
Financial Security. For Life

Julie A. Spiezio
Senior Vice President, Insurance Regulation & Deputy General Counsel

December 15, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548
williamso@gao.gov

RE: Draft Report on Reforming the Financial Regulatory System

Dear Ms. Williams:

These comments are submitted on behalf of the American Council of Life Insurers (ACLI). The ACLI is a national trade association with 353 member companies that account for 93 percent of the industry's total assets, 93 percent of U.S life insurance premiums and 95 percent of U.S. annuity considerations. We appreciate being given an opportunity to comment on the draft report.

At GAO's invitation, ACLI staff undertook a brief review of the draft report at GAO headquarters early last week. Speaking from an insurance industry perspective, we were surprised that the draft report did not include discussion of the need for insurance regulatory reform as part of the broader financial services industry reform effort. We believe this is an important oversight and one that should be addressed before the final report is issued by the GAO.

Currently there is no insurance expertise in the federal government. Prior to the crisis that has beset the financial service industry since September of this year, this fact was proving to be a costly problem for American consumers and insurers alike. A regulatory system that provides for uneven consumer protections and policy availability nationwide is not compatible with the economic model of the 21st century. In addition, the lack of a federal insurance regulatory office prevents the United States from adequately addressing its citizens' needs in international trade negotiations and treaty developments involving insurance industry issues. These issues alone warrant discussion of the need for a federal role in insurance regulation via the availability of an optional federal insurance charter (OFC).

The economic crisis has only served to underscore this need. The crisis has highlighted for policymakers and the general public alike that insurers play a systemic role in our economy, both nationally and internationally. And today, after all that has taken place over the past few months, both the executive and legislative branches of the federal government remain handicapped in their ability to completely understand and respond to the underlying insurance issues that are part of the financial crisis because they lack any insurance industry regulatory expertise.

These facts make the lack of reference to the issue of insurance regulatory reform in the draft GAO report just that much more puzzling. The report directly addresses the need for the federal government

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to assume some regulatory responsibility over other areas of the financial services industry where it currently lacks such authority (e.g., hedge funds), but remains conspicuously silent on the insurance regulatory reform/OFC issue. We feel this is not simply an oversight, but is a lost opportunity to help Congress in its effort to effectively reform and modernize the whole of financial services industry regulation moving forward.

For all of these reasons, we respectfully request that prior to the final publication of this GAO report it be revised to include discussion of the need for insurance regulatory reform. It is our opinion that releasing the report without such a revision will render the report incomplete and therefore of less value to both the Congress and the public at large then it otherwise might be.

Thank you again for this opportunity to comment on the draft report. Please feel free to contact me directly if you have any questions or would like to discuss this issue further.

Very truly yours,

Julie A. Spiezio

Julie A. Spiezio

Cc: Randy Fasnacht
Cody Goebel

Appendix V: Comments from the Conference of State Bank Supervisors

December 17, 2008

Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Williams:

Thank you for the opportunity to submit a second written comment in response to the GAO's upcoming report on the financial regulatory framework of the United States.

The Conference of State Bank Supervisors (CSBS) recognizes the current regulatory structure at both the state and federal level is sometimes complex for the industry, regulators, consumers, and policymakers to navigate. As financial institutions and service providers increase in size, complexity, and operations, our regulatory system must reflect this evolution. The current economic stresses have also shown that our financial regulatory system must better address the interconnected risks of the capital markets and our banking system.

CSBS is committed to working with the GAO, our federal counterparts, Congress, industry associations, and consumer advocates to further the development of a fair and efficient regulatory system that provides sufficient consumer protection and serves the interests of financial institutions and financial service providers, while ultimately strengthening the U.S. economy as a whole

We believe that changes are needed in both regulation and the way our regulatory structure functions to better respond to consumer needs and address systemic risks and market integrity. We are very concerned, however, that federal policy that addresses nationwide and global regulatory business models continues to threaten—or perhaps eliminate—the greatest strengths of our system. Specifically, we see policies that promote the needs of the very largest financial institutions at the expense of consumers, important federal checks and balances and diversity of banking and other financial institutions that are critical to our state economies.

The current financial regulatory structure allows for a diverse universe of financial institutions of varying sizes. While the financial industry continues to consolidate at a rapid pace, there are still well over 8,000 financial institutions operating within the United

CONFERENCE OF STATE BANK SUPERVISORS
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States, some of which are as small as $1 million in assets. Obviously, our nation's largest money center banks play a critical role in the economy. However, even the smallest bank in the country is absolutely critical to the economic health of the community in which it operates.

The complexity of the system is presented as a major source of the current financial crisis. While there are clearly gaps in our regulatory system and the system is undeniably complex, CSBS has observed that the greater failing of the system has been one of insufficient political and regulatory will, primarily at the federal level. We believe that decisions to consolidate regulation do not fix, but rather exacerbate this problem. Moreover, CSBS is deeply concerned that the GAO study does not fully appreciate the importance of creating an environment that promotes a diverse industry which serves our nation's diverse communities and avoids a concentration of economic and political power in a handful of institutions.

Specifically, we are offering the following comments to the elements of a successful supervisory framework.

Clearly Defined Regulatory Goals
Generally, we agree with the GAO's goals of a regulatory system that ensures adequate consumer protections, ensures the integrity and fairness of markets, monitors the safety and soundness of institutions, and acts to ensure the stability of the overall financial system. We disagree, however, with the GAO's claim that the safety and soundness goal is necessarily in direct conflict with the goal of consumer protection. It has been the experience of state regulators that the very opposite can be true. Indeed, consumer protection should be recognized as integral to safety and soundness of financial institutions and service providers. The health of a financial institution ultimately is connected to the health of its customers. However, we have observed that federal regulators, without the checks and balances of more locally responsive state regulators or state law enforcement do not always give fair weight to consumer issues or have the perspective to understand consumer issues. We consider this a significant weakness of the current system. Federal preemption of state law and state law enforcement by the Office of the Comptroller of the Currency and the Office of Thrift Supervision has resulted in less responsive consumer protections and institutions that are much less responsive to needs of consumers in our states.

Appropriately Comprehensive
CSBS disagrees that federal regulators were unable to identify the risks to the financial system because they did not have the necessary scope of oversight. As previously noted, we believe it was a failure of regulatory will and a philosophy of self-regulating markets that allowed for risks to develop. CSBS strongly believes a "comprehensive" system of regulation should not be construed as a consolidated regime under one single regulator. Instead, "comprehensive" should describe a regulatory system that is able to adequately supervise a broad, diverse, and dynamic financial industry. We believe that the checks and balances of the dual system of federal and state supervision are more likely to result in

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comprehensive and meaningful coverage of the industry. From a safety and soundness perspective and from a consumer protection standpoint, the public is better served by a coordinated regulatory network that benefits from both the federal and state perspectives We believe the Federal Financial Institutions Examination Council (FFIEC) could be much better utilized to accomplish this approach

Systemwide Focus
The GAO report states "a regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it was created " CSBS agrees with this assessment. Our current crisis has shown us that our regulatory structure was incapable of effectively managing and regulating the nation's largest institutions. CSBS believes the solution, however, is not to expand the federal government bureaucracy by creating a new super regulator. Instead, we should enhance coordination and cooperation among the federal government and the states. We believe regulators must pool resources and expertise to better manage systemic risk. The FFIEC provides a vehicle for working towards this goal of seamless federal and state cooperative supervision.

In addition, CSBS provides significant coordination among the states as well as with federal regulators. This coordinating role reached new levels when Congress adopted the Riegle-Neil Act to allow for interstate banking and branching The states, through CSBS, quickly followed suit by developing the Nationwide Cooperative Agreement and the State-Federal Supervisory Agreement for the supervision of multi-state banks. Most recently, the states launched the Nationwide Mortgage Licensing System (NMLS) and a nationwide protocol for mortgage supervision Further, the NMLS is the foundation for the recently enacted Secure and Fair Enforcement for Mortgage Licensing Act of 2008, or the S A F E Act The S A F E Act establishes minimum mortgage licensing standards and a coordinated network of state and federal mortgage supervision

Flexible and Adaptable
CSBS agrees that a regulatory system should be adaptable and forward-looking so that regulators can readily adapt to market innovations and chances to include a mechanism for evaluating potential new risks to the system. In fact, this is one of the greatest strengths of the state system. The traditional dynamic of the dual-banking system of regulation has been that the states experiment with new products, services, and practices that, upon successful implementation, Congress later enacts on a nationwide basis. In addition, state bank examiners are often the first to identify and address economic problems. Often, states are the first responders to almost any problem in the financial system The states can—and do—respond to these problems much more quickly than the federal government as evidenced by escalating state responses to the excesses and abuses of mortgage lending over the past decade. Unfortunately, the federal response was to thwart rather than encourage these policy responses.

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Efficient and Effective
In the report, GAO asserts that a system should provide for efficient and effective oversight by eliminating overlapping federal regulatory missions and minimizing regulatory burden. CSBS believes efficiency must not be achieved at the cost of protecting consumers, providing for a competitive industry that serves all communities or maintaining the safety and soundness of financial institutions. We recognize that our regulatory structure is complex and may not be as efficient as some in the industry would prefer. There is undoubtedly a need for improved coordination and cooperation among functional regulators. However, this efficiency must not be met through the haphazard consolidation or destruction of supervisory agencies and authorities. CSBS strongly believes that it is more important to preserve a regulatory framework with checks and balances among and between regulators. This overlap does not need to be a negative characteristic of our system. Instead, it has most often offered additional protection for our consumers and institutions. We believe that the weakening of these overlays in recent years weakened our system and contributed to the current crisis.

In addition, we should consider how "efficient" is defined. Efficient does not inherently mean effective. Our ideal regulatory structure should balance what is efficient for large and small institutions as well as what is efficient for consumers and our economy. While a centralized and consolidated regulatory system may look efficient on paper or benefit our largest institutions, the outcomes may be inflexible and be geared solely at the largest banks at the expense of the small community institutions, the consumer or our diverse economy.

Consistent Consumer and Investor Protection
The states have long been regarded as leaders in the consumer protection arena. This is an area where the model of states acting as laboratories of innovation is clearly working. State authorities often discover troubling practices, trends, or warning signs before the federal agencies can identify these emerging concerns. State authorities and legislature then are able to respond quickly to protect consumers. Ultimately, Congress and federal regulators can then rely on state experience to develop uniform and nationwide standards or best practices. Ultimately, we believe the federal government is simply not able to respond quickly enough to emerging threats and consumer protection issues. State authorities have also been frustrated by federal preemption of state consumer protection laws. If Congress were to act to repeal or more clearly limit these preemptions, states would be able to more effectively and consistently enforce consumer protection laws.

CSBS also agrees that there were significant loopholes and unequal regulation and examination of the mortgage industry. In fact, the states led the way to address these regulatory gaps. However, in describing where subprime lending occurred, we believe the report should acknowledge the fact that subprime lending took place in nearly equal parts between nonbank lenders and institutions subject to federal bank regulation. Federal regulation of operating subsidiaries has been inconsistent at best and nonexistent at worst. As acknowledged in the report, affiliate regulation for consumer compliance simply did

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not exist at the federal level until a recent pilot project led by the Federal Reserve was initiated.

The report also fails to acknowledge the very significant reforms of mortgage regulation adopted by Congress under the S.A.F.E. Act or the major efforts the states have engaged in to regulate the nonbank mortgage lenders and originators.

Regulators Provided with Independence, Prominence, Authority, and Accountability
The dual-banking system helps preserve both regulator independence and accountability. The state system of chartering, with an independent primary federal regulator probably serves as the best model for this goal.

Consistent Financial Oversight
Consistency in regulation is important, but our financial system must also be flexible enough to allow our diverse institutions all to flourish. The diversity of our nation's banking system has created the most dynamic and powerful economy in the world, regardless of the current problems we are experiencing. The strength at the core of our banking system is that it is comprised of thousands of financial intuitions of vastly different sizes. Even as our largest banks are struggling to survive, the vast majority of community banks remains strong and continues to provide financial services to their local citizens. It is vital that a one-size-fits-all regulatory system does not adversely affect the industry by putting smaller banks at a competitive disadvantage with larger, more complex institutions.

It is our belief that the report should acknowledge the role of federal preemption of state consumer protections and the lack of responsiveness of federal law and regulation to mortgage lending and consumer protection issues. For example, the states began responding in 1999 to circumventions of HOEPA and consumer abuses related to subprime lending. Nine years later and two years into a nationwide subprime crisis and Congress has not yet been able to adopt a predatory lending law. We believe that some industry advocates have pushed for preemption to prevent the states from being able to develop legislative and regulatory models for consumer protection and because they have been successful in thwarting legislation and significant regulation at the federal level.

Minimal Taxpayer Exposure
CSBS strongly agrees that a regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk. Part of this process must be to prevent institutions from becoming "too big to fail," "too systemic to fail," or simply too big to regulate. Specifically, the federal government must have regulatory tools in place to manage the orderly failure of the largest institutions rather than continuing to prop up failed systemic institutions.

CSBS Principles of Regulatory Reform
While numerous proposals will be advanced to overhaul the financial regulatory system, CSBS believes the structure of the regulatory system should

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1. Usher in a new era of cooperative federalism, recognizing the rights of states to protect consumers and reaffirming the state role in chartering and supervising financial institutions.
2. Foster supervision that is tailored to the size, scope, and complexity of the institution and the risk they pose to the financial system.
3. Assure the promulgation and enforcement of consumer protection standards that are applicable to both state and nationally chartered financial institutions and are enforceable by locally-responsive state officials against all such institutions.
4. Encourage a diverse universe of financial institutions as a method of reducing risk to the system, encouraging competition, furthering innovation, insuring access to financial markets, and promoting efficient allocation of credit
5. Support community and regional banks, which provide relationship lending and fuel local economic development
6. Require financial institutions that are recipients of governmental protection or pose systemic risk to be subject to safety and soundness and consumer protection oversight.

The states, through CSBS and the State Liaison Committee's involvement on the FFIEC, will be part of any solution to regulatory restructuring or our current economic condition. We want to ensure consumers are protected, and preserve the viability of both the federal and state charter to ensure the success of our dual-banking system and our economy as a whole.

CSBS believes there is significant work to be done on this issue, and we commend the GAO for undertaking this report.

Best regards,

John W. Ryan

John W. Ryan
Executive Vice President

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Appendix VI: Comments from Consumers Union

Consumers Union

Via Electronic Mail

December 16, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Re: GAO Report on Reforming the Financial Regulatory System

Dear Ms. Williams,

Consumers Union, the nonprofit publisher of *Consumer Reports*, is deeply interested in creating a more effective structure for the regulation of financial institutions and other participants in the financial markets. Financial regulation must be designed to protect individuals as consumers of credit and deposit services, as investors, and as taxpayers.

The spark for the financial crisis was unsuitable, poorly underwritten loans being sold to individual homeowners. The risk was amplified by widespread sale of financial instruments based on those mortgages. The resulting crisis of confidence has led to reduced credibility for the U.S. financial system, gridlocked credit markets, loss of equity for homeowners who accepted subprime mortgages and for their neighbors who did not, empty houses and reduced property tax revenue.

Any future financial regulatory structure must include active federal and state oversight, a priority on consumer protection, steps to make the pricing and features of financial products less complex, and more accountability by financial entities at each step of a financial transaction.

1. Regulators must be required to proactively monitor new products and practices to address dangers before they spread. Financial system regulators must identify, evaluate, and mitigate emerging risks both to the financial system and to individuals. Regulators must abandon the old "wait and see" regulatory approach, where a problem has to grow to be national in scope, and perhaps be in the public eye, before it is addressed. Financial regulators must have independence from the entities they oversee and an express charge to regulate for the prevention of harm both to individuals and to the financial system.

2. Financial system regulators should give the same priority to consumer protection as to safety and soundness. The mortgage crisis and its aftermath dramatically illustrate that the consumer protection and safety and soundness are inextricably linked. Regulators must increase the priority placed on consumer protection.

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3. Practices and features that make financial products sold to individuals too complex to understand must be stopped. The report speaks in several places about the need for financial literacy or improved disclosure. However, financial products which are too complex for the intended consumer carry special risks that no amount of additional disclosure or information will fix. In subprime mortgages, for example, many homeowners were induced to refinance an existing loan for one that would offer a reduced payment for just the first two years. Others were assured that they could refinance later, yet the loan documents contained an expensive prepayment penalty. Many of the tens of thousands of individuals who filed comments in the Federal Reserve Board's Regulation AA docket on unfair or deceptive credit card practices reported that they learned about harmful card issuer practices apparently permitted by the cardholder agreement only when the practice was first invoked against them. Regulatory reform will be incomplete unless regulators identify and stop practices that make credit and deposit products difficult for individuals to understand and evaluate.

4. Federal and state regulatory diversity is essential to robust oversight. We agree with report that it is important to eliminate the bottlenecks that can be caused by the coordination process between multiple federal regulators. However, no single federal agency leader can foresee all of the consequences of new practices and products. For this reason, Consumers Union supports both an independent federal consumer protection agency for financial services products (with concurrent jurisdiction with existing banking agencies), and the power of states to develop and enforce consumer protections. The swift and troubling developments in the financial meltdown show that we cannot rely on a single federal agency leader to anticipate all of the risks in new practices and products, nor to have the inclination or the resources to pursue all of the areas where law enforcement is needed.

5. Accountability must be built into the financial system. During the build-up to the crisis, loan originators and securitization packagers got fees even if loans couldn't later be repaid. Regulatory restructuring should include changing the incentives in the private market by requiring that everyone who gets a fee in connection with a credit product also keeps some of the risk of future nonpayment and the risk of problems with the loan. In addition, everyone who offers financial products to consumers should be subject to suitability requirements and fiduciary duties.

We appreciate the work of the GAO in this important issue area. Creating a strong, trusted regulatory structure for financial products and the financial markets is essential to rebuilding the public confidence in the U.S. financial markets.

Very truly yours,

Gail Hillebrand

Gail Hillebrand
Financial Services Campaign Manager
Consumers Union of U.S., Inc.

Appendix VII: Comments from the Credit Union National Association

CUNA
Credit Union National Association
cuna.org

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December 18, 2008

Mr. Cody Goebel
Assistant Director
Financial Markets and Community Investment U.S. Government Accountability Office
441 G Street, NW, Room 2440B
Washington, DC 20548

Dear Mr. Goebel:

On behalf of the Credit Union National Association, thank you for the opportunity Bill Hampel, Ryan Donovan, and I had December 12, 2008 to review the Government Accountability Office's draft report on restructuring the financial regulatory system. CUNA is the largest advocacy organization representing the nation's 8,200 state and federal credit unions, which serve approximately 91 million members.

The report's treatment of credit unions is understandably abbreviated, given the fact that credit unions were not the cause of the financial market meltdown -- although a limited number have experienced serious collateral effects. In line with GAO's approach, our letter focuses only on the independence of the National Credit Union Administration Board.

Unlike the Treasury's "Blueprint for Financial Modernization," which reflects a complete disregard for and lack of understanding of credit unions, the GAO draft stops short of offering specific recommendations. Even so, the report indicates there is merit to consideration of regulatory consolidation for certain purposes, such as consumer protection, and to address threats to the overall stability of the financial system. While we recognize the factors that support such consideration and appreciate that with four federal bank regulators, some consolidation there may be appropriate, we would strongly oppose any efforts to combine NCUA or its insurance function with another agency, as addressed below.

The draft report sets out several defined goals for an appropriate regulatory system, which include: a comprehensive approach to regulation that is system wide, flexible, efficient, and independent while providing consistent consumer protection and financial oversight.

CUNA likewise supports these objectives, which we believe are wholly consistent with the continuation of a separate regulator for credit unions. Earlier this month, CUNA's Governmental Affairs Committee reaffirmed strong support for a distinct

America's Credit Unions

Mary Dunn
December 18, 2008
Page 2 of 2

federal regulator as long as it provides rigorous, effective supervision that enhances their financial strength and is well-tailored to the level of risk credit unions demonstrate. At the same time, credit unions need and deserve a regulator that will facilitate, not stymie, their capabilities to provide innovative yet safe services to their consumer-members at favorable rates. While urging NCUA's independence, credit unions also appreciate the need for the agencies to address certain issues collectively, and to that end CUNA has recommended NCUA be included in the Presidential Working Group, which is currently comprised of the banking regulators but not NCUA.

Another goal the GAO draft includes is to minimize taxpayers' exposure in the event problems arise. To that end, the credit union regulatory structure combines the enforcement of demanding safety and soundness standards under NCUA's prompt corrective action provisions with an approach that seeks to contain credit union problems within the system. Virtually all of the funds to operate NCUA and the NCUSIF are provided by the credit union system, without reliance on taxpayer dollars, and since its inception in 1978, the NCUSIF has achieved a commendable record in managing problem cases and avoiding taxpayer losses. Another example of credit unions' self-sustaining efforts is their advocacy for the use of NCUSIF funds to purchase troubled assets from the limited number of natural person credit unions that might need such assistance first, before seeking back-up assistance from the Treasury's Troubled Asset Relief Program.

For many credit unions, maintaining a separate regulator is critical to their preservation as institutions with fundamentally different motivations than other financial intermediaries have. Credit unions are operated by volunteer boards who do not receive economic inducements to serve but rather serve to meet the financial needs of their member-owners. Banks are motivated by the need to reward their stockholders first, and then their customers. Because of these core differences, only a separate, effective regulator will provide the singular focus necessary to further credit unions' distinctiveness, thereby ensuring consumers will continue to have choices in the financial marketplace.

Again, thank you for the opportunity to provide these comments following the review of your draft. Please do not hesitate to contact any one of us if you have questions about credit unions or this letter. All the best for happy holidays.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
CUNA Deputy General Counsel and
Senior Vice President

Appendix VIII: Comments from the Federal Deposit Insurance Corporation

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

December 10, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The FDIC appreciates the opportunity to provide comments on the GAO's report titled Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. We understand that this report is self-initiated, and is intended to provide a set of principles by which policymakers can evaluate various proposals to restructure the U.S. financial regulatory system. We commend the GAO for undertaking this important project.

As an overarching premise, the report states that the U.S. financial regulatory structure is in need of modernization. The FDIC agrees that effective reform of the U.S. financial regulatory system would help avoid a recurrence of the economic and financial problems we are now experiencing.

As we consider recent experience, two issues related to U.S. financial regulatory performance stand out to us as being of particular concern. First, our regulatory structure collectively did not address a systematic breakdown in lending standards in wide segments of the U.S. mortgage market. An important lesson that should be incorporated in any regulatory reform proposal is that irresponsible or abusive lending practices are consistent neither with safe-and-sound banking nor with sustainable economic growth.

Second, the regulatory structure collectively permitted excessive leverage in the non-bank financial system. Facing no explicit leverage constraints, and lulled by quantitative models and agency ratings into believing risks were minimal, a variety of large investment banks, financial guarantee insurers and hedge funds operated with a degree of leverage that significantly diminished their ability to withstand financial stress. An important lesson from recent years is that unconstrained leverage places not only individual firms at risk, but greatly increases the severity of financial market downturns and imposes significant costs on taxpayers.

These two issues were not addressed as effectively as they should have been, in part because of regulatory gaps, and in part because of regulatory choices about how to exercise existing authority. Thus, while the role of regulatory structure is an important part of improving regulatory performance, statutory mandates for the regulators are of equal importance. Existing prompt corrective action law is a good example of a successful mandate. Any regulatory reform proposal should include consideration of appropriate mandates in the area of consumer protection. For example, some lending practices can be so egregious as to warrant their outright prohibition, as opposed to placing sole reliance on promoting financial literacy or improving disclosures. Regulatory reform proposals should also consider statutory mandates for leverage constraints for non-bank financial firms, and well-defined mechanisms to protect taxpayers from the cost of financial bailouts.

We believe the experience of recent years strongly supports the importance of an independent FDIC with the resources and authority to safeguard the government's financial stake in federal deposit insurance and promote public confidence in the banking system. The FDIC's independent perspective has been evidenced in recent years by its actions addressing both individual troubled financial institutions and systemic risk, strengthening our deposit insurance system, ensuring capital safeguards in the implementation of Basel II's advanced approaches, and promoting confidence in the banking system by promoting financial literacy, educating consumers about deposit insurance and taking actions to protect consumers.

Thank you once again for the opportunity to comment on this report. As always, we have appreciated the professionalism with which the GAO's review team conducted this assignment.

Sincerely,

Sandra L. Thompson
Director

Appendix IX: Comments from the Mortgage Bankers Association

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

December 18, 2008

Ms. Orice M. Williams
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Williams:

The Mortgage Bankers Association greatly appreciates the opportunity to comment on the forthcoming report of the United States Government Accountability Office entitled "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Regulatory System." MBA strongly supports the improvement of the regulatory requirements and the regulatory structure for mortgage lending and commends GAO's efforts in this vital area.

MBA's main comments are that the report should recognize that: (1) responsibility for the current financial crisis is diffuse; (2) solutions recommended for the lending sphere should include consideration of a uniform mortgage lending standard that is preemptive of state lending standards; and (3) federal regulation of at least independent mortgage bankers deserves discussion.

In MBA's view, the factors contributing to the current crisis are manifold. They include, but are not limited to, traditional factors such as unemployment and family difficulties, high real estate prices and overbuilding, extraordinary appetites for returns, lowering of lending standards to satisfy investor and borrower needs, the growth of unregulated and lightly regulated entities and, to some degree, borrower misjudgment and even fraud.

In MBA's view no single actor or actors can fairly be assigned sole or even predominant blame for where we are today. On the other hand, MBA strongly believes that all of these factors contributing to the crisis deserve review as we fashion regulatory solutions. Specifically, respecting mortgage lending, MBA believes that the crisis presents an unparalleled opportunity to reevaluate the current regulatory requirements and structure for mortgage lending to protect the nation going forward.

MBA has long supported establishment of a uniform national mortgage lending standard that establishes strong federal protections, preempts the web of state laws and updates and expands federal requirements. Currently, lending is governed, and consumers are protected by, a patchwork of more than 30 different state laws which are piled on top of federal requirements. Some state laws are overly intrusive and some are weak. The federal requirements in some cases are duplicative and in some areas are out-of-date. In some states, there are no lending laws and borrowers have little protection beyond federal requirements.

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MBA believes legislators should look at the most effective state and federal approaches and work with stakeholders to fashion a new uniform standard which is appropriately up-to-date, robust, applies to every lender, and protects every borrower. It should be enacted by the Congress and preempt state laws. A uniform standard would help restore investor confidence and be the most effective and least costly means of protecting consumers against lending abuses nationwide. Having one standard would avoid undue compliance costs, facilitate competition and ultimately decrease consumer costs.

MBA recognizes that one of the key objections to a preemptive national standard is that it would not be flexible and adaptable and preclude state responses to future abuse. MBA believes this problem is surmountable and could be resolved by injecting dynamism into the law. One approach would be to supplement the law as needed going forward with new prohibitions and requirements formulated by federal and state officials in consultation.

Currently, some mortgage lenders are regulated as federal depository institutions, some as state depositories and some as state-regulated non-depositories. MBA believes that along with establishment of a uniform standard, a new federal regulator for independent mortgage bankers and mortgage brokers should be considered and MBA is interested in exploring that possibility.

A new regulator should have sufficient authorities to assure prudent operations to address financing needs of consumers. If such an approach is adopted, states also could maintain a partnership with the federal regulator in examination, enforcement and licensing. MBA believes the combined efforts of state and federal officials in regulatory reviews and enforcement under a uniform standard would greatly increase regulatory effectiveness and focus.

Notably, any new regulatory scheme should address the differing regulatory concerns presented by mortgage bankers and by mortgage brokers, considering their differing functions and the differing policy concerns which the respective industries present. MBA has written extensively on this subject and commends to GAO's attention the attached report entitled Mortgage Bankers and Mortgage Brokers, Distinct Businesses Warranting Distinct Regulation (2008).

Again, MBA strongly believes today's financial difficulties present an unparalleled opportunity to establish better regulation in the years to come. Today's financial crisis reminds us daily that financial markets are national and international in scope. As the crisis worsened, the world looked to national and international governments for solutions. MBA believes it would be unwise not to use this moment to establish a national standard and cease dispersing regulatory responsibility, to help prevent crises ahead.

Thank you again for the opportunity to comment.

Sincerely,

John A. Courson

John A. Courson
Chief Operating Officer
Mortgage Bankers Association

Appendix X: Comments from the National Association of Federal Credit Unions

National Association of Federal Credit Unions
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(703) 522-4770 • (800) 336-4644 • Fax (703) 524-1082
NAFCU www.nafcu.org • nafcu@nafcu.org

December 15, 2008

Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, D.C. 20548

RE: Report of the U.S. Government Accountability Office on the Financial Markets and Financial Regulatory Structure

Dear Ms. Williams:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions (FCUs), I am providing the following comments regarding the upcoming report by the U.S. Government Accountability Office (GAO) regarding the state of the financial industry and the regulatory structure.

NAFCU would first like to express our appreciation for the opportunity to meet with GAO staff and to review the draft GAO Report. As a trade association that represents federal credit unions, which are uniquely structured to provide provident thrift at lower cost to persons whom they are chartered to serve, we believe we provide unique and specific insight regarding the crisis in the financial sector and the regulatory structure under which financial institutions operate. We applaud the GAO for preparing a well written draft Report We would like, however, to use this opportunity to provide the following specific comments and suggestions.

References to Credit Unions

The draft Report references comprehensive regulations to which "some institutions, such as banks ..." are subject. To ensure that readers of the Report do not misunderstand, we request the Report adds "credit unions." We specifically ask that the phrase "credit unions" is added in the following places of the draft report: (1) page 5 after "For example, some institutions, such as banks"; (2) page 8, line 1 after the word "banks"; and (3) on page 23, in the first full paragraph, add "credit unions" after "banks" and before "broker-dealers."

Ms. Orice M. Williams
December 15, 2008
Page 2 of 2

Also, we ask that the phrase "non-credit union" is added after "non-bank" on page 17, Figure 2. Similarly, "non-credit unions" should follow "non-banks" on page 23 in the subheading that presently reads "Activities of NonBank Mortgage Lenders Played A Significant Role." As you are aware, the non-banks referenced in the figure are also non-credit unions. As such, we believe the figure would be clearer if it more clearly explains that the non-banks are also not credit unions.

Framework for Regulatory Restructuring

A key aspect of the draft report is the provision of nine elements as a framework to restructure the financial regulatory system. While we believe the framework contains sound ideas, we strongly recommend that you fully incorporate the need to ensure that smaller institutions, particularly credit unions, are not inadvertently overlooked in any restructuring that Congress may institute.

We are particularly concerned about Element Two and Element Eight. Element Two recommends a single "market stability regulator." Element Eight recommends consistent financial oversight. As we have previously expressed to GAO staff, we believe an independent regulator should continue to oversee and examine federal credit unions. The distinctive characteristics of federal credit unions, including their cooperative structure and mission to provide provident service at lower cost to those they are chartered to serve, necessitates that they are regulated by an independent entity. Accordingly, we request that these two elements are revised to reflect the need of an independent regulator for federal credit unions.

NAFCU appreciates this opportunity to share its comments on this interim rule. Should you have any questions or require additional information please call me at (703) 522-4770 or (800) 336-4644 ext. 268.

Sincerely,

Tessema Tefferi
Associate Director of Regulatory Affairs

Appendix XI: Comments from the Center for Responsible Lending, the National Consumer Law Center, and the U.S. PIRG

December 16, 2008

VIA EMAIL AND U.S. MAIL

Ms. Orice M. Williams (williamso@gao.gov)
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

with copies via email to:
Mr. Cody Goebel, Assistant Director (goebelc@gao.gov)
Mr. Randall Fasnacht (fasnachtr@gao.gov)

Re: Comments on Draft Report, GAO-09-216

Dear Ms. Williams:

We appreciate the opportunity to review the draft report at your offices on December 4, and to offer comments. These are offered jointly by CRL, the National Consumer Law Center and USPIRG.

The report is a thoughtful and thorough review of the structural issues regarding regulatory reform. We especially appreciate that your report notes the problem of charter competition and the distorting impact of the funding structure for the banking regulators.

We would like to preface our comments by stating the obvious -- that this review does not occur in a vacuum, but rather in the context of a major crisis which exposed fundamental weaknesses on many fronts. The structural problems in the federal regulator system are but one. Some of these comments derive not from the specific content of the report, but the messages conveyed by some of the references to other aspects of the crisis, such as the nature of the market and consumer behavior. Another especially important comment derives as much from what is left unsaid. Perhaps it seems as though it should go without saying, but given much of the debate that this crisis has engendered, we fear that without at least an acknowledgement of what is not addressed by your report, necessary reminders of other integral parts of regulatory reform may be lost.

While the structure of regulation can create its own problems, such as the potential for charter competition and regulatory capture that you note, regulators also need tools (in the form of laws to enforce, or directives to promulgate rules in furtherance of such laws), adequate resources and, above all, the will to regulate. No amount of structural reform will succeed if regulators have no charge to fulfill in their job, nor the will to do so. We have had three decades of a deregulatory agenda, and without a change in that overarching view, structural changes will be insufficient. We recognize that the prevailing philosophy of regulation was not the focus of this report. However, we believe that any discussion of regulatory structural reform must be accompanied by an explicit caveat that it addresses only one aspect of the overall regulatory issues that contributed to

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this crisis, and that changing the structure, alone, will be insufficient if these other necessary conditions for effective oversight are not reformed, as well.

Beyond that overarching context for regulatory reform, we offer the following comments.

1. The best way to avoid systemic risk is to address problems that exist at the level of individual consumer transactions, before they pose a threat to the system as a whole.

The report appropriately addresses the need to effectively monitor and regulate problems that threaten the financial system as a whole. However, the most effective way to address systemic risk is to identify market failures that threaten abuse of individual consumers, and to address these failures before they threaten the system as a whole. The crisis today would not have reached its current state had problems been addressed and prevented before they evolved into the foreclosure epidemic now underway.

The report correctly notes that most *subprime* lending was done by nonbank lenders who were not subject to oversight by the federal banking agencies.[1] However, the market failures that contributed to the current crisis are not limited to the subprime market. The failure of the Alt-A market, including poorly underwritten non-traditional loans, are also significant contributors, as is becoming increasingly apparent. The failures of IndyMac and Washington Mutual, among others, are largely the function of overly aggressive lending of risky products that were unsuitable for far too many borrowers, and these did occur under the watch of the federal banking agencies. Though the federal banking agencies issued some guidelines for nontraditional lending, it was too little and too late. Further, to judge from the performance of the late vintages of these loans, even then, they were insufficiently enforced.

But in any case, neither bank nor nonbank lenders were subject to adequate consumer protection laws. Both banks and non-bank lenders pressed legislators and regulators not to enact such protections. Furthermore, banks subject to federal regulation also contributed to the problem by being part of the secondary market's demand for the risky products that permeated the subprime and Alt-A markets.[2] The report should make clear that to adequately protect consumers, and avoid systemic risk in the future, whatever regulatory structure emerges will need to be more robust and effective in protecting consumers than the current system has been to date.

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[1] Further, the threat of federal preemption and its absence of suitable consumer protection gave the nonbank lenders the argument that they just wanted a "level playing field," --on a field largely without rules. To that extent, the regulatory structure played into the separate thread of whether there were adequate tools for regulators. The preemption agenda was part of the momentum to the lowest common denominator for the substance of regulation.

[2] Recent studies have found that the securitization process in fact contributed to the aggressive lending and poor underwriting. *See, e.g.* Benjamin J. Keys, Tanmoy Mikherjee, Amit Seru, Vikrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities*, pp. 26-27 (January 2008), available at http://www2.law.columbia.edu/contracteconomics/conferences/laweconomics S08/Vig%20paper.pdf

2. To effectively protect consumers the regulatory system must prohibit unsustainable lending; disclosures and "financial literacy" are not enough.

The fundamental problem at the heart of today's crisis is that loan originators pushed borrowers into loan products that were inherently risky and unsustainable by design, and they did so notwithstanding the availability of the more suitable and affordable loans for which they qualified.[3] The most common product in the subprime market in recent years was not merely an adjustable rate mortgage, but rather an adjustable rate mortgage with built-in payment shock that lenders anticipated most borrowers could not afford, but that they could avoid only by refinancing before the payment shock took effect, typically paying typically 3% to 4% of the loan balance as a "prepayment penalty" in order to refinance.

According to a Wall Street Journal study, 55% of the borrowers who received such loans in 2005, and 60% of those who received them in 2006, had credit scores high enough to have qualified for lower cost prime loans.[4] And even those borrowers who did not qualify for prime could have had 30-year fixed rate loans for approximately 65 basis points above the introductory rate on the loans they received.[5] The report suggests incorrectly (pp. 43-44) that subprime loans "help[] borrowers afford houses" they could not otherwise afford, when in fact, most subprime loans refinanced existing loans, rather than purchased new homes.[6] But in either case, had borrowers been offered the more suitable loans for which many qualified, many more borrowers could have sustained homeownership.[7]

The experience with the recent vintages of Alt-A loans are similarly instructive. Chris Ferrell, an economics editor with the NPR program Marketplace referred to the Payment Option ARM product (many of which are Alt-A) as "the most complicated mortgage product ever marketed to consumers." The greater the complexity, the less suitable that disclosure is as a "market perfecting" tool. Further, the huge jump in payment option ARMS, (from $145 billion to $255 billion from 2004-2007), was primarily possible only by the increasingly poor underwriting. Countrywide, one of the major issuers of these

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[3] For more detail on causes of the crisis, *see* Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (October 16, 2008), http://banking.senate.gov/public/_files/RevisedSenateTestimony101608HearingSteinFinalFinal.pdf.

[4] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

[5] Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[6] *See, e.g.* Subprime Lending: *A Net Drain on Homeownership*, CRL Issue Paper, No. 14 (March 27, 2007).

[7] *See, e.g.* Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages. Disaggregating Effects Using Propensity Score Models*, Center for Community Capital, Univ. of North Carolina & Center for Responsible Lending (Working Paper, Sept. 13, 2008)

loans (that issued them under both its national bank and federal thrift charters, as well as some of its non-depository entities) admitted that an estimated 80% of its recent POARMs would not meet the late 2006 federal guidelines.[8]

The Federal Reserve has noted that, given the misaligned incentives of originators and the complexity of products and loan features, even with increased information or knowledge, borrowers could not have defended against poorly underwritten, risky products and deceptive practices. The main problem with these loans was not the inadequacy of the disclosures or the financial literacy of the borrowers. Rather, the fundamental problem was that – as the federal banking regulators belatedly recognized with respect to non-traditional loans in late 2006 and subprime lending in 2007 -- lenders should not have made loans that they knew borrowers would be unable to sustain without refinancing.

3. To effectively protect consumers, the regulatory system must monitor and address market incentives that encourage loan originators to push risky or unsuitable loan products.

The report correctly notes that market incentives encouraged loan originators to extend excessive credit (p 22). It should also note that these same incentives encouraged them to push riskier productions and features than the borrowers qualified for.[9] The report should note the need for regulatory oversight of market failures that reward market participants for irresponsible behavior.

We understand that philosophies of consumer protection and the adequacy of consumer protection laws is not your intended focus. However, there were occasional statements in the report which, intended or not, seemed to convey a message that improved disclosure or literacy would be adequate. Yet more people – including some of the regulators themselves – are recognizing that in an era of highly complex products and unseen perverse incentives, disclosure is an insufficient tool, and literacy is an elusive goal.

We would be happy to provide further information

[8] Countrywide, *3Q 07 Earnings Supplemental Presentation* (October 26, 2007). To again emphasize that the federal banking regulators contributed to the problem, some $161 billion of those payment option ARMs were issued when Countrywide was under the OCC's watch.

[9] After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?" Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages*, New York Times (January 26, 2007).

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Sincerely,

Center for Responsible Lending

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Appendix XII: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Staff Acknowledgments

In addition to the contacts named above, Cody Goebel (Assistant Director), Kevin Averyt, Nancy Barry, Rudy Chatlos, Randy Fasnacht, Jeanette Franzel, Thomas McCool, Jim McDermott, Kim McGatlin, Thomas Melito, Marc Molino, Susan Offutt, Scott Purdy, John Reilly, Barbara Roesmann, Paul Thompson, Winnie Tsen, Jim Vitarello, and Steve Westley made key contributions to this report.

Related GAO Products

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

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

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

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

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM PAUL A. VOLCKER

Q.1. There is pressure to move quickly and reform our financial regulatory structure. What areas should we address in the near future and which areas should we set aside until we realize the full cost of the economic fallout we are currently experiencing?

A.1. I recognize the desire to move quickly to reform the financial regulators structure, but more important is to get it right. Speed should not become the enemy of the good, and a piece-meal approach may inadvertently prejudice the thoroughgoing comprehensive measures we need. There may be a few measures—such as the proposed new crisis resolution procedure—that may be usefully enacted promptly, but we still have much to learn from unfolding experience and about the need to achieve international consistency.

Q.2. The largest individual corporate bailout to date has not been a commercial bank, but an insurance company. Given the critical role of insurers in enabling credit transactions and insuring against every kind of potential loss, and the size and complexity of many insurance companies, do you believe that we can undertake serious market reform without establishing Federal regulation of the insurance industry?

A.2. Consideration of Federal regulation of insurance companies and their holding companies is an example of the need for a comprehensive approach. A feasible starting point should be the availability of a Federal charter, at least for large institutions operating inter-state and internationally, with the implication of Federal supervision.

Q.3. As Chairman of the G–30, can you go into greater detail about the report's recommended reestablishment of a framework for supervision over large international insurers? Particularly, cm you provide some further details or thoughts on how this recommendation could be developed here in the United States? Can you comment on the advantages of creating a Federal insurance regulator in the United States?

A.3. As indicated, the absence of a Federal charter and supervision for insurance companies is a gap in our current regulatory framework. I am not prepared now to opine whether the Federal regulator should be separate from other supervisory agencies but some means of encouraging alignment is necessary. Again, I'd prefer to see the issue resolved in the context of a more comprehensive approach; in this case including consideration of appropriate and feasible international standards.

Q.4. How should the Government and regulators look to mitigate the systemic risks posed by large interconnected financial companies? Do we risk distorting the market by identifying certain institutions as systemically important? How do foreign countries identify and regulate systemically critical institutions?

A.4. The question of mitigating systemic risks is a key issue in financial reform, and can be approached in different ways. Specifically identifying particular institutions as systemically important, with the implication of special supervisory attention and support, has important adverse implications in terms of competitive balance and moral hazard. I am not aware of any foreign country that *explicitly* identifies and regulates particular systemically critical institutions, but in practice sizable banking institutions have been protected.

An alternative approach toward systemic risk would be to provide a designated regulatory agency with authority to oversee banks and other institutions, with a mandate to identify financial practices (*e.g.,* weak credit practices, speculative trading excesses, emerging "bubbles", capital weaknesses) that create systemic risk and need regulatory supervision. Particular institutions need not be identified for special attention.

Q.5. In your testimony you say that you support continuing past U.S. practice of prohibiting ownership or control of Government-insured, deposit-taking institutions by non-financial firms. What are your thoughts on the commercial industrial loan company (ILC) charter? Should this continue to exist?

A.5. I do believe recent experience only reinforces long-standing American aversion to mixtures of banking and commerce. The commercial industrial loan companies and other devices to blur the distinction should be guarded against, severely limited if not prohibited.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM GENE L. DODARO

Q.1. There is pressure to move quickly and reform our financial regulatory structure. What areas should we address in the near future and which areas should we set aside until we realize the full cost of the economic fallout we are currently experiencing?

A.1. As we noted in our January 2009 report, financial regulators have been appropriately focused on limiting the damage from the current crisis to the United States economy and its financial system.[1] Given the experiences of other countries, particularly Japan that suffered stagnation for a decade likely as a result of its ineffective attempts to address its financial crisis in the 1990s, Congress and regulators should likely continue to address in the near term efforts to further stem the crisis and restore our financial institutions to more normal operating conditions, including finding an appropriate and effective solution to the issue of troubled assets being held by so many institutions.

However, directing actions more to the current crisis should not preclude Congress from exploring with regulators plans for modernizing the United States financial regulatory system. As we pointed out, taking piecemeal actions and creating new regulations and regulatory bodies in the aftermath of past financial turmoil is one reason why our current structure is so fragmented and has the gaps and inconsistencies in oversight that have contributed to the current crisis. As a result, careful consideration of how best to develop a structure and financial regulatory bodies within it that more holistically embodies aspects like the nine elements of an effective regulatory system that we described in our report is impor-

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

tant. Taking adequate time to consider and complete this critical task is more advisable than taking quick actions that could lead to gaps or inconsistencies later.

Q.2. The largest individual corporate bailout to date has not been a commercial bank, but an insurance company. Given the critical role of insurers in enabling credit transactions and insuring against every kind of potential loss, and the size and complexity of many insurance companies, do you believe that we can undertake serious market reform without establishing Federal regulation of the insurance industry?

A.2. Over the years, GAO has reported on the inconsistency and lack of uniformity of regulation that insurance companies receive across states. This lack of consistency can lead to uneven protections for consumers across states as well as inefficiencies for insurers that could lead to higher premiums. We currently have a study under way looking at reciprocity and uniformity of State insurance regulation in three key areas: product approval, producer licensing, and market conduct regulation. The study will touch on issues of consistent oversight across states. Having an optional Federal charter for insurance would be one way to potentially increase the consistency of oversight of insurance companies.

Although the problems experienced by AIG and the subsequent action by the Government to address them demonstrates that the United States has significant gaps in its oversight of significant financial institutions, the extent to which this case demonstrates the need for Federal insurance oversight is unclear. Although some of AIG's financial difficulties arose from the securities lending activities engaged in by its life insurance companies, and some of the Federal assistance went toward unwinding those transactions, the insurance company operations were, and have remained, stable. Those companies have been negatively affected by the damage to the parent company's reputation, and may no longer benefit to the same extent from the parent company's financial strength, but they appear to be financially sound. While it's possible closer review by State insurance regulators may have more quickly identified the risk associated with the life insurance companies' securities lending operations, the primary problems appear to have originated in one of AIG's non-insurance subsidiaries. In addition, State insurance laws require State insurance regulators to approve any significant transactions between an insurance company and its parent company or other subsidiaries, and, *according to State regulatory officials and AIG securities filings,* some State regulators did not allow transactions that would have transferred capital from AIG's insurance companies to the parent company.

Q.3. The GAO recommends consistent financial oversight—to ensure that similar institutions, products, risk and services are subject to consistent regulation oversight and transparency. In the case of insurance, the regulation and oversight is not consistent. Shouldn't insurance receive the same consistent financial oversight that is desperately needed for other financial institutions?

A.3. In our January 2009 report on the need for regulatory reform, we noted that the United States needs a financial regulatory system that is appropriately comprehensive and provides consistent oversight of institutions engaging in similar activities and risks. In addition, we advocated that consumer protections be similarly consistent across institutions and products. As a result, to the extent that insurance companies conduct activities, such as over-the-counter derivatives trading or market products as investment alternatives to securities or bank saving products, we advocated that they be overseen with similar risk management, capital, and consumer disclosure requirements.

In general, the operations of most insurance companies themselves do not appear to have given rise to the complexities that made regulation difficult in the case of AIG. For entities that just engage in insurance activities, having Federal oversight could be one way that more uniformity of oversight is achieved. However, our report also noted that State regulators, including those for insurance, have played important roles in identifying and taking actions to address problems for consumers. As noted above, we have a study under way looking at reciprocity and uniformity of State insurance regulation that will touch on issues of consistent oversight across States.

Q.4. The GAO's report suggests that Congress should consider establishing a Federal insurance regulator; can you comment on the advantages of creating a Federal insurance regulator in the United States?

A.4. As we noted above, a Federal insurance charter could have the potential to alleviate some of the challenges in harmonizing insurance regulation across States. However, we also note that such an approach could have various disadvantages. Currently, property and casualty insurance activities are heavily influenced by State laws—including those relating to insurance, torts, and business operations—and having Federal oversight of such varying requirements could be very challenging. In addition, State regulators assert that because of their greater familiarity with the particular demographics of their jurisdictions, they are in a better position to protect consumers. Another issue that would have to be addressed in implementing a Federal insurance charter would be the loss of income to states from taxes paid on insurance premiums by consumers. These taxes generally provide funds beyond what is required to fund the regulation of insurance.

Q.5. How should the Government and regulators look to mitigate the systemic risks posed by large interconnected financial companies? Do we risk distorting the market by identifying certain institutions as systemically important? How do foreign countries identify and regulate systemically critical institutions?

A.5. Various options exist for addressing the systemic risk posed by large interconnected financial institutions. As we advocated in our January 2009 report, such institutions should receive comprehensive and consistent regulation from both a prudential and consumer protection standpoints.[2] Having such oversight should reduce the potential for such institutions to experience problems that threaten the stability and soundness of other institutions and the overall financial system itself. In addition, we advocated that our

[2] GAO–09–216.

regulatory system needs a systemwide focus to address the potential threats to system stability that can arise from institutions, products, and markets. Such a focus could be achieved by designating an existing regulator or creating a new entity to be tasked with overseeing systemic risk in the United States. Such an entity could also be tasked with prudential oversight of the large interconnected financial institutions or their primary oversight could remain the responsibility of another regulator with the systemic risk regulator supplementing this oversight by collecting information, examining operations, and directing changes from the large institutions as needed.

While one obvious way of ensuring that these large institutions are all subject to similar regulatory requirements and oversight would be to designate them as systemically important and place them under the regulation of a single regulatory body, such an approach also has disadvantages. Some market observers have expressed concerns that designating certain institutions as systemically important could distort competition in the financial market sectors in which these entities operate by providing the designated institutions with funding advantages and reducing market discipline of the firms that do business with them because of the belief that the Government will not allow such institutions to fail. In light of the experience of the housing Government-sponsored enterprises recently, such concerns should be taken seriously.

However, the more extensive oversight that systemically important financial institutions would likely receive could offset some of the competitive advantage they receive from being designated as so. Given such institutions greater potential than other institutions to create systemic problems, they should appropriately be subject to higher prudential standards for capital, liquidity, and counterparty risk management, *etc.* So although their status as systemically important institutions could possibly create competitive distortions or moral hazard, increased prudential standards would seek to mitigate that (and any systemic risks they might pose).

Other countries have not generally had to face the issue of whether their systemically important institutions should be supervised separately because of the differences in the regulatory and market structures outside the United States. In many countries, the primary financial institutions are universal banks that offer a range of services across sectors, including banking, securities, and insurance activities, and that are overseen by a single regulatory body, which reduces the potential for inconsistent oversight. In addition, the number of financial institutions in many countries is relatively small, which also reduces the potential for less consistent oversight across institutions that might provide a competitive advantage for those designated as systemically important.

United States Government Accountability Office

GAO

Report to Congressional Requesters

June 2007

CORPORATE SHAREHOLDER MEETINGS

Issues Relating to Firms That Advise Institutional Investors on Proxy Voting

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Highlights

Highlights of GAO-07-765, a report to congressional requesters

June 2007

CORPORATE SHAREHOLDER MEETINGS

Issues Relating to Firms That Advise Institutional Investors on Proxy Voting

Why GAO Did This Study

At annual meetings, shareholders of public corporations can vote on various issues (e.g., mergers and acquisitions) through a process called proxy voting. Institutional investors (e.g., mutual funds and pension funds) cast the majority of proxy votes due to their large stock holdings. In recent years, concerns have been raised about a group of about five firms that provide research and recommendations on proxy votes to their institutional investor clients.

GAO was asked to report on (1) potential conflicts of interest that may exist with proxy advisory firms and the steps that the Securities and Exchange Commission (SEC) has taken to oversee these firms; (2) the factors that may impede or promote competition within the proxy advisory industry; and (3) institutional investors' use of the firms' services and the firms' potential influence on proxy vote outcomes.

GAO reviewed SEC examinations of proxy advisory firms, spoke with industry professionals, and conducted structured interviews with 31 randomly selected institutional investors.

GAO is not making any recommendations.

GAO provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which GAO incorporated, as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-07-765.

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

What GAO Found

Various potential conflicts of interest can arise at proxy advisory firms that could affect vote recommendations, but SEC has not identified any major violations in its examinations of such firms. In particular, the business model of the dominant proxy advisory firm—Institutional Shareholder Services (ISS)—has been the most commonly cited potential conflict. Specifically, ISS advises institutional investors how to vote proxies and provides consulting services to corporations seeking to improve their corporate governance. Critics contend that corporations could feel obligated to retain ISS's consulting services in order to obtain favorable vote recommendations. However, ISS officials said they have disclosed and taken steps to mitigate this potential conflict. For example, ISS discloses the potential conflict on its Web site and the firm's policy is to advise clients of relevant business practices in all proxy vote analyses. ISS also maintains separate staff who are located in separate buildings for the two businesses. While all institutional investors GAO spoke with that use ISS's services said they are satisfied with its mitigation procedures, some industry analysts continue to question their effectiveness. SEC conducts examinations of advisory firms that are registered as investment advisers and has not identified any major violations.

Although new firms have entered the market, ISS's long-standing position has been cited by industry analysts as a barrier to competition. ISS has gained a reputation for providing comprehensive services, and as a result, other firms may have difficulty attracting clients. Proxy advisory firms must offer comprehensive coverage to compete and need sophisticated systems to provide the services clients demand. But firms interested in entering the market do have access to much of the information needed to make recommendations, such as publicly available documents filed with SEC. Competitors have attempted to differentiate themselves from ISS by, for example, providing only proxy advisory services and not corporate consulting services. While these firms have attracted clients, it is too soon to tell what their ultimate effect on enhancing competition will be.

Among the 31 institutional investors GAO spoke with, large institutions reportedly rely less than small institutions on the research and recommendations offered by proxy advisory firms. Large institutional investors said that their reliance on proxy advisory firms is limited because, for example, they have in-house staff to assess proxy vote issues and only use the research and recommendations offered by proxy advisory firms to supplement such research. In contrast, small institutional investors have limited resources to conduct their own research and tend to rely more heavily on the research and recommendations offered by proxy advisory firms. The fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place relatively less emphasis on advisory firm research and recommendations could serve to limit the firms' overall influence on proxy voting results.

Contents

Abbreviations

Egan-Jones	Egan-Jones Proxy Services
Glass Lewis	Glass Lewis & Co.
ICS	ISS Corporate Services, Inc.
ISS	Institutional Shareholder Services, Inc.
MCG	Marco Consulting Group
PGI	Proxy Governance, Inc.
PWBA	Pension Welfare Benefits Administration
SEC	Securities and Exchange Commission

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

June 29, 2007

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

The Honorable Deborah Pryce
Ranking Member
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

The Honorable Richard Baker
House of Representatives

Each year, publicly traded corporations hold shareholder meetings for director elections and to consider management and shareholder proposals that may have an effect on a corporation's operations and value, such as executive compensation, corporate governance matters, and proposed mergers and acquisitions. Most shareholders typically do not attend these meetings, opting instead to vote by mail or online, through a process known as proxy voting. According to Automatic Data Processing, Inc.—one of the largest providers of transaction services to the financial industry—most proxy votes are cast by or on behalf of institutional investors, such as mutual funds and pension plans, given the level of stocks they manage as compared to other types of investors.

In recent years, concerns have been raised about the proxy advisory industry, which is comprised of five major proxy advisory firms that help many institutional investors carry out their fiduciary responsibilities relating to proxy voting.[1] These proxy advisory firms may perform several

[1]See *Proxy Voting by Investment Advisers*, 68 Fed. Reg. 6585 (2003) (final rule) (codified in various sections of 17 C.F.R. Part 275), which requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that they vote proxies in the best interests of their clients. Similarly, the Employee Retirement Income Security Act of 1974 (ERISA) has been interpreted as imposing fiduciary obligations on persons authorized to vote proxies associated with equity securities owned by ERISA plans. See 29 C.F.R. § 2509.94-2 (2006).

functions on behalf of their clients, such as offering research and recommendations on particular proxy issues (e.g., whether to approve an executive compensation plan) or casting the actual votes. Critics of proxy advisory firms, including certain industry associations and academics, contend that the proxy advisory industry suffers from significant conflicts of interest and a lack of competition and that these firms have a disproportionate influence on proxy voting. Others counter that the firms provide a valuable service for institutional investors and note that such clients are sophisticated market participants that are free to choose whether and how to employ the services of proxy advisory firms.

Under the Securities Exchange Act of 1934,[2] the Securities and Exchange Commission (SEC) regulates the proxy solicitation process with respect to publicly traded equity securities, and SEC regulates the activities of proxy advisory firms that are registered with SEC as investment advisers under the Investment Advisers Act of 1940.[3] Under SEC rules, when soliciting proxies, certain information must be disclosed in writing to shareholders, and such disclosure, referred to as a proxy statement, must be filed with the agency.[4] These proxy statements must include important facts about the issues on which shareholders are asked to vote. Under the Investment Advisers Act and related SEC rules, registered investment advisers are required to take a variety of steps designed to help protect their clients. For example, an investment adviser must disclose information about its business practices and potential conflicts of interest to clients and potential clients. SEC monitors compliance with the laws and rules through, among other means, periodic examinations of registered investment advisers. Based on examination findings, SEC may send letters to investment advisers requiring them to correct identified deficiencies. SEC may also take enforcement actions for more serious violations, as deemed appropriate, such as seeking civil fines in federal district court.

Because of your interest in helping to ensure the integrity of proxy voting, you asked us to provide an overview of proxy advisory firms and SEC's oversight of this industry. This report (1) identifies potential conflicts of interest that may exist with proxy advisory firms and the steps that SEC

[2]15 U.S.C. §§ 78a et seq.

[3]Most, but not all, of the major proxy advisory firms have registered as investment advisers with SEC, as will be discussed in this report.

[4]See section 14 of the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. § 78n) and related rules.

has taken to oversee these firms; (2) discusses the factors that might impede or promote competition in this industry; and (3) analyzes institutional investors' use of proxy advisory services to help vote proxies and the influence proxy advisory firms may have on proxy voting.

To address these objectives, we conducted a literature review and examined studies relating to the proxy advisory industry. In addition, we identified and interviewed various professionals (experts, academics, industry association representatives, and others) with knowledge of the industry. To gain an understanding of SEC's oversight of proxy advisory firms, we reviewed relevant investment adviser regulations and examination reports and interviewed agency officials. Further, we conducted structured interviews with 31 institutional investors selected randomly by type, including mutual funds, corporate pension funds, government pension funds, and union pension funds, as well as some asset management institutions, to gain an understanding of the ways in which they use proxy advisory firms and the influence that such firms have on proxy voting.[5] Our sample was derived from Standard & Poor's Money Market Directories (January 2006), and consisted of a population of institutional investors with over $1 billion in assets, including large and small institutional investors from each type above this asset level. We defined "large" and "small" institutional investors as the top and bottom 15 percent of each investor type. Large and small institutional investors account for over 72 percent of the managed assets held by all of the institutional investors with over $1 billion in assets. Although we randomly selected these institutional investors, the size of the sample was small and might not have been representative of the universe of institutional investors. As a result, we could not generalize the results of this effort.

We conducted our work in Washington, D.C., between September 2006 and June 2007 in accordance with generally accepted government auditing standards. See appendix I for more information on our scope and methodology.

Results in Brief

Various potential conflicts of interest exist among proxy advisory firms that could affect vote recommendations, but SEC has not identified any

[5]For purposes of this report, the term "institutional investor" refers to both the institution that owns the securities as well as an asset manager delegated the authority to vote proxies on behalf of the investors as the context requires.

major violations in its examinations of such registered firms. In particular, the business model of the dominant advisory firm—Institutional Shareholder Services, Inc. (ISS)—has been cited by industry participants and analysts as creating a significant potential conflict of interest. ISS advises institutional investor clients on how to vote their proxies and at the same time provides consulting services to help corporations develop management proposals and improve their corporate governance. Because it provides both types of services, ISS could, for example, help a corporate client develop an executive compensation proposal to be submitted for shareholder approval while at the same time making a recommendation to investor clients on how to vote for this proposal. ISS's critics also contend that this could lead corporations to feel obligated to retain ISS's consulting services in order to obtain favorable proxy vote recommendations. However, ISS officials said that they have disclosed and taken steps to help mitigate this potential conflict. For example, ISS publicly discloses information about the potential conflict on its Web site and firm policy requires relevant disclosures to its institutional investor clients. In addition, ISS officials explained that the proxy advisory and corporate consulting businesses have separate staff, operate in separate buildings, and use segregated office equipment and information databases. While all institutional investors we spoke with that use ISS's services said they are satisfied with the steps ISS has taken to mitigate this potential conflict, some industry analysts we contacted said there remains reason to question the steps' effectiveness. We also identified other potential conflicts associated with proxy advisory firms. For example, owners or executives of proxy advisory firms may have a significant ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations. In its oversight capacity, SEC conducts examinations of proxy advisory firms that are registered as investment advisers, including, among other things, assessing compliance with requirements of the Investment Advisers Act and related rules, including the requirement that investment advisers identify, disclose, and mitigate conflicts of interest. To date, SEC has not identified any major violations and has not initiated any enforcement action against proxy advisory firms.

ISS's long-standing position in the proxy advisory industry has been cited as a potential barrier to competition in this industry, although new firms have entered the market in recent years. Since it began operating in 1985, ISS has gained a reputation with institutional investors for providing comprehensive proxy voting research and recommendations. Consequently, other providers may have difficulty attracting ISS's institutional client base of over 1,700 firms. According to industry participants, proxy advisory firms must offer comprehensive coverage of public companies in order to compete, because institutional investors may not be interested in subscribing to limited service offerings. Firms also need to develop sophisticated information systems to provide the research and vote-processing capabilities clients demand. But industry analysts also explained that firms interested in entering the market do have access to much of the information needed to conduct research, including the annual and quarterly reports companies file with SEC. In addition, various academics told us that once a firm has acquired the necessary technology and research processes, the marginal cost of providing services to additional clients and of updating and maintaining these services is relatively low. Competitors that have entered the market in recent years have attempted to differentiate themselves from ISS by, for example, emphasizing that they provide only proxy advisory services and not corporate consulting services. While these firms have attracted institutional clients, it is too soon to tell what their ultimate effect will be on enhancing industry competition.

Among the 31 institutional investors we spoke with, large institutions reportedly relied less than small institutions on the research and specific recommendations offered by proxy advisory firms to help decide how to vote proxies. Specifically, large institutional investors reported that their reliance on proxy advisory services is limited because these institutional investors (1) conduct their own research and analyses to make voting decisions and use the research and recommendations offered by proxy advisory firms only to supplement such analyses; (2) might develop their own voting policies, which the advisory firms would be responsible for executing; and (3) might contract with more than one advisory firm to gain a broader range of information on proxy issues. In contrast, small institutional investors reported that they have limited resources to conduct their own research and tend to rely more heavily on the research and recommendations of proxy advisory firms. Like large institutional investors, however, representatives of small institutions said that they are ultimately responsible for proxy voting decisions and retain the right to override recommendations made by advisory firms. While the institutional investors we contacted might not have been representative of all institutional investors, many industry analysts we spoke with agreed that large institutions would place less emphasis than small institutions on proxy advisory firms' research and recommendations when deciding how to vote. The fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place less emphasis than small institutions on such research and recommendations could serve to limit the overall influence advisory firms have on proxy voting results.

We provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which we incorporated, as appropriate. We also provided relevant sections of the draft to the proxy advisory firms for a technical review of the accuracy of the wording and made changes, as appropriate, based on the firms' comments.

Background

According to ISS, over 28,000 publicly-traded corporations globally send out proxy statements each year that contain important facts about more than 250,000 separate issues on which shareholders are asked to vote. Votes are solicited on a variety of key issues that could potentially affect the corporations' value, such as the election of directors, executive compensation packages, and proposed mergers and acquisitions, as well as other, more routine, issues that may not affect value, such as approving an auditor and changing a corporate name. The proxy statement typically includes a proxy ballot (also called a proxy card) that allows shareholders to appoint a third party (proxy) to vote on the shareholder's behalf if the shareholder decides not to attend the meeting. The shareholder may instruct the proxy how to vote the shares or may opt to grant the proxy discretion to make the voting decision. The proxy card may be submitted to the company via the mail or online.

The proxy advisory industry has grown over the past 20 years as a result of various regulatory and market developments. The management of a mutual fund's or pension plan's assets, including the voting of proxies, is often delegated to a person who is an investment adviser subject to the Investment Advisers Act of 1940.[6] In a 1988 letter, known as the "Avon Letter," the Department of Labor took the position that the fiduciary act of managing employee benefit plan assets includes the voting of proxies

[6]To the extent a mutual fund or pension plan has delegated the voting of its proxies to an asset manager, the proxy voting process is subject to the Investment Advisers Act of 1940 and the Employee Retirement Income Security Act of 1974 (ERISA). For purposes of this report, the term "asset manager" is used to refer both to investment advisers of registered investment companies, as well as to managers of pension plan assets. Registered investment companies are also required to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities and must file with SEC an annual report on its proxy voting record. See 17 C.F.R. § 270.30b1-4 and SEC Forms N-1, N-2, N-3 and N-CSR (adopted under the Investment Company Act of 1940 (codified as amended at 15 U.S.C. § 80a-1 et seq.)).

associated with shares of stock owned by the plan.[7] According to industry experts, managers of employee retirement plan assets began to seek help in executing their fiduciary responsibility to vote proxies in their clients' best interests. Consequently, the proxy advisory industry—particularly ISS, which had been established in 1985—started to grow. According to industry experts, ISS's reputation and dominance in the proxy advisory industry continued to grow in the 1990s and early 2000s, fueled by the growing fiduciary requirements of institutional investors and increased shareholder activism. This increased shareholder activism has been attributed in part to reaction by investors to the massive financial frauds perpetrated by management of public companies, including the actions that led to the bankruptcies of Enron and WorldCom. Many institutional investors sought the services of proxy advisory firms to assist in their assessments of the corporate governance practices of publicly traded companies and to carry out the mechanics of proxy voting. Finally, in 2003, SEC adopted a rule and amendments under the Investment Advisers Act of 1940 that requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that proxies are voted in the best interests of clients, which industry experts also cited as a reason for the continued growth of the proxy advisory industry.[8]

Today, the proxy advisory industry is comprised of five major firms, with ISS serving as the dominant player with over 1,700 clients. The other four firms—Marco Consulting Group (MCG), Glass Lewis & Co. (Glass Lewis), Proxy Governance, Inc. (PGI), and Egan-Jones Proxy Services (Egan-Jones)—have much smaller client bases and are relatively new to the industry: Glass Lewis, PGI, and Egan-Jones were all created within the past 6 years.

- Founded in 1985, ISS serves clients with its core business, which includes analyzing proxy issues and offering research and vote recommendations. ISS also provides Web-based tools and advisory

[7]The Deputy Assistant Secretary of the Pension Welfare Benefits Administration (PWBA, now known as the Employee Benefits Security Administration) issued the Avon letter to Mr. Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc., on February 23, 1988. Current U.S. Comptroller General David M. Walker was the Assistant Secretary of Labor for the PWBA from 1987 to 1989. The Department of Labor subsequently issued Interpretative Bulletin No. 94-2 (codified at 29 C.F.R. § 2509-94-2), which, among other things, set forth the department's interpretation of ERISA as it applies to the voting of proxies on securities held by employee benefit plan investment portfolios. The bulletin essentially restates the views set forth in the Avon Letter.

[8]See *Proxy Voting by Investment Advisers.*

services to corporate issuers through ISS Corporate Services, Inc. a separate division established in 1997 which was spun-out into a wholly-owned subsidiary in 2006. RiskMetrics Group, a financial risk management firm, acquired ISS in January 2007. RiskMetrics Group provides risk management tools and analytics to assist investors in assessing risk in their portfolios.

- MCG was established in 1988 to provide investment analysis and advice to Taft-Hartley funds and has since expanded its client base to public employee benefit plans.[9]
- Glass Lewis, established in 2003, provides proxy research and voting recommendations and was acquired by Xinhua Finance Limited, a Chinese financial information and media company, in 2007.
- Established in 2004, PGI offers proxy advice and voting recommendations and is a wholly-owned subsidiary of FOLIOfn, Inc., a financial services company that also provides brokerage services and portfolio management technology for individual investors and investment advisers.
- Egan-Jones was established in 2002 as a division of Egan-Jones Ratings Company, which was incorporated in 1992. Egan-Jones provides proxy advisory services to institutional clients to facilitate making voting decisions.

Of the five major proxy advisory firms, three—ISS, MCG, and PGI—are registered with SEC as investment advisers and are subject to agency oversight, while according to corporate officials, the other two firms are not. In their SEC registration filings, the three registered firms have identified themselves as pension consultants as the basis for registering as

[9]The Labor Management Relations Act, also known as the Taft-Hartley Act, allows for the establishment of multiemployer trust funds, known as Taft-Hartley funds, for the purpose of providing pension and welfare benefits to employees and their families. Act of June 23, 1947, ch. 120, 61 Stat. 136 (1947) (codified as amended at 29 U.S.C. §§ 141 et seq.). These funds, or benefit plans, are financed in whole or part by employer contributions and are administered jointly by labor and management. These funds are subject to ERISA and regulated by the U.S. Department of Labor. Accordingly, managers of Taft-Hartley fund assets have a fiduciary obligation to protect plan assets as required by ERISA.

investment advisers under the Investment Advisers Act.[10] Although Glass Lewis initially identified itself as a pension consultant and registered with SEC as an investment adviser, it withdrew its registration in 2005. According to SEC officials, an investment adviser is not required to disclose a reason for its decision to withdraw its registration in the notice of withdrawal filed with SEC. Officials from Glass Lewis and Egan-Jones did not elaborate on their decisions not to be registered with SEC as investment advisers, other than to note that their decisions were made with advice from their respective counsel.

Potential Conflicts of Interest Exist among Proxy Advisory Firms That Could Affect Their Vote Recommendations, but SEC Has Not Identified Any Major Violations in Its Examinations of Registered Firms

In the proxy advisory industry, various conflicts of interest can arise that have the potential to influence the research conducted and voting recommendations made by proxy advisory firms. The most commonly cited potential for conflict involves ISS, which provides services to both institutional investor clients and corporate clients. Several other circumstances may lead to potential conflicts on the part of proxy advisory firms, including situations in which owners or executives of proxy advisory firms have an ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations. Although the potential for these types of conflicts exists, in its examinations of proxy advisory firms that are registered as investment advisers, SEC has not identified any major violations, such as a failure to disclose a conflict, or taken any enforcement actions to date.

ISS's Business Model Has Been Identified as the Major Potential Conflict of Interest

Industry professionals and institutional investors we interviewed cited ISS's business model as presenting the greatest potential conflict of interest associated with proxy advisory firms because ISS offers proxy advisory services to institutional investors as well as advisory services to corporate clients. Specifically, ISS provides institutional investor clients

[10] Section 203A of the Investment Advisers Act prohibits state-regulated investment advisers who have less than $25 million in assets under management from registering with SEC, unless the person is an investment adviser to a registered investment company, like a mutual fund. SEC Rule 203A-2(b), exempts certain pension consultants from this general prohibition and permits them to register with SEC. 17 C.F.R. § 275.203A-2(b). An investment adviser is a pension consultant for purposes of Rule 203A-2(b), if he or she provides investment advice relating to assets of certain employee benefit plans having an aggregate value of at least $50 million.

with recommendations for proxy voting and ratings of companies' corporate governance. In addition, ISS helps corporate clients develop proposals to be voted on and offers corporate governance consulting services to help clients understand and improve their corporate governance ratings.

Because ISS provides services to both institutional investors and corporate clients, there are various situations that can potentially lead to conflicts. For example, some industry professionals stated that ISS could help a corporate client design an executive compensation proposal to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal. Some industry professionals also contend that corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings. One industry professional further believes that, even if corporations do not feel obligated to subscribe to ISS's consulting services, they still could feel pressured to adopt a particular governance practice simply to meet ISS's standards even though the corporations may not see the value of doing so.

ISS has disclosed and taken steps to help mitigate situations that can potentially lead to conflicts. For example, on its Web site, ISS explains that it is "aware of the potential conflicts of interest that may exist between [its] proxy advisory service ... and the business of ISS Corporate Services, Inc. [ICS]." The Web site also notes that "ISS policy requires every ISS proxy analysis to carry a disclosure statement advising the client of the work of ICS and advising ISS's institutional clients that they can get information about an issuer's use of ICS's products and services." In addition, some institutional investors we spoke with noted that ISS has on occasion disclosed to them, on a case-by-case basis, the existence of a specific conflict related to a particular corporation.

In addition to disclosure, ISS has implemented policies and procedures to help mitigate potential conflicts. For example, according to ISS, it has established a firewall that includes maintaining separate staff for its proxy advisory and corporate businesses, which operate in separate buildings and use segregated office equipment and information databases in order to help avoid discovery of corporate clients by the proxy advisory staff. ISS also notes on its Web site that it is a registered investment adviser and is subject to the regulatory oversight of SEC. In addition, according to ISS's Web site, corporations purchasing advisory services sign an agreement acknowledging that use of such services does not guarantee preferential treatment from ISS's division that provides proxy advisory services.

All of the institutional investors—both large and small—we spoke with that subscribe to ISS's services said that they are satisfied with the steps that ISS has taken to mitigate its potential conflicts. Most institutional investors also reported conducting due diligence to obtain reasonable assurance that ISS or any other proxy advisory firm is independent and free from conflicts of interest. As part of this process, many of these institutional investors said they review ISS's conflict policies and periodically meet with ISS representatives to discuss these policies and any changes to ISS's business that could create additional conflicts. Finally, as discussed in more detail later in this report, institutional investors told us that ISS's recommendations are generally not the sole basis for their voting decisions, which further reduces the chances that these potential conflicts would unduly influence how they vote.

Although institutional investors said they generally are not concerned about the potential for conflicts from ISS's businesses and are satisfied with the steps ISS has taken to mitigate such potential conflicts, some industry analysts we contacted said there remains reason to question the steps' effectiveness. For example, one academic said that while ISS is probably doing a fair job managing its conflicts, it is difficult to confirm the effectiveness of the firm's mitigation procedures because ISS is a privately-held company, thereby restricting information access. Moreover, according to another industry analyst, because ISS's recommendations are often reported in the media, the corporate consulting and proxy advisory services units could become aware of the other's clients.

Other Potential Conflicts May Arise on the Part of Proxy Advisory Firms

In addition to the potential conflict of interest discussed above, several other situations in the proxy advisory industry could give rise to potential conflicts. Specifically:

- Owners or executives of proxy advisory firms may have a significant ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations. A few institutional investors told us that such situations have been reported to them by ISS and Glass Lewis, both of which, in order to avoid the appearance of a conflict, did not make voting recommendations.

- Institutional investors may submit shareholder proposals to be voted on at corporate shareholder meetings. This raises concern that proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals.
- Several proxy advisory firms are owned by companies that offer other financial services to various types of clients, as is common in the financial services industry, where companies often provide multiple services to various types of clients. This is the case at ISS, Glass Lewis, and PGI, and may present situations in which the interests of different sets of clients diverge.

SEC Has Not Identified Any Major Violations in Its Oversight of Proxy Advisory Firms That Are Registered as Investment Advisers

SEC reviews registered investment advisers' disclosure and management of potential conflicts, as well as proxy voting situations where a potential conflict may arise. Specifically, SEC's Office of Compliance Inspections and Examinations monitors the operations and conducts examinations of registered investment advisers, including proxy advisory firms. An SEC official stated that, as part of these examinations, SEC may review the adequacy of disclosure of a firm's owners and potential conflicts; particular products and services that may present a conflict; the independence of a firm's proxy voting services; and the controls that are in place to mitigate potential conflicts.[11] As discussed previously, three of the five proxy advisory firms (ISS, MCG, and PGI) are registered as investment advisers while Glass Lewis and Egan-Jones are not. According to SEC, to date, the agency has not identified any major violations of applicable federal securities laws in its examinations of proxy advisory firms that are registered as investment advisers and has not initiated any enforcement action against these firms.[12]

[11]We did not attempt to assess the adequacy of these examinations.

[12]We cannot disclose the specific results of examinations because of SEC confidentiality considerations.

Analysts Cite ISS's Long-standing Position in the Industry as a Potential Barrier to Competition, Although Firms Have Entered the Market in Recent Years

As the dominant proxy advisory firm, ISS has gained a reputation with institutional investors for providing reliable, comprehensive proxy research and recommendations, making it difficult for competitors to attract clients and compete in the market. As shown below in table 1, ISS's client base currently includes an estimate of 1,700 institutional investors, more than the other four major firms combined. Several of the institutional investors we spoke with that subscribe to ISS's services explained that they do so because they have relied on ISS for many years and trust it to provide reliable, efficient services. They said that they have little reason to switch to another service provider because they are satisfied with the services they have received from ISS over the years. Because of ISS's clients' level of satisfaction, other providers of proxy advisory services may have difficulty attracting their own clients. In addition, because of its dominance and perceived market influence, corporations may feel obligated to be more responsive to requests from ISS for information about proposals than they might be to other, less-established proxy advisory firms, resulting in a greater level of access by ISS to corporate information that might not be available to other firms.

Table 1: Overview of the Major Proxy Advisory Firms

Firm	Founded	Estimated number of employees	Estimated number of clients	Estimated clients' equity assets (dollars)[a]
Institutional Shareholder Services (ISS)	1985	630	1,700	25.5 trillion
Marco Consulting Group (MCG)	1988	70	350	85 billion
Glass Lewis & Company (Glass Lewis)	2003	70	300	15 trillion
Proxy Governance, Inc. (PGI)	2004	31	100	1 trillion
Egan-Jones Proxy Services (Egan-Jones)	2001	Not available	400	Not available

Source: GAO presentation of information provided by proxy advisory firms.

[a]Clients' equity assets refers to the total assets under management by the firms' institutional investor clients. There is overlap between proxy advisory firms' clients' equity assets since, as will be discussed later in this report, some clients use the services of several proxy advisory firms.

Industry analysts explained that, in addition to overcoming ISS's reputation and dominance in the proxy advisory industry, proxy advisory firms must offer comprehensive coverage of corporate proxies and implement sophisticated technology to attract clients and compete. For instance, institutional investors often hold shares in thousands of different corporations and may not be interested in subscribing to proxy advisory firms that provide research and voting recommendations on a limited portion of these holdings. As a result, proxy advisory firms need to provide thorough coverage of institutional holdings, and unless they offer comprehensive services from the beginning of their operations, they may have difficulty attracting clients. In addition, academics and industry experts we spoke with said that new firms need to implement a sophisticated level of technology to provide the research and proxy vote execution services that clients demand. The initial investment required to develop and implement such technology can be a significant expense for firms.

Although newer proxy advisory firms may face challenges attracting clients and establishing themselves in the industry, several of the professionals we spoke with believed that these challenges could be overcome. For example, while firms may need to offer comprehensive coverage of corporate proxies in order to attract clients and although ISS might have access to corporate information that other firms do not, much of the information needed to conduct research and offer voting recommendations is easily accessible. Specifically, anyone can access corporations' annual statements and proxy statements, which are filed with SEC, are publicly available, and contain most of the information that is needed to conduct research on corporations and make proxy voting recommendations. Also, although developing and implementing the technology required to provide research and voting services can be challenging, various industry professionals told us that once a firm has done so, the marginal cost of providing services to additional clients and of updating and maintaining such technology is relatively low.

Some of the competitors seeking to enter the proxy advisory industry in recent years that we spoke with have offered their services as alternatives to ISS. Specifically, they have attempted to differentiate themselves from ISS by providing only proxy advisory services to institutional investor clients. ISS's competitors have chosen not to provide corporate consulting services in part to avoid the potential conflicts that exist at ISS. Proxy advisory firms have also attempted to differentiate themselves from the competition on the basis of the types of services provided. For example, some firms have started to focus their research and recommendation services on particular types of proxy issues or on issues specific to individual corporations.

The institutional investors we spoke with had a variety of opinions about the level of competition in the industry. Some questioned whether the existing number of firms is sufficient, while others questioned whether the market could sustain the current number of firms. However, many of the institutional investors believe that increased competition could help reduce the cost and increase the range of available proxy advisory services. For example, some institutional investors said that they have been able to negotiate better prices with ISS because other firms have recently entered the market. While some of these newer proxy advisory firms have attracted clients, it is too soon to tell what the firms' ultimate effect on competition will be.

Large Institutional Investors Reportedly Rely Less Than Small Institutional Investors on Advisory Firms, Limiting the Influence These Firms Have on Proxy Voting Results

We conducted structured interviews with 31 randomly selected institutional investors to gain an understanding of the ways in which they use proxy advisory firms and the influence that such firms have on proxy voting. Of the 20 large institutional investors we interviewed, 19 reported that they use proxy advisory services in one or more ways that may serve to limit the influence that proxy advisory firms have on proxy voting results (see table 2), while only 1 reported relying heavily on a proxy advisory firm's research and recommendations.[13]

Table 2: Reliance of Large Institutional Investors on Proxy Advisory Firms

	Use proxy advisory firm to supplement in-house research	Use proxy advisory firm to execute customized voting policy	Subscribe to several proxy advisory firms
Number of large institutional investors (out of 20 interviewed)[a]	15	14	8

Source: GAO analysis of structured interviews with 20 large institutional investors.

[a]Many of the large institutional investors we spoke with explained that, although they subscribe to a customized voting policy, they may also continue to use their proxy advisory firm to supplement their own in-house research, subscribe to several proxy advisory firms, or both. This results in overlap among the three categories of how these institutional investors use proxy advisory firms, as shown in the table.

[13]Of the 20 large institutional investors we spoke with, 7 were asset management institutions that vote proxies on behalf of their clients. Many large and small institutional investors we initially attempted to contact reported that they do not vote their own proxies. Instead, these institutional investors said that companies that provide asset management services also vote proxies on their behalf. We added these asset management institutions, which were referred to us by pension funds, to our sample in order to understand the extent to which they rely on proxy advisory services.

The following summarizes several of the reasons that large institutional investors' reliance on proxy advisory firms' research and recommendations is limited:

- Most of the large institutional investors we spoke with (15 out of 20) reported that they generally rely more on their own in-house research and analyses to make voting decisions than on the research and recommendations provided by their proxy advisory services providers. These institutional investors tend to have their own in-house research staffs, and their in-house research reportedly drives their proxy voting decisions. They explained that they use the research and recommendations provided by proxy advisory firms to supplement their own analysis and as one of many factors they consider when deciding how to vote.

- In addition, many (14) of the large institutional investors we contacted reported that they subscribe to a customized voting policy that a proxy advisory firm executes on the institutions' behalf. These institutional investors develop their own voting policies and guidelines that instruct the advisory firm how to vote on any given proxy issue. In such instances, the proxy advisory firms simply apply their clients' voting policies, which then drive the voting decisions.

- Further, 8 of the large institutional investors we contacted explained that they subscribe to more than one proxy advisory firm to help determine how to vote. These institutional investors said that they consider multiple sets of proxy advisory firm research and recommendations to gain a broader range of information on proxy issues and to help make well-informed voting decisions.

We also interviewed representatives from 11 smaller institutional investors, and the results of these interviews suggest that proxy advisory firm recommendations are of greater importance to these institutions than they are to the large institutional investors we spoke with. In particular, representatives from smaller institutional investors were more likely to say that they rely heavily on their proxy advisory firm and vote proxies based strictly on the research and recommendations of their firm, given these institutions' limited resources. Consequently, the level of influence held by proxy advisory firms appears greater with these smaller institutional investors.

However, whether large or small, all of the institutional investors we spoke with explained that they retain the fiduciary obligation to vote proxies in the best interest of their clients irrespective of their reliance on proxy advisory firms. Institutional investors emphasized that they do not delegate this responsibility to proxy advisory firms and retain the right to override any proxy advisory firm recommendations, limiting the amount of influence proxy advisory firms hold. In addition, large and small institutional investors reported that they tend to provide greater in-house scrutiny to, and rely even less on, proxy advisory firm recommendations about certain high-profile or controversial proxy issues, such as mergers and acquisitions or executive compensation.

Institutional investors' perspectives on the limited influence of proxy advisory firms reflected what we heard from professionals that we spoke with who have knowledge of the industry. Many of these industry analysts and academics agreed that large institutional investors would be less likely than small institutional investors to rely on proxy advisory firms, because large institutions have the resources available to conduct research and subscribe to more than one proxy advisory service provider. These professionals also thought that large institutional investors would be likely to use proxy advisory firms as one of several factors they consider in the research and analysis they perform to help them decide how to vote proxies. Further, several believed that small institutional investors would be more likely to vote based strictly on proxy advisory firms' recommendations, because they do not have the resources to conduct their own research.

The results of our work suggest that the overall influence of advisory firms on proxy vote outcomes may be limited. In particular, large institutional investors, which cast the great majority of proxy votes made by all institutional investors with over $1 billion in assets, reportedly place relatively less emphasis on the firms' research and recommendations than smaller institutional investors. However, we could not reach a definitive conclusion about the firms' influence because the institutional investors we contacted were not necessarily representative of all such investors. Further, we could not identify any studies that comprehensively isolated advisory firm research and recommendations from other factors that may influence institutional investors' proxy voting.[14]

Agency Comments

We provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which we incorporated into the final report, as appropriate. We also provided relevant sections of the draft to the proxy advisory firms for a technical review of the accuracy of the wording and made changes, as appropriate, based on the firms' comments.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time we will provide copies of this report to the Chairman and Ranking Member, Senate Committee on Banking, Housing, and Urban Affairs; the Chairman, House Committee on Financial Services; the Chairman, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services; other interested committees; and the Chairman of the Securities and Exchange Commission (SEC). 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

[14]We identified a study—"The Role of Advisory Services in Proxy Voting," by Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt (Dec. 14, 2006)—that examined the extent to which recommendations can influence vote outcomes and stock prices by focusing on recommendations made by ISS that were reported in the media. The authors documented "significant stock price movements around recommendation dates, indicating that proxy advice brings new information to the market," as well as "a robust association between recommendations and contest outcomes after controlling for differences in contest characteristics, voting rules, dissidents, and incumbents." As the authors note, "although not all ISS recommendations are reported in the media, restricting attention to the newsworthy cases ensures that our sample consists of contests in which the underlying issues are significant and the recommendation is most likely to play an important role." However, most of the institutional investors we spoke with reported that they tend to provide greater in-house scrutiny to, and rely even less on, proxy advisory firm recommendations about high-profile or controversial proxy issues, which are the recommendations that would be more likely to appear in the media.

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 to this report are listed in appendix II.

Yvonne D. Jones

Yvonne D. Jones
Director, Financial Markets
and Community Investment

Appendix I: Scope and Methodology

Our objectives were to (1) identify potential conflicts of interest that exist with proxy advisory firms and the steps that the Securities and Exchange Commission (SEC) has taken to oversee these firms; (2) review the factors that might impede or promote competition in this industry; and (3) analyze institutional investors' use of proxy advisory services to help vote proxies and the influence proxy advisory firms may have on proxy voting.

To determine the types of potential conflicts of interest that could arise in the proxy advisory industry, we conducted a literature review and examined studies relating to potential conflicts that may arise in this industry. Further, we interviewed various professionals with knowledge of the proxy advisory industry, including industry experts, academics, industry association representatives, and proxy advisory firm representatives, as well as institutional investors and officials at SEC. We selected these professionals based, in part, on literature searches we conducted on topics relating to proxy advisory and corporate governance services, as well as referrals by several of the professionals we met with. The professionals we spoke with represent a wide range of perspectives, and include experts from academia, business, government, and professional organizations. We did not attempt to assess any of the proxy advisory firms' conflict mitigation policies or procedures and, therefore, did not come to any conclusions about the adequacy of these policies or procedures. To gain an understanding of SEC's oversight of proxy advisory firms, we reviewed relevant investment adviser regulations and examinations conducted by SEC since 2000 and interviewed agency officials. We did not attempt to assess the adequacy of SEC's oversight.

To identify the factors that might impede or promote competition in this industry, we reviewed the relevant literature and examined studies relating to the level of competition in the industry, and we spoke with various industry professionals. We did not attempt to evaluate the level of competition in this industry and, therefore, did not come to any conclusions about the extent to which competition exists.

Finally, to explore institutional investors' use of proxy advisory services to help vote proxies and the influence proxy advisory firms may have on proxy voting, we conducted structured interviews with 31 institutional investors selected randomly by type, including mutual funds, corporate pension funds, government pension funds, and union pension funds, as well as asset management institutions. Our sample included several of the largest institutional investors and was derived from Standard & Poor's Money Market Directories (January 2006). The sample consisted of a population of mutual funds and pension funds with over $1 billion in assets, and included large and small institutional investors from each investor type. We defined "large" and "small" institutional investors as the top and bottom 15 percent of each institutional investor type. In total, these large and small institutional investors accounted for over 72 percent of assets under management held by mutual funds and pension funds with over $1 billion under management. Although we randomly selected these institutional investors, the size of the sample was small and may not necessarily be representative of the universe of institutional investors. As a result, we could not generalize the results of our analysis to the entire population of institutional investors.

We conducted structured interviews with 20 large and 11 small institutional investors. Initially, we had contacted a total of 126 mutual funds and pension funds that were randomly selected from our sample of institutional investors and 20 (13 large and 7 small institutions) reported using proxy advisory firm services and agreed to participate in our structured interviews. The other 106 institutional investors we had initially contacted declined to participate in the structured interviews for several reasons. In particular, many of these institutions said that they do not vote proxies themselves, but rather hire asset management institutions to both manage their investment portfolios and vote proxies on their behalf. We conducted interviews with 11 (7 large and 4 small institutions) of these asset management institutions, which were referred to us by several of the pension funds we had initially contacted. The results of these asset manager interviews are included among the total of 20 large and 11 small institutional investors that we interviewed. In addition, some of the 106 institutional investors declined to participate because they vote proxies themselves or do not vote proxies at all, while others refused to participate or could not be reached.

In our structured interviews with the 31 institutional investors, we spoke with officials from the organizations who are responsible for proxy voting activities. We asked these officials a variety of questions relating to their institutions' policies on proxy voting and use of proxy advisory firms. Further, we asked the officials to comment on potential conflicts of interest associated with proxy advisory firms, steps taken to mitigate such potential conflicts, and the level of competition in the proxy advisory industry.

Finally, we spoke with various industry professionals discussed earlier to gain their perspectives on the influence of proxy advisory firms. We could not identify any studies that comprehensively measured the influence that these firms have on proxy voting.

We conducted our work in Washington, D.C., between September 2006 and June 2007 in accordance with generally accepted government auditing standards.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

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

Staff Acknowledgments

In addition to the above contact, Wes Phillips, Assistant Director; Emily Chalmers; Rudy Chatlos; Eric Diamant; Fred Jimenez; Yola Lewis; and Omyra Ramsingh made key contributions to this report.

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United States Government Accountability Office

GAO

Report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate

August 2004

PENSION PLANS

Additional Transparency and Other Actions Needed in Connection with Proxy Voting

GAO

Accountability * Integrity * Reliability

GAO-04-749

GAO Highlights

Accountability · Integrity · Reliability

Highlights of GAO-04-749, a report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, United States Senate

August 2004

PENSION PLANS

Additional Transparency and Other Actions Needed in Connection with Proxy Voting

Why GAO Did This Study

In 1998, about 100 million Americans were covered in private pension plans with assets totaling about $4 trillion. The retirement security of plan participants can be affected by how certain issues are voted on during company stockholders meetings. Fiduciaries, having responsibility for voting on such issues on behalf of some plan participants (proxy voting), are to act solely in the interest of participants. Recent corporate scandals reveal that fiduciaries can be faced with conflicts of interest that could lead them to breach this duty. Because of the potential adverse effects such a breach may have on retirement plan assets, we were asked to describe (1) conflicts of interest in the proxy voting system, (2) actions taken to manage them, and (3) DOL's enforcement of proxy voting requirements.

What GAO Recommends

GAO recommends that Congress consider amending ERISA to require fiduciaries to (1) develop proxy-voting guidelines, (2) disclose guidelines and votes annually, and (3) appoint an independent fiduciary to vote the company's own stock in its pension plan in certain instances. GAO recommends that DOL conduct another proxy enforcement study, and enhance coordination of enforcement strategies with SEC. DOL generally disagreed with our recommendations, but we believe that additional transparency and enhanced enforcement are needed.

www.gao.gov/cgi-bin/getrpt?GAO-04-749.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

Conflicts of interest in proxy voting can occur because various business relationships exist, which can influence a fiduciary's vote. When a portion of a company's pension plan assets are invested in its own company stock, the internal proxy voter may be particularly vulnerable to conflicts of interest because management has an enhanced ability to directly influence their voting decisions. Although situations representing conflicts will occur, limited disclosure of proxy voting guidelines and votes may make proxy voting more vulnerable to such conflicts. Because of limited transparency, concerned parties do not have the information needed to raise questions regarding whether proxy votes were cast solely in the interest of plan participants and beneficiaries.

Some plan fiduciaries and the Securities and Exchange Commission (SEC) have taken steps to help manage conflicts of interest in proxy voting. Specifically, some plans voluntarily maintain detailed proxy voting guidelines that give proxy voters clear direction on how to vote on certain issues. The SEC has imposed new proxy voting regulations on mutual funds and investment advisers, requiring that specific language be included in the fund's guidelines on how fiduciaries will handle conflicts of interest. Some plan fiduciaries voluntarily make their guidelines available to participants and the public. In addition, some plans voluntarily disclose some or all of their proxy votes to participants and the public. Some plans also voluntarily put additional procedures in place to protect proxy voters from conflicts of interest in order to avoid breaches of fiduciary duty. For example, some plan sponsors hire independent fiduciaries to manage employer stock in their pension plans and vote the proxies associated with those stock. Plans may also hire proxy-voting firms to cast proxies to ensure that they are made solely in the interest of participants and beneficiaries.

DOL's enforcement of proxy voting requirements has been limited for several reasons. First, participant complaints about voting conflicts are infrequent, at least in part, because votes cast by a plan fiduciary or proxy voter generally are not disclosed; therefore, participants and others are not likely to have information they need to raise questions regarding whether a vote has been cast solely in their interest. Second, for DOL, the Employee Retirement Income Security Act of 1974 presents legal challenges for bringing cases such that it is often difficult to obtain evidence that the fiduciary was influenced in his or her voting by something other than the sole interests of plan participants. Finally, even if such evidence existed, monetary damages are difficult to value and fines are difficult to impose. And, DOL has no statutory authority to impose a penalty without first assessing damages and securing a monetary recovery. In part, because of these challenges, DOL has devoted few resources to enforcing proxy voting by plans.

Contents

Abbreviations

AMEX	American Stock Exchange
DeAM	Deutsche Bank Asset Management
DeIB	Deutsche Bank's Investment Banking
DOL	Department of Labor
EBSA	Employee Benefits Security Administration
EIN	Employer Identification Number
ERISA	Employee Retirement Income Security Act of 1974
ESOP	employee stock ownership plan
HP	Hewlett-Packard
IB	Interpretive Bulletin
IMs	investment managers
NASDAQ	National Securities Dealers Stock Exchange
NYSE	New York Stock Exchange
SARs	summary annual reports
SEC	Securities Exchange Commission
SPDs	summary plan descriptions
TAQ	Trade and Quote

GAO
Accountability * Integrity * Reliability
United States Government Accountability Office
Washington, DC 20548

August 10, 2004

The Honorable Edward M. Kennedy
Ranking Minority Member
Committee on Health, Education, Labor, and Pensions
United States Senate

Dear Senator Kennedy:

Pensions are an important source of income for millions of retirees, and the federal government has encouraged private employers to sponsor and maintain private pension and retirement savings plans for their employees. In 1998, about 100 million workers and retirees were covered in private defined benefit[1] or defined contribution[2] pension plans with assets totaling about $4 trillion. In 2001, pension plans, as a whole, owned about 20 percent of the total corporate equity issued by U.S. companies, with private pension funds owning about 59 percent of that amount.[3] As shareholders, pension plans have certain rights, including the right to vote on certain corporate governance matters. Some matters such as the election of directors, executive compensation packages, and mergers and acquisitions are significant voting items that may affect long-term share value, while other matters may not. While they may vote in person, fiduciaries typically do not attend the annual meetings in which corporate policies are voted. Instead, they usually submit ballots prior to the meeting, generally via mail or online instructions. This is called proxy voting. According to the Department of Labor's (DOL's) interpretation of the Employee Retirement Income Security Act (ERISA) of 1974, with these

[1]A defined benefit plan promises to provide a benefit that is generally based on an employee's salary and years of service. Defined benefit plans use a formula to determine the ultimate pension benefit that participants are entitled to receive. The employer, as plan sponsor, is responsible for making contributions that are sufficient for funding the promised benefit, investing and managing the plan assets, and bearing the investment risk.

[2]Under defined contribution plans, employees have individual accounts to which the employee, employees, or both make periodic contributions. Defined contribution plan benefits are based on the contributions to and investment returns (gains and losses) on individual accounts. In a defined contribution plan, the employee bears the risk and often controls, at least in part, how his or her individual account assets are invested.

[3]These data are according to the flow of funds data issued on March 2004 from the Federal Reserve Board. Mutual funds own about 18 percent of total corporate equity, while households directly own about 39 percent.

voting rights, fiduciaries are required to cast votes solely in the interest of plan participants and beneficiaries.[4]

The retirement security of these plan participants can be affected by how certain issues are voted on during company stockholder meetings and, therefore, relies on fiduciaries acting solely in the interest of pension plan participants and beneficiaries. However, recent corporate scandals have highlighted the fact that fiduciaries are faced with conflicts of interest that could lead them to breach their responsibility to act solely on behalf of participants. For example, in 2002, the Securities Exchange Commission (SEC) investigated whether a vote cast in favor of a merger between Hewlett-Packard (HP) and Compaq by Deutsche Bank Asset Management (DeAM), a large asset manager with the fiduciary responsibility for voting proxies, was influenced by a conflict of interest. The SEC found that a material conflict of interest was created when DeAM failed to disclose to its advisory clients that Deutsche Bank's Investment Banking (DeIB) division was working for HP on the merger and had intervened in DeAM's proxy process on behalf of HP.

Because of conflicts of interest in the proxy voting system and the potential adverse effects of such conflicts on the retirement security of Americans, you asked us to describe (1) conflicts of interest in proxy voting, (2) actions taken by plans and plan fiduciaries to manage conflicts of interest, and (3) DOL's enforcement of proxy voting requirements.

To determine what conflicts exist in proxy voting, we conducted face-to-face and telephone interviews which included officials at DOL's Employee Benefits Security Administration (EBSA) and at SEC, securities and proxy voting industry professionals, officials of public and private pension plans, ERISA attorneys, asset managers, and proxy voting firms, research organizations, and proxy solicitors. We asked 25 shareholder activist professionals, academics, and economists to respond to a series of questions for a written reply and received 14 responses. To determine the

[4]A plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the management of plan assets. Any person who makes investment decisions with respect to a qualified employee benefit plan's assets is generally a fiduciary. The duties the person performs for the plan rather than their title or office determines whether that person is a plan fiduciary. Unless otherwise indicated, in this report we use the term fiduciary or plan fiduciary as those persons who have the responsibility for voting proxies. Plan fiduciaries have a responsibility to vote proxies on issues, including those that may affect the value of the shares in the plan's portfolio.

extent to which certain companies' pension plans hold proxy voting power within the plan sponsor, we analyzed plan financial information filed annually (Form 5500 data) with DOL's EBSA. We analyzed data for the Fortune 500 companies for plan year 2001, which was the most recent year for which complete plan-specific data were available. To determine what safeguards fiduciaries have put in place to manage conflicts of interest, we reviewed proxy voting guidelines and interviewed a number of public and private pension plan sponsors, asset managers, proxy voting firm representatives, and other experts. To determine DOL's enforcement efforts in this area, we reviewed DOL enforcement material and previously issued GAO reports on DOL's enforcement program and interviewed officials at EBSA.

We conducted our work between April 2003 and May 2004 in accordance with generally accepted government auditing standards. See appendix I for more information on our scope and methodology.

Results in Brief

Experts we interviewed said that conflicts of interest exist in proxy voting and occur because of the various business relationships that may influence a proxy voter's vote. These experts also said that conflicts can exist in situations when an employee of the plan sponsor votes proxies—internally—or by a person or entity outside of the plan—externally. When a portion of a company's pension plan assets are invested in its own company stock, the internal proxy voter may be particularly vulnerable to conflicts of interest because management has the ability to directly influence voting decisions. For the external proxy voter, a variety of conflicts may arise due to business relationships. For example, when the external proxy voter is an investment manager that is part of a larger corporation that provides a variety of services, business relationships between branches of the corporation and the plan sponsor may influence the investment manager's proxy voting decisions. Consistent with current DOL requirements, proxy votes and guidelines are disclosed to the plan. Proxy voters are not required to publicly disclose proxy voting guidelines and votes, though plans are required to make voting guidelines available to participants upon request. Although conflicts will exist, limited disclosure may make proxy voters more vulnerable to such conflicts. Because of this limited transparency, concerned parties do not have the information needed to raise questions regarding whether proxy votes were cast in the sole interest of plan participants and beneficiaries.

Some plan fiduciaries and SEC have taken steps to help manage conflicts of interest in proxy voting. Some plans voluntarily maintain detailed proxy-voting guidelines that give proxy voters clear direction on how to vote on certain issues. SEC has imposed new proxy voting regulations on mutual funds and investment advisers requiring that specific language be included in policies and procedures on how fiduciaries will handle conflicts of interest. In addition, some plan fiduciaries voluntarily make their guidelines available to participants and the public. Furthermore, some plans voluntarily disclose to participants and the public how they voted on some or all of the issues in which they voted. Similarly, SEC now requires mutual funds to publicly disclose all proxy votes and policies and procedures. Some plans voluntarily put additional procedures in place to protect proxy voters from conflicts of interest that may lead to breaches of fiduciary duty. For example, some plans have a rule that, in the event that an attempt is made to influence a proxy vote, the voting responsibility on that issue moves from the proxy voter to a committee. Some plan sponsors have hired independent fiduciaries to manage employer stock in their pension plans. Plans may also hire an independent proxy voter or proxy-voting firm to cast proxy votes to ensure that they are solely in the interest of plan participants.

DOL's enforcement of proxy voting requirements has been limited for several reasons. First, participant complaints about voting conflicts are infrequent, at least in part, because votes cast by a plan fiduciary or proxy voter generally are not disclosed. Therefore, plan participants and others are not likely to have the information they need to raise questions regarding whether a vote has been cast solely in their interest. Second, ERISA presents legal challenges for prosecuting proxy voting cases. Specifically, it is often difficult to obtain evidence that the plan fiduciary was influenced in his or her voting by something other than the interests of plan participants because, among other things, the fiduciary's vote is based on judgment. Finally, even if such evidence existed, monetary damages are difficult to value and, because the department has no statutory authority to impose a penalty without assessing damages, fiduciary penalties are difficult to impose. In part, because of these challenges and its limited resources, DOL has devoted few resources to enforcing proxy voting practices by fiduciaries. For example, the agency conducted three enforcement studies between 1988 and 1996 to determine the level of compliance with proxy voting requirements among select fiduciaries. According to DOL, as a result of these proxy reviews, they found improvements over time within the proxy voting system as the number of voting fiduciaries and plan administrators who voted and established proxy voting guidelines increased. The department has not conducted similar reviews in recent years. DOL officials told us that they believe that proxy voters are generally in compliance, they receive few complaints and that with limited resources they focus instead on other priority areas, which may result in identifying violations that can be corrected. Furthermore, DOL officials said that they do not have specific investigations focused on proxy voting, and they do not allocate many resources to this issue.

This report contains Matters for Congressional Consideration to improve the disclosure of proxy voting guidelines and votes and the independence of fiduciaries voting proxies in certain circumstances. The report also contains recommendations for executive agency action to improve oversight and enforcement in this area. In its response to our draft report, DOL generally disagreed with our matters for congressional consideration and recommendations, saying that conflicts of interest affecting pension plans are not unique to proxy voting and that requiring independent fiduciaries and increased disclosures would increase costs and discourage plan formation. While we acknowledge that fiduciaries face conflicts beyond proxy voting issues and that DOL has limited statutory authority related to proxy voting, we believe that additional transparency and an enhanced enforcement presence are needed.

Background

ERISA established the broad fiduciary requirements related to private pension plans and was designed to protect the pension and welfare benefit rights of workers and their beneficiaries. The act requires a plan fiduciary to act "...solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits" to them and to act "...with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use." Failure to act in accordance with these requirements might constitute a breach of fiduciary duty. Breaches of the fiduciary duty to act solely in the interest of plan participants and beneficiaries with respect to proxy voting could arise when a fiduciary has a conflict of interest. Conflicts of interest occur in a variety of ways in proxy voting. Conflicts occur when a plan fiduciary or proxy voter has either business or personal interests that compete with the interests of participants. When conflicts are not appropriately managed, they could lead to a breach of fiduciary responsibility or, at least, may raise concern that a breach has occurred. For example, an SEC investigation showed that DeIB division had an undisclosed business relationship with HP, which may have influenced the proxy voter's vote cast by DeAM about a merger between HP and Compaq Computer Corporation.[5]

ERISA's fiduciary requirements apply to plan sponsors, trustees, managers, and others who act as fiduciaries. These requirements do not explicitly address proxy voting; however, DOL—having responsibility for the investigation and enforcement of violations of ERISA, which includes provisions related to fiduciary responsibility—has stated that the fiduciary act of managing plan assets that are shares of corporate stock generally includes the voting of proxies pertaining to those shares of stock. The provisions of ERISA were enacted to address public concerns that funds of private employee benefit plans were being mismanaged and abused. DOL can take several actions to correct fiduciary violations it identifies. These include acceptance of voluntary fiduciary agreements to implement corrective actions, initiation of civil litigation in federal district court, and referral of certain violations to other enforcement agencies.

On the matter of proxy voting, DOL has issued several letters and bulletins discussing the duties of pension plan fiduciaries. For example, the "Avon Letter," released in 1988, stated that the voting of a proxy is a fiduciary duty and that the responsibility for voting falls on the plan's trustee unless otherwise delegated.[6] Through its "ISS letter," issued in 1990, among other things, DOL stated that with respect to monitoring activities, that the plan fiduciary, in order to carry out his or her fiduciary responsibilities, must be able to periodically review voting procedures and actions taken in individual situations so that a determination can be made whether the investment manager is fulfilling its fiduciary responsibility. Furthermore, DOL issued Interpretive Bulletin (IB) 94-2 in 1994, which clarified the guidance in the previous two letters and also stressed the importance of statements of investment policy, including voting guidelines. While DOL said that maintenance of such statements of investment policy are

[5]SEC brought an enforcement action against Deutsche Bank Asset Management in connection with its voting of client proxies for the HP-Compaq merger transaction and imposed a $750,000 penalty. The fine was imposed for not disclosing a conflict. SEC action found that DeAM violated its fiduciary duty to act solely in the best interests of its advisory clients by voting the proxies on the HP stock owned by its advisory clients without first disclosing the conflict.

[6]The Deputy Assistant Secretary of the Pension Welfare Benefits Administration (PWBA now known as EBSA) issued the Avon letter to Mr. Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc., on February 23, 1988. Current U.S. Comptroller General David M. Walker was the Assistant Secretary of Labor for the PWBA from 1987 to 1989.

consistent with ERISA, DOL officials said that they do not have the statutory authority to require plans to maintain such statements.

SEC, under the Investment Company Act of 1940, regulates companies, including mutual funds, that engage primarily in certain operations, such as investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. A primary mission of SEC is to protect investors and maintain the integrity of the securities markets through disclosure and enforcement. Employees in participant-directed pension plans might be given the choice of investing in securities, including employer securities, as well as a variety of mutual funds. Because plan participants may have such investment options, securities law protections applicable to investors are relevant to plan participants. In addition, some pension plans use investment managers to oversee plan assets and these managers may be subject to securities laws.

Congress previously studied the issue of DOL's enforcement and proxy voting. In the 1980s, reports emerged that fiduciaries were not voting their proxies or that conflicts of interest may have influenced the decisions of some plan fiduciaries. The Congress consequently became concerned about whether fiduciaries were fulfilling their responsibility to protect the interests of pension plan participants and beneficiaries. Because ERISA does not specifically lay out what the fiduciary responsibility is regarding proxy voting, many fiduciaries were thought to be unclear about their responsibility to vote proxies and maintain voting guidelines. This was cited as one of the major factors that led the Subcommittee on Oversight of Government Management, Senate Committee on Governmental Affairs, to conduct an investigation of and hold hearings in 1986 on DOL's enforcement of ERISA. Among other things, the Subcommittee concluded that disclosure of proxy votes would facilitate the DOL's enforcement efforts by providing the agency and other interested parties with much needed information. DOL officials believe that the agency does not have the statutory authority to require plan fiduciaries to publicly disclose their proxy votes and guidelines.

Business Relationships and Limited Disclosure of Votes Can Make Proxy Voting Vulnerable to Conflicts

Some experts we interviewed said that conflicts of interest exist in the proxy voting system and limited disclosure makes proxy voting vulnerable to conflicts of interest. Conflicts of interest occur because of the various business relationships that may influence a plan fiduciary's or proxy voter's vote. For example, when a company provides investment advisory services for a company-sponsored pension plan and also provides investment banking services to the company sponsoring that pension plan. Although conflicts will exist, limited disclosure makes proxy voting vulnerable to them. Because of this lack of transparency, participants do not have the information needed to raise questions regarding whether proxy votes were cast solely in their interest.

Fiduciary's Business Associations Can Create Conflicts of Interest

Business associations between a proxy voter and any entity that may influence their vote presents a conflict of interest. Some experts we interviewed explained that these associations may form whether proxies are internally or externally managed because company management has direct access to the proxy voter who is either an employee, in the case of internally voted proxies, or is a service provider, in the case of externally voted proxies.

When a portion of a company's pension plan assets are invested in its own company stock, the proxy voter may be particularly vulnerable to conflicts of interest because management has the ability to directly influence its voting decisions and, since company stock held in the company's own pension plan is typically managed internally,[7] the proxy voter may at times be more concerned about their own interests. While ERISA states that fiduciaries must act solely in the interest of pension plan participants, there is no requirement that an independent fiduciary be appointed to provide additional protections for participants with company stock in their pension plans.

Several experts explained that conflicts of interest that occur in this type of arrangement are considerably problematic. For example, one expert said that since proxy voting and other decisions relating to company stock are much more likely to be handled in-house, votes may be cast in

[7] The named fiduciary could also delegate the proxy voting responsibility to a trustee bank, third-party proxy voting firm, or an independent fiduciary.

accordance with the wishes of the company's senior management.[8] In such cases, the company's management may not consider the best interest of plan participants and beneficiaries independently from management's opinion of what is best for the company. The Enron case provides an example of how management's own concerns may come before that of participants and beneficiaries.[9]

In addition, some experts said that when proxies are internally managed, the proxy vote may be influenced by the fiduciary's own personal concerns, particularly in instances when casting a vote solely in the interests of plan participants and beneficiaries means voting against company management. Specifically, if the plan fiduciary is a lawyer, investment analyst, or a member of the management team for the company, their proxy vote on management proposals such as a merger and acquisition or for individuals they have chosen to serve on the board of directors could be influenced by concerns about their personal standing, or job security, in the company. A few experts said that a fiduciary in this situation is not likely to vote against a management proposal such as an executive compensation package because of their own personal concerns. Additionally, DOL officials said that conflicts for an internal fiduciary could arise when the company is experiencing problems, which, if publicly known, would cause stock value to decline. In order to protect participants, fiduciary duty might require the fiduciary to publicly disclose the information to participants and other shareholders and sell shares of the company stock. Insider trading rules would, however, prevent the fiduciary from taking action on nonpublic information.[10] However, making this information public could cause a rapid decline in share value as investors sell off their shares of stock, thereby, potentially harming the company and the fiduciary's own personal standing in the firm.

[8]Defined benefit plans may not acquire any qualifying employer security or qualifying employer real property in excess of 10 percent of fair market value of the plan's assets. Defined contribution plans are generally exempt from the 10 percent limitation.

[9]The DOL sued Enron, corporate directors, and the administrative committee on June 26, 2003, for violating ERISA. The suit alleges that certain company and plan officials failed to consider the prudence of Enron stock as an appropriate investment for the retirement plans and did nothing to protect the workers and retirees from extensive losses. The former corporate executive was also charged with misrepresenting Enron's financial condition to employees and plan officials and encouraging them to buy the stock.

[10]Insider trading rules state that a person or entity may not sell or buy stock based on information that is not publicly available.

Because company management could influence the fiduciary responsible for voting the proxies related to the company's own stock,[11] management may have a significant amount of influence over the outcome of a proxy contest.[12] In order to assess the influence management could have in a proxy contest, we conducted an analysis of Fortune 500 companies. (See appendix I for further information on our methodology.) In our analysis, we compared the number of voting shares of company stock held in a company's pension plans[13] to the total voting shares held in the market. About 272 of the Fortune 500 companies that reportedly had their own company stock in their pension plans and in separate accounts, such as master trust agreements held over $210 billion in employer securities in plan year 2001. Of those companies, 27 percent held at least 5 percent or more of company stock in their company's pension and benefit plans, while another 26 percent held between 2 and 5 percent. None of the Fortune 500 firms we analyzed held more than 21 percent of the total voting power of their company's stock in their pension and welfare benefit plans, while 47 percent held less than 2 percent of company stock in their company's pension and benefit plans.

[11]Management also has access to other proxy voters—employees who participate in the company's pension plan which has company stock as an investment choice in their 401(k) plan or if the plan sponsor offers an Employee Stock Ownership Plan (ESOP). The plan fiduciary is responsible for voting unallocated stock and stock allocated to pension plan participants that has not been voted. Unallocated shares of stock are those that have not been distributed and are held by the company in a suspense account. Allocated shares of stock are those shares that have been both distributed to the employees of the company's pension plan and to outside investors (e.g., by institutional investors such as other pension plans and mutual funds, or individual investors). How the fiduciary must vote those stock is outlined in the plan documents. The directions provided in the plan documents may include voting by the trustee in accordance with fiduciary principles, voting by the trustee to mirror the vote for directed shares, and refraining from voting the shares on the assumption that the employee intended to cast a no vote.

[12]For defined benefit plans, plan assets are typically institutionally managed by an external asset manager. The external asset manager also has the responsibility to vote the proxies unless that responsibility is retained by the plan trustees. For defined contribution plans, pension plan participants may have the responsibility to vote the proxies for the shares of their own company's stock in their 401(k) plan account. This called pass through voting, which is required for a plan to receive Section 404(c) relief with respect to the investment in company stock. It is at the plan's discretion to permit pass thru voting to participants, though most defined contribution plans are designed to comply with Section 404(c).

[13]This includes company stock held in defined contribution plans (including ESOPs) and defined benefit plans, or indirectly through certain trusts, accounts, and other investment arrangements. This also includes allocated and unallocated stock.

While the results showed that the pension and welfare benefit plans of the Fortune 500 companies we analyzed were not holding large percentages of the total voting power of a company's shares, these findings may still be significant. For example, in a contentious proxy contest such as a merger and acquisition where 51 percent of outstanding shares is needed to complete the merger, a company whose pension assets comprise just 2 percent of the total stock issued by a company might act as the deciding vote if the proxy contest is close. In this case, how the plan fiduciary or proxy voter casts its vote could make the difference between 49 percent and 51 percent—that is, the difference between the merger being approved or rejected. Some of the largest and most influential pension plans typically hold no more than 1 to 2 percent of any one company's shares in their plan's investment portfolios. As such, a Fortune 500 company whose pension plans holds more than 1 or 2 percent of its own company stock could give them an advantage in a proxy contest.

When the fiduciary is not an employee of the plan sponsor—that is, he or she is external to the company—experts explained that a variety of different types of conflicts might also arise because of business associations. For example, when the proxy voter is an investment manager that is part of a larger corporation that provides a variety of services, experts said that business relationships between the company's other branches and the plan sponsor might influence the investment manager's voting decisions. These relationships may influence the proxy voter to vote with the plan sponsor's management, particularly if the proxy voter wishes to maintain business relationships with the plan sponsor or create an opportunity for future business relationships. For instance, some experts we interviewed contend that DeAM division—the proxy voter in this case—was influenced by a business relationship between DeIB division and their mutual client, HP. SEC records reveal that DeAM reversed its vote to vote in favor of HP's merger after the investment banking division set up a meeting between the proxy voter and HP management. SEC found that, unbeknownst to DeAM's advisory clients, DeIB was working for HP on the merger and had intervened in DeAM's proxy process on behalf of HP. This created a material conflict of interest for DeAM, which has a fiduciary duty to act solely in the interests of its advisory clients. The SEC action found that DeAM violated this duty by voting the proxies on the HP stock owned by its advisory clients without first disclosing the conflict.[14]

While some experts we interviewed said that they believe most plan fiduciaries vote solely in the interest of participants and beneficiaries, others said that some fiduciaries might prioritize other interests when casting their votes. For example, a few experts said that fiduciaries are taking their proxy voting responsibility seriously and voting appropriately. Other experts we interviewed said that the proxy voting decisions of some external asset managers are often influenced by short-term quarterly returns on assets rather than on voting patterns that support long-term goals that benefit shareholders and participants. Some experts we interviewed also said that some external asset managers believe that they are retained and compensated because of superior investment performance and not because of how they vote proxies. Last, some experts said that there are only downsides to devoting resources to proxy voting.

Limited Disclosure May Make Proxy Voting Vulnerable to Conflicts of Interest

Experts we interviewed said that the limited disclosure might create inappropriate incentives and result in inadequate accountability, which may make proxy voting especially vulnerable to conflicts of interest. Proxy votes, in some cases, may not be monitored by the plan fiduciary and are not routinely disclosed to the public, two actions that could help ensure that fiduciaries cast votes solely in the interest of pension participants.

Limited disclosure and lack of adequate monitoring of proxy voting practices by plans hinders accountability for how votes are cast. Consistent with current DOL requirements, votes are disclosed to the appropriate plan fiduciaries.[15] Fiduciaries are not required to publicly disclose proxy voting guidelines and votes, though the plan would be

[14]SEC found that DeAM violated Section 206(a) of the Investment Advisers Act of 1940 by failing to disclose to its clients any material fact about a potential or actual conflict of interest that may affect its unbiased service to its clients.

[15]According to the January 1990 interpretive letter to the Institutional Shareholder Services Inc., DOL advised that the named fiduciary must be able to comprehensively monitor proxy voting activities of the investment (or asset) manager so as to make an informed determination as to whether the investment manager has met its fiduciary obligations. Thus, the named fiduciary must have access to, and the investment manager must maintain accurate records of, the investment manager's voting procedure and actions taken in specific cases.

required to make any written proxy voting guidelines available to participants upon request.[16] Hence, only plans have easy access to the information that allows them to monitor how proxy voters are voting. However, not all plans have the resources to devote to such monitoring; therefore, the attention given to the proxy voting responsibility can vary greatly by plan. Some large plans devote a significant amount of expertise and resources to proxy voting while other plans may not. Furthermore, a few experts said that in many cases where the proxy voting responsibility is delegated externally, the plan provides limited to no review of how the proxies were voted.

Experts we interviewed said that limited disclosure might provide incentives for fiduciaries to cast their votes according to their own interests. These experts also said that publicly disclosing proxy votes could help discourage voting that is inconsistent with participants' interests. For example, a few experts believed that the economic incentives for fiduciaries to vote with management could be significant enough, and the potential for penalties as a fiduciary weak enough, to make voting with management hard to resist.[17] Several experts explained that since breaches of fiduciary duty are very difficult to uncover, limited transparency prevents participants and others from raising questions regarding whether votes were made solely in the interest of participants. They also contend that increased transparency provided by public disclosure may provide participants, regulators, and others with more comprehensive information needed to hold fiduciaries and corporations accountable for their actions. In this regard, SEC concluded that shedding light on mutual fund proxy voting could illuminate potential conflicts of interest and discourage voting that is inconsistent with fund shareholders' best interests.

SEC's new disclosure rules for mutual funds and investment advisers may provide a limited benefit to some pension plan participants, while the new rule for investment advisers may also benefit pension plans whose proxies are voted externally. In 2003, SEC issued a final rule requiring mutual

[16]See DOL Interpretive Bulletin 94-2 and a March 20, 1997 interpretive letter to Kirkland & Ellis with respect to the scope of the disclosure requirements of Section 104(b)(4).

[17]Voting with management is not necessarily against the interests of participants and beneficiaries. In some cases, voting in favor of a management proposal would benefit participants. As with any proxy decision, the vote should be based on analysis and should be made solely in the interest of participants.

funds to publicly disclose their proxy votes on an annual basis and to adopt and disclose proxy voting policies and procedures to shareholders. However, this rule may provide some benefit for pension plan participants in defined contribution plans. Specifically, pension plan participants who invest their defined contribution dollars in mutual funds might find proxy voting results cast by investment managers of their funds on the web site of the mutual fund provider. On the other hand, defined benefit plan participants may receive little benefit from this rule if defined benefit plans invest few assets in mutual funds.[18] Furthermore, SEC's new disclosure rule for investment advisers requires investment advisers to inform their clients how they can obtain information on how the clients' securities were voted. However, this rule may provide little benefit to plan participants in defined contribution and defined benefit plans since this ruling requires disclosure to the plan as the client and not to plan participants.

SEC's new disclosure rule for investment advisers may also provide protections beyond those provided by ERISA for private pension plans whose proxies are voted externally. SEC's new disclosure rule for investment advisers may provide requirements that are either not specifically stated or covered in DOL interpretations of ERISA. For example, SEC requires, in part, that investment advisers[19] exercising proxy voting authority over client securities adopt and implement proxy voting policies and procedures for voting clients' proxies.[20] ERISA, on the other hand, does not require fiduciaries to maintain statements of investment policy, which includes statements of proxy voting policy. Also, SEC requires that voting policies and procedures must describe how the adviser addresses material conflicts between its interests and those of its

[18]Under defined benefit plans, the employer, as the plan sponsor, bears the investment risk as well as those risks associated with voting proxies.

[19]This rule applies to all investment advisers registered with SEC that exercise proxy voting authority over client securities.

[20]This new rule also requires that the written policies and procedures for voting client proxies must be reasonably designed to ensure that the adviser votes client securities in the best interests of the clients, to disclose to clients how they may obtain information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies. The rule amendments also require advisers to maintain certain records relating to proxy voting. The rule and rule amendments are designed to ensure that advisers vote proxies in the best interest of their clients and provide clients with information about how their proxies are voted. This new rule also requires investment advisers to furnish a copy of written policies and procedures to clients upon request.

clients with respect to proxy voting, while ERISA does not. SEC's investment adviser rule may provide no benefit to plans that retain voting responsibility because it covers only investment advisers that exercise proxy voting authority over client securities.

Certain changes in the retirement savings environment are making the need for enhanced transparency more important. For example, the shift from defined benefit plans to defined contribution plans increases the need for disclosure to plan participants.[21] Because under a defined contribution plan participants bear the investment risk, as with shareholders, participants need information to be more active in protecting their retirement assets. SEC reported that the proposal generated significant comment and public interest. Of the approximately 8,000 comment letters, the overwhelming majority supported the proposals and urged SEC to adopt the proposed amendments. Many commenters, including individual investors, fund groups that currently provide proxy-voting information to their shareholders, labor unions, and pension and retirement plan trustees, supported the proposals.[22] Furthermore, one expert said that pension plans should be required to disclose votes and guidelines to participants because participants cannot switch plans the way shareholders can switch their money from one investment company to another. This expert further said that having policies such as these in place makes ERISA stronger especially given the impact that having their money tied up in a retirement portfolio could potentially have on a participant's retirement assets. Additionally, the expert said that the differences between disclosures provided to shareholders and pension plan participants should be eliminated.

[21]DOL statistics show that the number of single employer and multiemployer defined benefit plans are on the decline, while the number of defined contribution plans being adopted is on the rise. The decline in defined benefit plans is attributed to the fact that fewer plans are being adopted, some employers are replacing defined benefit plans with defined contribution plans, and some defined benefit plans have been terminated.

[22]Many fund industry members supported the proposed amendments regarding the disclosure of policies and procedures. However, most fund industry members opposed the proposed amendments that would require disclosure of a fund's complete proxy voting record and disclosure of votes that are inconsistent with fund policies and procedures.

Some Plan Fiduciaries Have Taken Actions to Manage Conflicts

To manage conflicts, some plan fiduciaries have taken special actions, some of which are similar to SEC requirements for mutual funds. One such action is the maintenance by fiduciaries of detailed proxy voting guidelines that give proxy voters clear direction, reducing ambiguity and vulnerabilities related to conflicts that may influence the voter. Additionally, some fiduciaries include in their guidelines information on what the plan does when a conflict of interest exists on a proxy vote; they also publicly disclose their guidelines. Some plans also disclose a record of all their votes cast to participants and the public. Some pension plans also put additional procedures and structural protections in place to help manage conflicts.

Some Fiduciaries Have Developed Detailed Proxy-Voting Guidelines to Manage Conflicts

To help manage conflicts, some fiduciaries use detailed proxy voting guidelines that they make public. However, such guidelines are not required by ERISA, nor does DOL give guidance to fiduciaries as to the level of detail and specificity that guidelines should contain. Hence, some plan guidelines vary widely in their level of detail and specificity and some provide only minimal guidance. For example, some plan officials we interviewed said that their guidelines instruct proxy voters to always vote in the best economic interest of participants, while other experts said that some guidelines only instruct proxy voters to vote with management but offer no guidance beyond this broad statement. Other plans, on the other hand, create detailed, up-to-date guidelines. Some plans that we reviewed, for example, maintain guideline documents that direct proxy voters which way to vote, or factors to consider in deciding which way to vote, on a wide range of routine and non-routine proxy issues. The issues include, but are not limited to, board of director elections, auditor selections, executive compensation, reincorporation, capital issues (such as stock issuance), environmental and social concerns, and mergers and acquisitions. In addition, some plans, according to plan officials we spoke with, review their guidelines on a regular basis, and update them if needed. This allows the guidelines to reflect new issues in corporate governance. For example, in 2002, one plan updated its guidelines twice to reflect new corporate governance issues arising from the Sarbanes-Oxley Act.[23]

Detailed guidelines reduce ambiguity in the proxy voting process by providing direction to help fiduciaries determine how to vote. For

[23]The Sarbanes-Oxley Act was passed in 2002 and contained a number of corporate governance and accounting provisions in response to recent corporate scandals.

example, detailed guidelines may instruct a voter how to analyze an executive compensation vote based on a number of factors, so that the vote is made in what the fiduciary believes is solely in the interest of participants. As a result, proxy voters have clear direction on how to vote on a specific voting issue. For example, one plan official said that because their guidelines are clear, there is no confusion about how to vote on any proxy issue. Furthermore, a plan fiduciary or proxy voter may use detailed guidelines to defend against complaints about votes by demonstrating that a given vote was based on their guidelines and was not influenced by a conflict of interest.

Some guidelines include what steps a proxy voter should take to prevent a fiduciary breach and ensure that the vote is made solely in the interest of participants when a conflict of interest exists. Similar to the recent SEC rule requiring mutual funds and investment advisers to disclose "the procedures that a mutual fund company/complex and investment advisers use when a vote presents a conflict...." some pension plan fiduciaries include such a discussion in their guidelines. For example, the guidelines of one plan fiduciary we examined indicate that, in the case of a conflict of interest, the issue is to be reported to the president and general counsel of the plan sponsor who decide how to proceed and ensure that a record of the conflict and the related vote is maintained. In addition, some fiduciaries provide further detail about what constitutes a conflict of interest. For example, one plan's guidelines define a conflict of interest as being "a situation where the Proxy Analyst or Proxy Committee member, if voting the proxy, has knowledge of a situation where either" the plan fiduciary "or one of its affiliates would enjoy a substantial or significant benefit from casting its vote in a particular way."

In addition to developing detailed guidelines, some plan fiduciaries voluntarily make their guidelines/policies and procedures available to the public, as SEC has required mutual funds to do. Some public pension plans disclose their guidelines on their Web sites, making them available not only for participants and beneficiaries but also the general public. The officials of some private plans indicated to us that they would probably produce a copy of their guidelines if explicitly requested by a participant, though they admitted that such a request is rarely, if ever, made. SEC addressed the issue of disclosure, when, in 2003, it began to require mutual funds to disclose their voting policies and procedures in their registration statement. Mutual fund policies and procedures are required to be available at no charge to shareholders upon request. Also, mutual funds must inform shareholders that the policies and procedures and votes are available through SEC's Web site, and, if applicable, on the fund's Web site. SEC made the case for guideline disclosure by stating that, "shareholders have a right to know the policies and procedures that are being used by a fund to vote proxies on their behalf." Many fund industry members publicly supported SEC's disclosure rule through comment letters sent to SEC after the rule proposal was released. Officials for one mutual fund company, for example, supported guideline disclosure because the transparency resulting from disclosure would encourage mutual funds to make better proxy voting decisions, which in turn could enhance fund performance. Also, they believed that guideline disclosure would deter casting proxy votes that are not in the best interest of shareholders.

Some Fiduciaries Disclose Proxy Votes, Providing Greater Incentive to Vote Appropriately

Some plan fiduciaries also publicly disclose their proxy votes in an attempt to manage conflicts of interest. We met with officials of some public pension plans that disclose proxy votes on their Web sites, making them available not only to participants and beneficiaries, but also to the public.[24] While some public plans disclose only the votes of a few hundred different equities, other plans disclose all their votes. These funds present a list of companies and how relevant proxies for that company have been voted during a specified timeframe. In addition, one plan sometimes includes a note that briefly explains the rationale for their vote (e.g., why they withheld their vote for a certain director). Two plans, whose officials we met with, also disclose the number of shares that were voted on each proxy.

In April 2003, a SEC rule went into effect requiring mutual funds to disclose, on an annual basis, a record of all proxy votes cast during the previous year. Mutual fund votes are required to be available on the fund's Web site or provided at no charge to shareholders upon request. Also, mutual funds must inform shareholders that the votes are available through SEC's Web site. SEC, in its rule release on mutual fund proxy vote

[24] A public pension plan is a pension, annuity, retirement, or similar fund or system maintained by a state or local government that provides a retirement benefit to the state or local government employee. Some of the largest pension plans in the United States such as the California Public Employees Retirement System and the New York City Employees Retirement System are public pension plans. These public plans are not governed by ERISA.

disclosure, stated that the overall costs of disclosure are reasonable.[25] The experience of the plans we examined that disclose their votes indicates that their costs are not substantial and not a serious burden because proxy voting is done electronically, and voting records are required to be maintained.

Some experts we interviewed argue that proxy vote disclosure can benefit participants by giving them information on how the plan votes proxies and providing an incentive to the plan fiduciary or proxy voter to vote appropriately. Disclosure would allow plan participants to review votes and raise questions as to whether votes were made appropriately. The knowledge that participants and beneficiaries might complain to the plan and to others if they believe a breach of its fiduciary duty has taken place may encourage fiduciaries to vote appropriately to avoid such problems. Some experts said that participants would be overwhelmed by the information and would not understand what to do with it. In addition, a few experts have said that it is possible that, while participants might not have the time or the knowledge to analyze proxy votes, an investigative journalist might look at votes of a certain pension plan and publicly discuss any possible breaches they have uncovered or notify the appropriate authorities if any breaches are found or are suspected.

Proxy voting disclosure may also influence the voting behavior of fiduciaries, as seen in the example of one large mutual fund. As reported in the news, one large mutual fund voted in favor of the full slate of directors nominated to serve on the board of directors on 29 percent of proxy contests in which they voted in 2003, while in 2002 the fund had voted in favor of the full slate in 90 percent of the contests.[26] And while the fund had voted for 100 percent of auditor approvals in 2002, in 2003 it had voted for only 79 percent. Experts we interviewed said that SEC's disclosure rules might have contributed to that change in behavior. Nine of 12 respondents to our written interview support proxy vote disclosure by

[25]Opponents to vote disclosure argued against the rules largely by arguing that disclosure would be prohibitively costly. However, in its final rule, SEC noted that several fund groups that currently provide disclosure of their complete proxy voting records to their shareholders commented that although there are start-up costs for compliance systems, this cost decreases over time, and that the overall costs of the disclosure are minimal. SEC found arguments made by funds that are providing this disclosure to be particularly persuasive and continue to believe that the costs of disclosure are reasonable.

[26]Ken Brown, "Vanguard Gives Corporate Chiefs A Report Card," *Wall Street Journal*, November 10, 2003. pg. C.1.

pension plan fiduciaries and many experts we spoke with also support proxy vote disclosure by plans. Very few respondents and experts we interviewed believed that disclosure of votes would not benefit pension plan participants. Specifically, they cited as reasons that: (1) the costs of disclosure outweigh any benefits to participants; (2) there is the potential for politicizing proxy voting; (3) disclosure may serve as a detriment to the investment manager's investment strategy; and (4) participants lack interest in proxy voting.

Some Fiduciaries Have Voluntarily Taken Additional Steps to Manage Conflicts of Interest

Some plan fiduciaries have voluntarily taken additional steps to help manage conflicts of interest that may lead to breaches of fiduciary duty, including implementing structural protections and special proxy voting procedures. For example, a few plans we reviewed structure their organization to separate those who cast votes from executives who make policy decisions about the plan. Some plans delegate the responsibility for proxy voting in a way that protects against fiduciary breaches. One public plan, for example, had external asset managers cast proxy votes, but decided to bring the proxy voting process in house to avoid having the plan's proxies voted on both sides of an issue. By doing all voting internally, plan fiduciaries can provide better safeguards ensuring that votes are cast solely in the interest of participants and provide consistency to how votes were cast.

In order to address concerns about conflicts of interests related to employer stock in pension plans, a few pension plan officials we interviewed said that their company stock is managed and proxies are voted by an independent fiduciary outside of the company. In other cases, some fiduciaries use independent proxy-voting firms for research and analysis or to cast proxy votes on their behalf. For example, officials from one plan that we met with told us that they use an outside proxy-voting firm to make the vote decision when a conflict exists. One asset manager, for example, did so during a contentious merger in which their Chief Executive Officer was a director of the acquiring company. Some fiduciaries we met with have an outside proxy-voter execute proxy votes based on their plan's own guidelines. Other fiduciaries simply use outside proxy-voter firms to provide analysis and research, which the fiduciary may then use to help determine how to vote.

Outside proxy voting firms are not without their own conflicts of interest, however. Some proxy-voting firms have expanded to other services. One firm, for example, provides a service to corporations in helping design proxies to improve the chances that proxy issues will succeed. A conflict of interest would exist when the proxy-voting firm has to vote on a proxy that it helped create or when it must vote a proxy for the same company from which it received revenue for some other service.

In addition to the structural protections some fiduciaries have put into place, some fiduciaries have implemented special procedures that are used when a conflict exists. For example, according to officials at one company we interviewed, if a proxy vote is to be cast not in accordance with the plan's guidelines, then the vote is decided by the plan's proxy committee, which is also required to note why the vote was inconsistent with plan guidelines. At other plans we reviewed, in the event that an attempt is made to influence a proxy vote, the plan's executive committee makes the vote decision. Additionally, officials from one private plan said that when a material conflict of interest exists an independent third-party proxy voter is given the responsibility to determine how to vote, based on the plan's guidelines. Furthermore, this plan has a "Material Conflict of Interest Form" which is filled out and signed by the voting analyst and a member of the plan sponsor's proxy committee. This form includes information on the stock being voted, the issue being voted on, what the plan's proxy voting guidelines indicate about that issue, details on the conflict of interest, and certification from the third-party proxy voter on how the vote was cast. In addition, at another plan, when a material conflict of interest exists during a proxy vote, the vote is reported to the president and general counsel of the plan sponsor. They decide how to address the situation, such as getting an outside vote recommendation or disclosing the existence of the conflict. A record of meeting notes and issues surrounding conflicts are maintained by the plan in case any questions arise.

The Department of Labor's Related Enforcement Efforts Have Been Limited

The Department of Labor's enforcement of proxy voting requirements has been limited for several reasons. First, participant complaints about voting conflicts are infrequent, at least in part, because votes cast by a fiduciary or proxy voter generally are not disclosed; therefore, participants and others are not likely to raise questions regarding whether a vote may not have been cast solely in their interest. In addition, for the department, ERISA presents legal challenges for bringing proxy voting cases.[27] Specifically, because of the subjective nature of fiduciary votes, it is difficult to obtain evidence that would prove the plan fiduciary was influenced by something other than the interests of participants. Furthermore, even if such evidence could be obtained, monetary damages are difficult to value and, because the department has no statutory authority to impose a penalty without assessing damages, fiduciary penalties are difficult to impose. In part, because of these challenges, but also because of its limited resources, DOL's reviews of proxy voting in recent years have been limited. As a result, some experts we interviewed do not view the department as a strong enforcement agent.

Identifying and Proving Breaches in the Proxy Voting System Is Difficult

Challenges exist in the proxy voting system that limit DOL's ability to identify breaches and to prove that a fiduciary was influenced to act contrary to the interests of plan participants. In March 2002, we reported that DOL enforces ERISA primarily through targeted investigations. DOL determines what issues it will investigate using a multifaceted enforcement strategy, which ranges from responding to participant and others' concerns to developing large-scale projects involving a specific industry, plan type, or type of violation.[28] DOL also uses the Annual Returns/Reports of Employee Benefit Plans (Form 5500 Returns) to

[27] DOL noted, however, that it filed amicus briefs in three proxy voting cases. In *O'Neill v. Davis*, 721 F.Supp. 1013, 1015 (N.D.Ill. 1989), a DOL amicus brief was instrumental in obtaining a holding that "the voting of Plan-owned shares by the Plan's trustees was a fiduciary act under ERISA, and one which the trustees were bound to exercise in the sole interest of the Plan participants." DOL also filed two amicus briefs in *Grindstaff v. Green*, 133 F.3d 416 (6th Cir. 1998), where, over a strong dissent, the court rejected DOL's views on the extent to which ERISA's fiduciary duties attach to plan fiduciaries' voting of plan shares. DOL officials said that they also filed a brief on the voting of plan shares and exercise of other shareholder rights on plans' behalf in district court in *Krause v. Columbia Quarry Co.*, 4:98 CV 01373 ERW (E.D. Mo.), although that case wound up being decided on other grounds.

[28] Throughout this report, references to DOL's regular investigations refer to those investigations that are not specifically aimed at detailed reviews of proxy voting practices.

identify potential issues for investigation.[29] In addition, its regional outreach activities, while aimed primarily at educating both plan participants and sponsors, are used to gain participants' help in identifying potential violations.

Although DOL's strategy includes a number of ways to target investigations, DOL officials consider information provided by plan participants and beneficiaries an integral starting point to developing many of its investigations. For instance, through information provided in summary annual reports (SARs), summary plan descriptions (SPDs), individual benefit statements, and other related reports, participants have access to financial and operational information regarding their pension plan and their accrued benefits. The information provided in these reports can help participants and beneficiaries monitor their plans and identify some warning signs that might alert them that possibly there is a problem warranting DOL's attention.

While participant complaints might be useful in targeting some DOL investigations, relying on participant complaints may not currently be the most effective way to identify potential proxy voting cases. Because of the current limited level of disclosure, DOL receives few complaints related to proxy voting. For instance, as previously mentioned, the SARs and other related reports provide plan financial and operational information; however, they do not contain proxy voting information such as voting guidelines and a record of how votes were cast. In addition, DOL officials told us that proxy votes and guidelines are disclosed to the plan and guidelines must be made available to participants and beneficiaries when requested. However, one expert explained that participants generally do not know to ask for this information. As such, they are not likely to raise questions about whether or not a vote was cast solely in their interest. Likewise, because proxy votes are not publicly disclosed, complaints to DOL from those outside of plan participants and beneficiaries are less likely to occur.

In addition to difficulties identifying potential breaches in the proxy voting system, difficulties proving under ERISA that a fiduciary was influenced to act contrary to the interests of plan participants are also a challenge for DOL. Because a plan fiduciary's vote requires judgment, determining what

[29] The Form 5500 Returns are forms that most qualified retirement plans must file annually with the Internal Revenue Service.

influenced his or her vote can be difficult. If a plan fiduciary can provide his or her rationale for voting a certain way—proving that, in his or her opinion, proxies were voted solely in the interest of plan participants—it is very difficult for DOL or others to prove otherwise. Proving a fiduciary breach requires evidence that the plan fiduciary was influenced in the voting by something other than the interests of plan participants. Certain information—such as existing conflicts of interest between the plan fiduciary and some other influential party, the plan fiduciary's own self-interest, or the potential impact of certain votes, for instance—are important when trying to establish that such influence was acted upon. Absent this or similar information, leaks by informed parties—whistleblowers—are likely to be the only way one might prove a breach actually occurred.

Monetary Damages Are Difficult to Value and Penalties Are Difficult to Impose

Another challenge that DOL faces is that monetary damages are difficult to value and, therefore, penalties and other sanctions are difficult to impose. According to DOL, it is difficult to link a single proxy vote to damages to the plan participants. This is often the case because there are many economic variables that have an impact on share value. That is, underlying economic factors such as fiscal policy, monetary policy, unemployment, the threat of inflation, the global economy, and currency valuations are all major determinants of share value. Therefore, it is difficult to isolate the effect a single proxy vote may have had. Also, because of the potential for a vote to have a long-term rather than a short-term effect on share value, damages may not be immediately evident.

In addition, while the research community and others have differing opinions about whether proxy votes have economic value, where it is believed that these votes do have a value, the determination of this value can be complicated. For example, in response to our written interview, most experts who responded to this question indicated that valuing proxy votes is a complex task, its difficulty dependent upon variables such as the issue being voted on and an entities' governance structure. One respondent said that a case could possibly be made if a decline in the value of a company could be tied to the specific point in time when the plan fiduciary voted for a self-serving measure. However, the fiduciary's vote would have to be significant enough to affect the outcome of the proxy contest. Using the Hewlett-Packard situation as an example, the respondent added that one cannot know what the value of Hewlett-Packard shares would have been if the merger had not gone through and thus one cannot calculate the difference between that value and the current value of the merged Hewlett-Packard/Compaq shares.

Additionally, others commented that, in the end, DeAM's vote might not have affected the outcome of the proxy contest.

With respect to penalties, unlike SEC, which has the authority to impose a penalty without first assessing and then securing monetary damages, DOL does not have such statutory authority and, as such, must assess penalties based on damages or, more specifically, the restoration of plan assets.[30] Under Section 502(l), ERISA provides for a mandatory penalty (1) against a fiduciary who breaches a fiduciary duty under, or commits a violation of, Part 4 of Title I of ERISA or (2) against any other person who knowingly participates in such a breach or violation. This penalty is equal to 20 percent of the "applicable recovery amount," or any settlement agreed upon by the Secretary or ordered by a court to be paid in a judicial proceeding instituted by the Secretary. However, the applicable recovery amount cannot be determined if damages have not been valued. As we reported in 1994, this penalty can be assessed only against fiduciaries or knowing participants in a breach who, by court order or settlement agreement, restore plan assets.[31] Therefore, if (1) there is no settlement agreement or court order or (2) someone other than a fiduciary or knowing participant returns plan assets, the penalty may not be assessed. Because DOL has never found a violation that resulted in monetary damages, it has never assessed a penalty or removed a fiduciary as a result of a proxy voting investigation.

As a Result of Challenges, DOL Has Devoted Few Resources to Proxy Voting Issues

As a result of challenges in the proxy voting system, DOL has devoted few resources to proxy voting over the last several years. Between 1988 and 1996, DOL conducted three enforcement studies to determine the level of compliance with proxy voting requirements among select fiduciaries (see table 1). The first of these projects was initiated in May 1988,[32] when the department looked at the management of plan votes from a broad range of investment managers, with a particular focus on certain contested issues considered at annual shareholders' meetings in that year. Then in 1991,

[30]DOL can also seek removal of a fiduciary for breaches of fiduciary duty or seek other sanctions.

[31]See U.S. General Accounting Office, *Pension Plans: Stronger Labor ERISA Enforcement Should Better Protect Plan Participants*, GAO/HEHS-94-157 (Washington, D.C.: August 8, 1994).

[32]Current U.S. Comptroller General David M. Walker was the Assistant Secretary of Labor for the PWBA from 1987 to 1989. The report was issued in March 1989.

DOL started its second project to determine how banks were fulfilling their responsibilities with respect to proxy voting practice. DOL looked at proxy voting procedures at 75 banks, covering the application of procedures during the 1989 or 1990 proxy season. Finally, during its last project, the department once again reviewed the practices of investment managers—12 in total—alongside 44 pension plans, with respect to corporate governance issues. It reviewed certain proxy votes at five annual shareholders' meetings held in 1994 and general proxy voting polices and practices. According to DOL, overall the enforcement studies found that there were improvements in proxy voting practices as virtually all plans and investment managers in the studies voted their proxies. The enforcement studies also found that additional improvement is needed in the plans' monitoring of investment managers to ensure that proxies are voted in accordance with stated policies. Furthermore, they found that although investment managers appear to have the records to enable clients to review managers' decisions on proxy voting, few plan clients actually review the reports that are automatically provided to them. In the situations in which reports are available upon request, few plans request a copy. Given these findings, the department has not conducted similar reviews in recent years to determine current levels of compliance. DOL officials told us that they believe that proxy voters are generally in compliance, that they receive few complaints in this area, and that they focus most of their limited resources on other priority areas, which may result in identifying violations that can be corrected.

Table 1: Summary of the Department of Labor's Proxy Projects

Years	Project	Scope	Summary of findings
1988 -1989	No. 1	General fiduciary compliance review of investment managers (IMs) with control over employee benefit plan assets subject to ERISA. Focused on certain contested issues considered at annual shareholders' meetings in 1988.	Not all investment managers who voted on behalf of employee benefit plans were delegated the authority to vote proxies. Instead, many managers assumed the duty of voting as part of their overall responsibilities. Not all managers had internal decision making procedures or written proxy voting guidelines in place when they voted proxies, and those that did often had a policy to simply vote with management. Managers often lacked accurate recordkeeping with regard to whether proxies had been received and voted.
1991 - 1992[a]	No. 2	Review of 75 banks' proxy voting practices (covering the application of procedures during the 1989 or 1990 proxy season only).	Many banks lacked a policy that addressed the maintenance and retention of proxy voting records or related materials'. Several banks had policies to abstain from voting or not vote on certain issues. Many banks followed the "Wall Street Rule," giving the proxy to management of the company or selling the shares of stock.
1994 - 1996	No. 3	Review of practices of 12 IMs and 44 pension plans with respect to corporate governance issues covered by Interpretive Bulletin 94-2. Focused on certain proxy votes at five annual shareholders' meetings held in 1994 and the general polices and practices with respect to proxy voting.	Most plans delegated the authority to vote proxies to an IMs via written agreement. Most IMs received written proxy voting policies from their clients, but on an irregularly basis. Fourteen of 44 plans reviewed submitted proxy voting guidelines to their IMs; over half had no proxy guidelines; and 7 retained the authority to vote proxies. The content of the guidelines were mixed—some general, some quite detailed. All IMs tracked proxy-related items and kept written documentation justifying votes cast; most had written procedures to report votes to clients, but few did so automatically. Most plans did not monitor proxy voting by their IMs, about 35 percent appeared to have performed substantive monitoring of IMs.

Source: DOL Proxy Project Report, March 2, 1989; Speech by David George Ball, Assistant Secretary, Pension and Welfare Benefits Administration, February 17, 1992; Proxy Project Report, February 23, 1996.

[a]Results of the second proxy project were not released in a formal report.

DOL officials said that they typically do not conduct specific investigations focused on proxy voting, and they allocate few resources to this issue. They, instead, focus its limited resources according to their Strategic Enforcement Plan.[33] However, proxy voting practices may be examined

[33]The primary purpose of the Strategic Enforcement Plan is to establish a general framework through which EBSA's enforcement resources may be efficiently and effectively focused to achieve the agency's policy and operational objectives.

during their investigations of investment managers. DOL said that its investment management investigative guide has steps for reviewing proxy voting, but the investigators have discretion whether to review proxy voting practices. According to DOL officials, investigators receive training on the general fiduciary obligations of named fiduciaries and investment managers with respect to the voting of proxies on plan-owned stock. When asked how often these reviews included the examination of proxy voting, DOL officials responded that this information is not tracked.

Some plan fiduciaries and industry experts that we interviewed have indicated that DOL lacks visibility as an enforcement agent in this area. For example, some experts said that DOL's examination of proxy voting practices does not seem to occur routinely and that it is not clear what enforcement action DOL has taken in recent years related to proxy voting. Additionally, others have described an environment that provides little incentive to do what is best for participants, indicating that fiduciaries have no expectation that DOL will take action should they breach their proxy voting responsibilities. One DOL official said that the department has made its position on proxy voting known and issued clear guidance on what is required of fiduciaries. Also, given its limited statutory authority and resources, the department has a strategic enforcement plan, and based on this plan, they place their limited resources in areas that will result in identifying violations that can be corrected.[34]

Conclusions

The retirement security of pension plan participants is dependent on decisions made each day in the market place by pension plan fiduciaries. DOL guidance requires fiduciaries to cast proxy votes solely in the interest of plan participants and beneficiaries. While ERISA requires that voting guidelines be made available to participants upon request, ERISA does not require disclosure of proxy votes to participants and the public. Increased transparency of both proxy guidelines and votes could provide participants and others with information needed to monitor actions that affect retirement assets. Nor does ERISA require, as current SEC

[34]For example, in the area of tender offers, the Polaroid ESOP (or NationsBank) case was a major enforcement action brought by DOL in a case where DOL was able to show losses to the plan for fiduciary breach involving a failure properly to exercise shareholder rights (in that case, a failure to tender shares). See *Harman v. NationsBank Trust Co.* (Georgia) N.A., 126 F.3d 1354 (11th Cir. 1997), *reh'g denied*, 135 F.3d 1409 (11th Cir.), *cert. denied*, 525 U.S. 816 (1998). Another enforcement action involving fiduciaries' misuse of shareholder powers was *Martin v. Feilen*, 965 F.2d 660 (8th Cir. 1992), *cert. denied*, 506 U.S.1054 (1993) (involving, in part, failure of plan fiduciaries to bring a shareholder derivative action).

regulations do for mutual fund investment companies and investment advisers, that plans include in their guidelines language regarding what actions fiduciaries will take to respond to conflicts of interest. However, some plan fiduciaries have taken actions to manage conflicts of interest, including maintaining proxy voting guidelines and disclosing votes. Likewise, a few plan sponsors have hired independent fiduciaries to manage company stock in their pension plans.

DOL's role in enforcing ERISA's fiduciary provisions, including proxy voting requirements, is essential to ensuring that plan fiduciaries are voting solely in the interest of plan participants and beneficiaries. Yet, DOL has faced a number of enforcement challenges, including legal requirements restricting its ability to assess penalties under ERISA. Furthermore, DOL officials said that the agency does not have the statutory authority to require plan fiduciaries to periodically and publicly disclose proxy votes and guidelines. SEC, because of its role in protecting all investors, including those in participant-directed retirement savings plans, has taken steps to increase transparency in the mutual fund industry. DOL's inability to take similar steps with respect to pension plan fiduciaries may provide inappropriate incentives for fiduciaries not to act solely in the interest of plan participants when voting proxies. Furthermore, given both DOL and SEC goals to protect plan participants as investors, coordination of their efforts to achieve this goal is important.

Matters for Congressional Consideration

If the Congress wishes to better protect the interest of plan participants and increase the transparency of proxy voting practices by plan fiduciaries, it should amend ERISA to require that plan fiduciaries

- develop and maintain written proxy-voting guidelines;
- include language in voting guidelines on what actions the fiduciaries will take in the event of a conflict of interest; and
- given SEC's proxy vote disclosure requirements for mutual funds, annually disclose votes as well as voting guidelines to plan participants, beneficiaries, and possibly also to the public. From a practical perspective, this disclosure could apply to all votes, but at a minimum, it should include those votes that may affect the value of the shares in the plan's portfolio. Such disclosures could be made electronically on the applicable Website. Since many plans often use multiple fiduciaries for voting proxies, the plan also could provide participants and others directions on how voting records by the various fiduciaries could be

obtained. We believe that Congress should assure that participants have the right to request proxy voting records at least annually, consistent with their current right to request other plan documents.

Congress should also consider amending ERISA to give the Secretary of Labor the authority to assess monetary penalties against fiduciaries for failure to comply with applicable requirements.

Finally, Congress should consider amending ERISA to require that, at a minimum, an independent fiduciary be used when the fiduciary is required to cast a proxy vote on contested issues or make tender offer decisions in connection with company stock held in the company's own pension plan. In our view, this independent fiduciary requirement would not affect votes by a participant in an eligible individual account plan.

Recommendations for Executive Action

To improve oversight and enforcement of proxy voting, we recommend that the Secretary of Labor direct the Assistant Secretary of EBSA to increase the Department's visibility in this area by

- conducting another enforcement study and/or taking other appropriate action to more regularly assess the level of compliance by plan fiduciaries and external asset managers with proxy voting requirements. Such action should include examining votes, supporting analysis, and guidelines to determine whether fiduciaries are voting solely in the interest of participants and beneficiaries, and
- enhancing coordination of enforcement strategies in this area with SEC.

Agency Comments and Our Evaluation

We provided a draft of this report to DOL and SEC for their review and comment. DOL's comments are included in appendix II; SEC did not provide written comments. Both agencies provided technical comments, which we have incorporated as appropriate. In its response to our draft report, DOL generally disagreed with our matters for congressional consideration and recommendations, saying that conflicts of interest affecting pension plans are not unique to proxy voting and that requiring independent fiduciaries and increased disclosures would increase costs and discourage plan formation. DOL also said that the enforcement studies of proxy voting practices undertaken previously by the department provide an adequate measure of compliance in this area and, therefore, to undertake new such studies, with an expectation of finding no significant level of noncompliance, would be an inappropriate use of resources.

Our recommendations and matters for congressional consideration are predicated on two principles: additional transparency and enhanced enforcement presence. We believe that disclosing pension plans' proxy voting guidelines and votes makes it more likely that votes will be cast solely in the interest of plan participants, and that a visible enforcement presence by DOL helps to reinforce the public interest in this result. So although we agree with certain of DOL's points, we cannot agree that additional transparency and an enhanced enforcement presence would not be beneficial. Furthermore, because DOL believes that it does not have the authority to require proxy voting guidelines and disclosure of votes, and, in our view, it is important to shed more light on events such as proxy voting—particularly contested proxy votes—we believe Congress should consider amending ERISA to include such requirements.

We acknowledge that plan fiduciaries face conflicts beyond proxy voting and that conflicts associated with casting a proxy vote may be no greater than the potential for conflicts in making other fiduciary decisions. However, our work and, therefore, our recommendations are focused on issues related to proxy voting. Furthermore, we found that DOL's enforcement in this area has been limited, which may not be the case in its oversight of other fiduciary actions. For example, tender offer decisions made by fiduciaries may suffer from similar conflicts. DOL, however, has been able to develop investigative cases and secure positive results for plan participants and beneficiaries in connection with this area. However, DOL has not been similarly successful in developing proxy voting cases. Given that plan participants may be particularly vulnerable when internal fiduciaries vote employer stock held in the plan sponsor's s own pension plan, we believe it is an appropriate safeguard to require an independent fiduciary be appointed to vote these proxies. We are recommending independent fiduciaries for certain circumstances. Furthermore, in our view, this independent fiduciary requirement would not affect votes by a participant in an eligible individual account plan.

In disagreeing with our recommendation that Congress consider amending ERISA to require that an independent fiduciary be used to vote proxies for employer stock held in a plan sponsor's own pension plan, DOL said that the Congress already considered, but did not include, an independence requirement for plan fiduciaries when it passed ERISA in 1974. We acknowledge that Congress did not require independent fiduciaries when it originally enacted ERISA. However, the conflicts of interest associated with plan holdings of company stock have received increased public attention in the last several years, and we believe the Congress should reconsider ERISA's current legal requirements in connection with company stock.

In response to our recommendation that DOL conduct another enforcement study to determine the level of compliance with proxy voting requirements, DOL said that it has seen no evidence of a negative change in the level of compliance and that another proxy enforcement study would absorb a considerable amount of resources. Rather than conducting another proxy enforcement study, DOL said that it would evaluate proxy voting information during its investigations in the financial services area. As we discuss in our report, limited statutory authority and other challenges are obstacles to effective DOL enforcement in this area. Furthermore, we understand that DOL must balance efforts in this area with other enforcement priorities. The statutory changes we have suggested, if enacted, may help DOL's enforcement efforts in the future. Nonetheless, even with such changes, we believe that conducting reviews of proxy voting issues on a periodic basis is important to ensure compliance and increase DOL's presence and visibility in this area. We acknowledge that conducting another enforcement study is just one of various options available to DOL to accomplish these goals and have altered our recommendation to be explicit on this point. However, in our view, any review in this area should go beyond simply determining whether fiduciaries cast proxy votes, and should include assessing whether plans are monitoring proxy voting practices by external investment managers and evaluating whether fiduciaries voted solely in the interest of plan participants and beneficiaries.

Regarding our matter for congressional consideration that plan fiduciaries be required to disclose proxy voting guidelines and votes, at a minimum, to plan participants, DOL noted that appropriate plan fiduciaries are required to monitor proxy voting information and that proxy voting guidelines are available to participants upon request. DOL further said that requiring disclosure to the general public or even to all participants would significantly increase costs to plans. Recognizing that ERISA's disclosure requirements are focused on plan participants and beneficiaries, not the general public, we modified our matter for congressional consideration to state that proxy guidelines and votes should at a minimum be disclosed to participants and beneficiaries. Our report addressed concerns about the potential costs of disclosing proxy voting guidelines and votes by suggesting that such information could be made available electronically.

Unless you publicly announce its contents earlier, we plan no further distribution until 30 days after the date of this report. At that time, we will send copies of this report to the Secretary of Labor, the Chairman of the Securities and Exchange Commission, appropriate congressional committees, and other interested parties. We will also make copies available to others on request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact me at (202) 512-7215 or George Scott at (202) 512-5932. See appendix III for other contributors to this report.

Sincerely yours,

Barbara D. Bovbjerg
Director, Education, Workforce,
and Income Security Issues

Appendix I: Scope and Methodology

To determine what conflicts exist in the proxy voting system and the extent to which fiduciary breaches occur as a result of these conflicts, we interviewed officials at the Department of Labor's Employee Benefits and Security Administration (DOL) and at the Securities and Exchange Commission (SEC). Using a standard set of questions, we conducted interviews with proxy voting experts, academics, economists, and Employee Retirement Income Security Act (ERISA) attorneys. We also interviewed various proxy voting experts which include academics, ERISA lawyers, industry experts, pension plan sponsors, asset managers, proxy voting firm representatives, proxy soliciting companies, and plan practitioners. These experts were, in part, selected from news articles involving abuses in the mutual fund industry, from news reports regarding corporate scandals such as Enron, from reported highly contested proxy contests, from historical articles dated back to the proxy scandals in the 1980s and 1990s, and from recent reports in the news and SEC's Web site pertaining to SEC's proxy voting disclosure proposals. Experts were also selected based on published research on proxy voting, based on discussions with plan sponsors and industry experts, congressional testimony, and Congressional Research Service reports.

To determine what safeguards fiduciaries have put in place to protect against breaches, we interviewed a number of public and private pension plan sponsors, asset managers, proxy voting firm representatives, and other experts. These public and private pension plans were selected for their promising practices based on discussions with industry experts, from pension industry publications and other published reports of the corporate governance practices of these plans. To explore the practices of internally managed plans, we interviewed various proxy voting experts and interviewed officials of the plans listed in the Pensions and Investments with internally managed assets.

To determine DOL's enforcement of proxy voting requirements, we interviewed officials at EBSA and reviewed DOL enforcement material and previously issued GAO reports on DOL's enforcement program.

Obtaining Total Number of Employer Securities Held in the Company's Own Pension and Welfare Benefit Plans

To determine the extent to which private pension plans invested in their own employer securities, we obtained the total value of the employer stock in the company's pension and welfare benefit plans. To do so, we analyzed plan financial information filed annually (Form 5500s) with the Internal Revenue Service and EBSA. The Form 5500 report is required to be submitted annually by the administrator or sponsor for any employee benefit plan subject to ERISA as well as for certain employers maintaining a fringe benefit plan. The report contains various schedules with information on the financial condition and operation of the plan. The total value of employer shares information is provided on either schedule H or schedule I depending on the number of participants covered by the plan. EBSA provided us with a copy of the 2001 electronic Form 5500 database for our analysis.[1] We assessed the reliability of these data for our purposes by evaluating the electronic records selected for analysis for outliers, duplicate records, and otherwise inappropriate values. Form 5500 records that did not meet our review standards were eliminated from our analysis.

We decided to focus our analysis of companies with Form 5500 data to those corporations listed in the Fortune 500.[2] To do so, we matched each Fortune 500[3] company to their pension plans on the basis of their Employer Identification Numbers (EINs).[4]

We used several methods to identify EINs associated with each corporation. We started with a list of EINs for Fortune 500 companies that was purchased from Compustat (a database from Standard & Poors). To

[1]Plan year 2001 is the most recent year for which plan-specific Form 5500 data were available for our review.

[2]Fortune 500 companies are those representing the 500 largest corporations that are based in the United States, ranked in order of revenues. The Fortune 500 list is released annually in April. The rankings are based on reported revenues in corporate annual reports (10Ks) filed in the year leading up to January 31. Therefore, only public corporations and private corporations that voluntarily release a 10K are included. For example, the April 2004 Fortune 500 list is based on revenues reported between February 1, 2003, and January 31, 2004.

[3]Not all 500 companies were included in our analysis. For example, some companies on the Fortune 500 are privately owned and, therefore, don't have publicly traded stock. Furthermore, there are a handful of companies that were on the Fortune 500 in 2001 but have since gone bankrupt, or are no longer public. This often made it difficult to find the appropriate data for those companies and when that was the case, they were eliminated from the analysis.

[4]An EIN, known as a federal tax identification number, is a nine-digit number that the Internal Revenue Service assigns to organizations.

identify the EINs for the remaining companies, we searched the 10K annual filing statement for each relevant company. We then searched those companies whose Form 5500s reported that they held their own employer securities at the year's plan end year date.[5] This resulted in a database for filing year 2001 containing the information of 490 Form 5500 returns filed by 272 of the Fortune 500 companies.

Obtaining the Total Number of Shares Outstanding for Selected Fortune 500 Companies

To analyze the total voting power of those 272 Fortune 500 companies on our list for plan year 2001, we obtained the proxy statements filed with SEC as form 14-A DEF for those companies. Form 14-A DEF statements are the final annual proxy statements sent to all shareholders of a corporation that detail all the issues that are to be voted on. The statements also list the number of shares entitled to vote on the proxy issues and, where applicable, the number of votes per share (e.g., some companies might issue different classes of preferred stock which entitle the owner to more than one vote per share). For each company, we multiplied the number of shares outstanding for each class of share by the number of votes entitled to that class and added up those figures for all classes of shares to get a reflection of total number of shareholder votes. We used data from the 14-A DEF statements filed as soon after the end of calendar year 2001, which was typically in the spring of 2002.

Obtaining the Closing Price for Our Fortune 500 Companies

We also obtained share price data from the New York Stock Exchange's (NYSE) Trade and Quote (TAQ) database. We used that database to obtain the closing price (the price of the last transaction of the day) on the day indicated as the plan end of year date from the Form 5500 for each company. The TAQ database contains a listing of intraday transactions (including shares involved and the price) for all companies listed on the NYSE, the National Securities Dealers Stock Exchange (NASDAQ) and the American Stock Exchange (AMEX). To ensure the reliability of the TAQ price date, GAO economists previously conducted a random crosscheck of

[5] Additionally, we included the employer securities held by master trust investment accounts associated with Fortune 500 benefit plans. A "master trust" is a trust in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held. In such cases, a benefit plan reports the value of its interest in the master trust account and not any employer securities held by the master trust. Accordingly, we included employer securities reported by master trusts accounts held by Fortune 500 benefit plans.

the TAQ data with data provided by NADAQ, Yahoo! Finance, and other publicly available stock data sources.

Computing the Number of Voting Shares Held in Fortune 500 Company Pension and Welfare Benefit Plans

From the 5500 data, we obtained the total value at yearend for company stock holdings by corporations in their pension and welfare benefit plans. From the TAQ database, we obtained the closing price of the stock on the plan yearend date. We then divided the closing price of the stock into the total value at yearend to get a number of voting shares held in the company's pension and welfare benefit plans.[6]

We then divided the total votes outstanding (i.e., total number of votes based on available classes of stock for each of our Fortune 500 companies) by the number of votes controlled by the pension plan to obtain the voting power, or the percentage of votes controlled by the company's pension and welfare benefit plans.

[6]We assumed that those shares held by the company and its pension plan(s) are common stock with one vote per share for computation of voting power. To the extent that assumption is inaccurate, our estimates for the voting power of plans in their own company might also be inaccurate.

Appendix II: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D C. 20210

July 9, 2004

Barbara D. Bovbjerg
Director, Education, Workforce, and
Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Bovbjerg:

Thank you for giving the Department of Labor (DOL) the opportunity to offer remarks regard the General Accounting Office's (GAO) draft report entitled "Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting" (GAO-04-749). This letter provides comments on the recommendations contained in the draft report; we have already provided technical comments directly to you and your staff.

The GAO report recommends that Congress amend ERISA to require fiduciaries to implement proxy voting guidelines, to disclose these guidelines and proxy votes cast on an annual basis, and to require the appointment of an independent fiduciary to cast proxy votes. These recommendations appear to be predicated on the notion that proxy-voting issues present unique conflict of interest concerns for ERISA fiduciaries, and that these potential conflicts expose plan participants and beneficiaries to significant risks.

The report concludes legislative action is necessary as "conflicts of interest in proxy voting can occur because various business and personal relationships exist, which can influence a fiduciary's vote." In so concluding, however, the report overlooks the fact that Congress did not include an independence requirement for plan fiduciaries when it passed ERISA in 1974, and instead expressly allowed corporate officers and other persons to "wear two hats." While Congress recognized that this created the possibility of conflicts of interest, it addressed these possible conflicts through the high standards of fiduciary duty, the personal liability of fiduciaries for their decisions, the creation of prohibited transactions and similar provisions. Requiring wholly independent fiduciaries would increase costs and discourage the formation of voluntary employee benefit plans. The potential for a conflict of interest in casting a proxy vote is no greater than the potential for a conflict of interest in making dozens of other fiduciary decisions in an ERISA plan. As in those other decisions, the issue is whether the fiduciary acted in the best interests of the participants and beneficiaries.

Part of the Department's duty to oversee ERISA plans is to monitor the exercise of fiduciary duties, including how fiduciaries manage potential conflicts. With respect to proxy voting, the Department has examined the issue on a regular basis, issued several forms of guidance on ERISA's requirements, and filed amicus briefs in several key court cases. In addition, the Department has conducted three specific enforcement studies of proxy voting practices that determined fiduciaries generally comply with ERISA and, since the completion of the last study, has seen no evidence of a negative change in the level of compliance—indeed, industry best practices embrace proxy guidelines. The Department now includes steps for reviewing proxy voting in its investment management investigative guide and, when such reviews have taken place, few, if any, violations have been uncovered.

The three proxy enforcement studies absorbed a considerable amount of resources, as would any new proxy enforcement study. Given the DOL's other pressing enforcement priorities, the diversion of needed resources to an enforcement study that we have no reason to believe will find significant non-compliance with ERISA would be an inappropriate use of resources. Understanding proxy voting practices is very important, but rather than undertaking another study, the DOL will capture for further evaluation additional proxy voting information during our investigations in the financial services area.

The report also concludes that proxy votes and voting guidelines should be distributed to all participants and be released to the general public. Proxy voting information is required to be monitored by appropriate plan fiduciaries and proxy guidelines are available to participants upon request. Requiring disclosures of proxy voting to all participants would significantly increase printing, mailing and administrative costs to the plan. Current law strikes the proper balance between cost and access by guaranteeing that fiduciaries monitor compliance with proxy guidelines and any participant who wishes to may receive copies of any guidelines upon request.

We appreciate having had the opportunity to review and comment on this draft report.

Sincerely,

Ann L. Combs

Appendix III: GAO Contacts and Staff Acknowledgments

Contacts

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United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Committee on Homeland Security & Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:30 p.m. EDT
Monday, April 30, 2007

FINANCIAL LITERACY AND EDUCATION COMMISSION

Further Progress Needed to Ensure an Effective National Strategy

Statement of Yvonne D. Jones, Director
Financial Markets and Community Investment

G A O
Accountability * Integrity * Reliability

GAO-07-777T

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-07-777T, a testimony before the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Committee on Homeland Security & Governmental Affairs, U.S. Senate

Why GAO Did This Study

The Financial Literacy and Education Improvement Act created, in December 2003, the Financial Literacy and Education Commission. This statement is based on a report issued in December 2006, which responded to the act's mandate that GAO assess the Commission's progress in (1) developing a national strategy; (2) developing a Web site and hotline; and (3) coordinating federal efforts and promoting partnerships among the federal, state, local, nonprofit, and private sectors. To address these objectives, GAO analyzed Commission documents, interviewed its member agencies and private financial literacy organizations, and benchmarked the national strategy against GAO's criteria for such strategies.

What GAO Recommends

In its report, GAO recommended that the Commission (1) incorporate additional elements into the national strategy to help measure results and ensure accountability, (2) conduct usability tests of and measure customer satisfaction with its Web site, (3) provide for an independent reviewer to evaluate duplication and effectiveness of federal activities, and (4) expand upon current efforts to cultivate sustainable partnerships with nonprofit and private entities. The Commission has taken steps to address some of these recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-07-777T.

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

April 30, 2007

FINANCIAL LITERACY AND EDUCATION COMMISSION

Further Progress Needed to Ensure an Effective National Strategy

What GAO Found

The National Strategy for Financial Literacy serves as a useful first step in focusing attention on financial literacy, but it is largely descriptive rather than strategic and lacks certain key characteristics that are desirable in a national strategy. The strategy provides a clear purpose, scope, and methodology and comprehensively identifies issues and challenges. However, it does not serve as a plan of action designed to achieve specific goals, and its recommendations are presented as "calls to action" that generally describe existing initiatives and do not include plans for implementation. The strategy also does not fully address some of the desirable characteristics of an effective national strategy that GAO has previously identified. For example, it does not set clear and specific goals and performance measures or milestones, address the resources needed to accomplish these goals, or fully discuss appropriate roles and responsibilities. As a result of these factors, most organizations that GAO spoke with said the strategy was unlikely to have a significant impact on their financial literacy efforts.

The Commission has developed a Web site and telephone hotline that offer financial education information provided by numerous federal agencies. The Web site generally serves as an effective portal to existing federal financial literacy sites. Use of the site has grown, and it averaged about 69,000 visits per month from October 2006 through March 2007. The volume of calls to the hotline—which serves as an order line for a free tool kit of federal publications—has been limited. The Commission has not tested the Web site for usability or measured customer satisfaction with it; these are recommended best practices for federal public Web sites. As a result, the Commission does not know if visitors are able to find the information they are looking for efficiently and effectively.

The Commission has taken steps to coordinate the financial literacy efforts of federal agencies and has served as a useful focal point for federal activities. However, coordinating federal efforts has been challenging, in part because the Commission must achieve consensus among 20 federal agencies, each with its own viewpoints, programs, and constituencies, and because of the Commission's limited resources. A survey of overlap and duplication and a review of the effectiveness of federal activities relied largely on agencies' self-assessments rather than the independent review of a disinterested party. The Commission has taken steps to promote partnerships with the nonprofit and private sectors through various public meetings, outreach events, and other activities. The involvement of state, local, nonprofit, and private organizations is important in supporting and expanding Commission efforts to increase financial literacy, and our report found that the Commission could benefit from further developing mutually beneficial and lasting partnerships with these entities that will be sustainable over the long term.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to be here today to discuss the federal government's role in financial literacy. Ensuring that Americans have the knowledge and skills to manage their money wisely is a key element in improving the economic health of our nation in current and future generations. Financial literacy has become increasingly important in recent years due to the convergence of a number of economic, policy, and demographic trends. For example, workers today are increasingly responsible for managing their own retirement savings—yet at the same time, the nation's personal saving rate has fallen dramatically over the past few decades, and household debt hovers at record high levels. In recent years, we have issued several products on the federal government's role in improving financial literacy.[1] My statement today focuses on the Financial Literacy and Education Commission, which is comprised of 20 federal agencies and was created in 2003 by the Financial Literacy and Education Improvement Act.[2]

Today I will discuss the Commission's progress in (1) developing an effective national strategy to promote financial literacy and education; (2) implementing its Web site, hotline, and multimedia campaign; and (3) coordinating federal financial literacy efforts and promoting partnerships among government, nonprofit, and commercial organizations. This statement is based primarily on our December 2006 report that assessed the Commission's effectiveness.[3] In preparing that report, we reviewed the Financial Literacy Act and analyzed relevant Commission documents, including the National Strategy for Financial Literacy. We assessed the national strategy, in part, by benchmarking it against general

[1]For example, see GAO, *Increasing Financial Literacy in America*, GAO-07-284CG (Washington, D.C.: Dec. 11, 2006); GAO, *Credit Reporting Literacy: Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts*, GAO-05-223 (Washington, D.C.: Mar. 16, 2005); GAO, *Highlights of a GAO Forum: The Federal Government's Role in Improving Financial Literacy*, GAO-05-93SP (Washington, D.C.: Nov. 15, 2004).

[2]Title V of the Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, Title V, 117 Stat. 2003 (Dec. 4, 2003) (*codified at* 20 U.S.C. §§ 9701–08). Hereafter, this statement refers to the Financial Literacy and Education Improvement Act as the "Financial Literacy Act." The act also mandated that we assess the Commission's effectiveness in promoting financial literacy and education. Our December 2006 report fulfilled that mandate.

[3]GAO, *Financial Literacy and Education Commission: Further Progress Needed to Ensure an Effective National Strategy*, GAO-07-100 (Washington, D.C.: Dec. 4, 2006).

characteristics of an effective national strategy we have identified in prior work. We interviewed representatives of all 20 federal agencies that are members of the Commission as well as representatives of nonfederal organizations that address issues of financial literacy. We also gathered and analyzed data on the content and usage of the Commission's Web site, telephone hotline, and publication tool kit. We conducted our work from January 2006 through November 2006 in accordance with generally accepted government auditing standards.

In summary:

- The National Strategy for Financial Literacy serves as a useful first step in focusing attention on financial literacy, but it is largely descriptive rather than strategic and lacks certain key characteristics that are desirable in a national strategy. While the strategy comprehensively identifies issues and challenges related to financial literacy, its recommendations are presented as "calls to action" that generally describe existing initiatives and do not include plans for implementation. Further, the strategy only partially addresses some of the characteristics we previously have identified as desirable for any effective national strategy. For example, although it provides a clear purpose, scope, and methodology, it does not go far enough to establish specific goals and performance measures or milestones; discuss the resources that would be needed to implement the strategy; or discuss, assign, or recommend roles and responsibilities for achieving its mission. As a result, most federal and nonfederal agencies we interviewed said that the national strategy was unlikely to have a significant impact on their financial literacy and education efforts. Our report recommended that the Commission incorporate additional elements into the national strategy to help measure results and ensure accountability. In commenting on our report, the Department of the Treasury (Treasury), in its capacity as chair of the Commission, noted that the national strategy was the nation's first such effort and said its calls to action were appropriately substantive and concrete.
- The Commission has developed a Web site and telephone hotline that offers financial education information from numerous federal agencies. The site serves as a portal to other federal financial education sites, and representatives of financial literacy organizations generally told us that the site served its purpose effectively. Use of the site has been growing, and it averaged about 69,000 visits monthly from October 2006 through March 2007. The volume of calls to the hotline—which acts as an order line for free publications—has been limited. For example, it received 526 calls in March 2007. The Commission has not yet implemented some best practices recommended for federal public Web sites, such as testing its

site for usability and measuring customer satisfaction. As a result, the Commission does not know if visitors can readily find the information for which they are looking. Our report recommended that the Commission conduct usability tests of and measure customer satisfaction with its Web site, which the Commission said it will do by the second quarter of 2009. To fulfill a Financial Literacy Act requirement that the Treasury Department develop a pilot national public service campaign for financial literacy and education, the department has contracted with the Advertising Council to create a campaign designed to improve credit literacy among young people. The campaign, which is scheduled to be distributed to media outlets in the third quarter of 2007, will also promote the Commission's Web site and telephone hotline.

- The Commission has played a role in coordinating federal agencies' financial literacy efforts and promoting public-private partnerships but has faced several challenges in these areas. The Commission serves as a single focal point for federal agencies to come together on the issue of financial literacy, and several calls to action in the Commission's national strategy involve interagency efforts. However, coordinating federal efforts has been challenging, in part because the Commission must achieve consensus among 20 federal agencies, each with its own viewpoints, programs, and constituencies, and because of the Commission's limited resources. Further, the Commission's survey of overlap and duplication and its review of the effectiveness of federal activities relied largely on agencies' self-assessments rather than the independent review of a disinterested party. The Commission has taken some steps to promote partnerships with the nonprofit and private sectors through various public meetings, outreach events, and other activities, but the impact of these steps is unclear. Our report recommended that the Commission expand its current efforts to cultivate sustainable partnerships with nonprofit and private entities. We also recommended that the Commission provide for an independent third party to review for duplication in federal programs and evaluate the effectiveness of federal activities. Since our report was issued, the Commission has identified several steps it is taking or plans to take to address these recommendations, including plans for independent third-party assessments.

Background

According to the Financial Literacy Act, the purpose of the Financial Literacy and Education Commission is to improve financial literacy and education through the development of a national strategy to promote them. The act defines the composition of the Commission—the Secretary of the Treasury and the heads of 19 other federal departments and agencies—and allows the President to appoint up to five additional members.[4] The Commission must hold one public meeting at least every 4 months. It held its first meeting in January 2004 and nine subsequent meetings, most recently in January 2007.

The act requires the Commission to undertake certain activities, including (1) developing a national strategy to promote financial literacy and education for all Americans; (2) establishing a financial education Web site to provide information about federal financial literacy education programs and grants; (3) establishing a toll-free hotline; (4) identifying areas of overlap and duplication among federal activities and coordinating federal efforts to implement the national strategy; (5) assessing the availability, utilization, and impact of federal financial literacy and education materials; and (6) promoting partnerships among federal, state, and local governments, nonprofit organizations, and private enterprises. The act requires that the national strategy be reviewed and modified as deemed necessary at least once a year. It also requires the Secretary of the Treasury to develop, implement, and conduct a pilot national public service multimedia campaign to enhance the state of financial literacy and education in the United States.

The Treasury Department's Office of Financial Education provides primary support to the Commission and coordinates its efforts. As of April 2007, the office had assigned the equivalent of about 3 full-time professional staff to handle work related to the Commission and in the past also has received assistance from staff detailed from other federal agencies. The Commission has no independent budget. The act authorized appropriations to the Commission of amounts necessary to carry out its work, and for fiscal year 2005 Congress specified that $1 million should be used for the development and implementation of the national strategy.

[4]Under the act, the agencies represented on the Commission are the Departments of Agriculture, Defense, Education, Health and Human Services, Housing and Urban Development, Labor, Treasury, and Veterans Affairs; the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Office of Thrift Supervision; the Federal Deposit Insurance Corporation; the National Credit Union Administration; the Securities and Exchange Commission; the Federal Trade Commission; the General Services Administration; the Small Business Administration; the Social Security Administration; the Commodity Futures Trading Commission; and the Office of Personnel Management. As of April 2007, the President had not appointed any additional members.

The National Strategy Is Descriptive Rather Than Strategic, Limiting Its Value in Guiding the Nation's Financial Literacy Efforts

To develop the National Strategy for Financial Literacy, the Commission formed a national strategy working group of 13 member agencies, issued a call for public comment in the Federal Register, and held six public meetings—five organized around the commercial, government, nonprofit, education, and banking sectors and one for individual consumers.[5] Although the Financial Literacy Act required the Commission to adopt the strategy within 18 months of enactment, or June 2005, the strategy was not publicly released until April 2006.[6] The Commission sought unanimous consent on the national strategy, and Commission members told us that the Treasury Department faced a significant challenge in trying to get 20 federal agencies—each with its own mission and point of view—to unanimously agree to a strategy. A particular source of disagreement involved whether nonfederal entities should be cited by name as illustrative examples in the strategy. The Commission ultimately agreed that it would not name these organizations in the national strategy, but cite them in a separate document issued by Treasury, called the Quick Reference Guide to the strategy.[7]

The content of the National Strategy for Financial Literacy largely consists of a comprehensive overview of issues related to financial literacy and examples of ongoing initiatives. It describes many major problems and challenges that relate to financial literacy in the United States, identifies key subject matter areas and target populations, and describes what it believes to be illustrations of potentially effective practices in financial education across a broad spectrum of subjects and sectors. As such, the strategy represents a useful first step in laying out key issues and highlighting the need for improved financial literacy. At the same time, as some representatives of the Commission told us, the strategy is fundamentally descriptive rather than strategic. It provides information on

[5] Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* (Washington, D.C.: April 2006).

[6] The Financial Literacy Act required the National Strategy for Financial Literacy to be provided to Congress as part of a report issued by the Commission called the "Strategy for Assuring Financial Empowerment." U.S. Department of the Treasury, *Strategy for Assuring Financial Empowerment* (Washington, D.C.: Apr. 3, 2006). That report also contained other elements required by the act, including a survey and assessment of certain federal financial education materials and information on the activities and future plans of the Commission. 20 U.S.C. § 9703 (h)(2).

[7] U.S. Department of the Treasury, *Quick Reference Guide to the National Strategy for Financial Literacy* (Washington, D.C.: Apr. 4, 2006).

disparate issues and initiatives but is limited in presenting a long-term plan of action for achieving its goal.

Most notably, the strategy's recommendations are presented as "calls to action," defined as concrete steps that should be taken for improving financial literacy and education. Sixteen of these 26 calls to action are addressed to federal entities, 5 to private or nonprofit organizations, and 5 to the public. However, many of these calls to action are very general and do not discuss an implementation strategy, and others describe initiatives that already exist. For example, one call to action states, "Investors should take advantage of the wealth of high quality, neutral, and unbiased information offered free of charge," but does not lay out a plan for helping ensure that investors will do so.

We have previously identified a set of desirable characteristics for any effective national strategy.[8] While national strategies are not required to contain a single, consistent set of attributes, we found six characteristics that can offer policymakers and implementing agencies a management tool to help ensure accountability and more effective results. As shown in the table below, we found that the National Strategy for Financial Literacy generally addresses the first of these characteristics and partially addresses the other five.

Table 1: Extent the National Strategy for Financial Literacy Addresses GAO's Desirable Characteristics of an Effective National Strategy

Desirable characteristic	Generally addresses	Partially addresses	Does not address
Clear purpose, scope, and methodology	X		
Detailed discussion of problems and risks		X	
Desired goals, objectives, activities, and performance measures		X	
Description of future costs and resources needed		X	
Organizational roles, responsibilities, and coordination		X	
Description of integration with other entities		X	

Source: GAO analysis of the National Strategy for Financial Literacy.

[8]GAO, *Combating Terrorism: Evaluation of Selected Characteristics in National Strategies Related to Terrorism*, GAO-04-408T (Washington, D.C.: Feb. 3, 2004).

The six characteristics we considered follow:

- *Clear Purpose, Scope, and Methodology.* An effective strategy describes why the strategy was produced, the scope of its coverage, and how it was developed. The National Strategy for Financial Literacy generally addresses this characteristic. For example, it cites the legislative mandate that required the strategy, the overall purpose, and subsidiary goals such as making it easier for consumers to access financial education materials. At the time of our review, the strategy did not specifically define "financial literacy" or "financial education" and we noted that doing so could provide additional benefit in helping define the scope of the Commission's work. In its April 2007 report to Congress, the Commission provided definitions of these terms that it said would guide its work.[9]

- *Detailed Discussion of Problems and Risks.* A strategy with this characteristic provides a detailed discussion or definition of the problems the strategy intends to address, their causes, and the risks of not addressing them. Based on our review, the National Strategy for Financial Literacy partially addresses this characteristic. It identifies specific problems that indicate a need for improved financial literacy and often discusses the causes of these problems. However, it might benefit further from a fuller discussion of the long-term risks—to the well-being of individuals, families, and the broader national economy—that may be associated with poor financial literacy. As we have reported in the past, a clear understanding of our nation's overall financial condition and fiscal outlook is an indispensable part of true financial literacy.[10] Due to current demographic trends, rising health care costs, and other factors, the nation faces the possibility of decades of mounting debt, which left unchecked will threaten our economic security and adversely affect the quality of life available to future generations.[11] One element of financial literacy is ensuring that Americans are aware of these potential developments in planning for their own financial futures since, for example, we can no longer assume that current federal entitlement programs will continue indefinitely in their present form.

[9]U.S. Department of the Treasury, *Strategy for Assuring Financial Empowerment* (Washington, D.C.: April 2007).

[10]GAO-05-93SP, pp. 2-3.

[11]For example, see GAO, *The Nation's Long-Term Fiscal Outlook: September 2006 Update*, GAO-06-1077R (Washington, D.C.: Sept. 15, 2006).

- *Desired Goals, Objectives, Activities and Performance Measures.* The National Strategy for Financial Literacy partially addresses this characteristic, which deals not only with developing goals and strategies to achieve them, but also the milestones and outcome measures needed to gauge results. The strategy does identify key strategic areas and includes 26 calls to action that, although often lacking detail, provide a picture of the types of activities the strategy recommends. However, in general, the strategy neither sets clear and specific goals and objectives, nor does it set priorities or performance measures for assessing progress. Several stakeholders in the financial literacy community that we spoke with noted that the strategy would have been more useful if it had set specific performance measures. The Commission might also have set measurable goals for changing consumer behavior, such as seeking to reduce the number of Americans without bank accounts or increase the number saving for their retirement to a specified figure in the next 5 or 10 years. Without performance measures or other evaluation mechanisms, the strategy lacks the means to measure progress and hold relevant players accountable.

- *Description of Future Costs and Resources Needed.* Effective national strategies should include discussions of cost, the sources and types of resources needed, and where those resources should be targeted. The National Strategy for Financial Literacy discusses, in general terms, the resources that are available from different sectors and its Quick Reference Guide provides a list of specific organizations. However, the strategy does not address fundamental questions about the level and type of resources that are needed to implement the national strategy. The strategy does little to acknowledge or discuss how funding limitations could be a challenge to improving financial literacy and offers little detail on how existing resources could best be leveraged. Neither does it provide cost estimates nor does it discuss specifically where resources should be targeted. For example, it does not identify the sectors or populations most in need of additional resources. The strategy also might have included more discussion of how various "tools of government" such as regulation, standards, and tax incentives might be used to stimulate nonfederal organizations to use their unique resources to implement the strategy. Without a clear description of resource needs, policymakers lack information helpful in allocating resources and directing the strategy's implementation.

- *Organizational Roles, Responsibilities, and Coordination.* Effective national strategies delineate which organizations will implement the strategy and describe their roles and responsibilities, as well as mechanisms for coordinating their efforts. The National Strategy for

Financial Literacy partially addresses these issues. For example, it discusses the involvement of various governmental and nongovernmental sectors in financial education and identifies in its calls to action which agencies will or should undertake certain tasks or initiatives. However, the strategy is not specific about roles and responsibilities and does not recommend changes in the roles of individual federal agencies. Addressing these issues more fully is important given our prior work that discussed the appropriate federal role in financial literacy in relation to other entities and the potential need to streamline federal efforts in this area.[12] In addition, the strategy is limited in identifying or promoting specific processes for coordination and collaboration between sectors and organizations.

- *Description of Integration with Other Entities.* This characteristic addresses how a national strategy relates to other federal strategies' goals, objectives, and activities. The National Strategy for Financial Literacy does identify and describe a few plans and initiatives of entities in the federal and private sectors, and it includes a chapter describing approaches within other nations and international efforts to improve financial education. However, the strategy is limited in identifying linkages with these initiatives, and it does not address how it might integrate with the overarching plans and strategies of these state, local, and private-sector entities.

Because the National Strategy for Financial Literacy is more of a description of the current state of affairs than an action plan for the future, its effect on public and private entities that conduct financial education may be limited. We asked several major financial literacy organizations how the national strategy would affect their own plans and activities, and the majority said it would have no impact at all. Similarly, few federal agencies with which we spoke could identify ways in which the national strategy was guiding their work on financial literacy. Most characterized the strategy as a description of their existing efforts.

Our report recommended that the Secretary of the Treasury, in concert with other agency representatives of the Financial Literacy and Education Commission, incorporate into the national strategy (1) a concrete definition for financial literacy and education to help define the scope of the Commission's work; (2) clear and specific goals and performance measures that would serve as indicators of the nation's progress in

[12] GAO-05-93SP, pp. 5-8.

improving financial literacy and benchmarks for the Commission; (3) actions needed to accomplish these goals, so that the strategy serves as a true implementation plan; (4) a description of the resources required to help policymakers allocate resources and direct implementation of the strategy; and (5) a discussion of appropriate roles and responsibilities for federal agencies and others, to help promote a coordinated and efficient effort. In commenting on our report, Treasury, in its capacity as chair of the Commission, noted that the National Strategy for Financial Literacy was the nation's first such effort and, as such, was designed to be a blueprint that provides general direction while allowing diverse entities the flexibility to participate in enhancing financial education. The department said that the strategy's calls to action are appropriately substantive and concrete—setting out specific issues for discussion, conferences to be convened, key constituencies, and which Commission members should be responsible for each task. As noted earlier, in its April 2007 report to Congress, the Commission provided definitions for "financial literacy" and "financial education" to help guide its work. We acknowledge that the national strategy represents the nation's first such effort, but continue to believe that future iterations of the strategy would benefit from inclusion of the characteristics cited in our report.

Web Site and Telephone Hotline Offer Financial Education Information from Federal Agencies

The Financial Literacy Act required the Commission to establish and maintain a Web site to serve as a clearinghouse and provide a coordinated point of entry for information about federal financial literacy and education programs, grants, and materials. With minor exceptions, the Commission did not create original content for its Web site, which it called My Money. Instead, the site serves as a portal that consists largely of links to financial literacy and education Web sites maintained by Commission member agencies. According to Treasury representatives, the English-language version of the My Money site had more than 290 links as of April 2007, organized around 12 topics.[13] A section on federal financial education grants was added to the site in October 2006, which includes links to four

[13]The topic areas are Budgeting and Taxes; Credit; Financial Planning; Home Ownership; Kids; Paying for Education; Privacy, Fraud and Scams; Responding to Life Events; Retirement Planning; Saving and Investing; Starting a Small Business; and Financial Education Grants.

grant programs.[14] Many representatives of private and nonprofit financial literacy initiatives and organizations with whom we spoke were generally satisfied with the Web site, saying that it provided a clear and useful portal for consumers to federal financial education materials.

From its inception in October 2004 through March 2007, the My Money Web site received approximately 1,454,000 visits.[15] The site received an average of 35,000 visits per month during the first 6 months after its introduction in October 2004. Use of the site has increased since that time and reached 78,000 visits in April 2006, when the Commission and the Web site received publicity associated with the release of the national strategy. From October 2006 through March 2007, the site averaged about 69,000 visits per month. The number of visits to the My Money Web site has been roughly comparable to some recently launched private Web sites that provide financial education.[16] Some representatives of financial literacy organizations with whom we spoke said the Commission should do more to promote public awareness of the Web site. Commission representatives, however, noted to us several steps that have been taken to promote the site, including, for example, a promotional effort in April 2006 that printed the My Money Web address on envelopes containing federal benefits and tax refunds.

[14]The Financial Literacy Act required that the Web site offer information on all federal grants to promote financial literacy and education, and on how to target, apply for, and receive such grants. 20 U.S.C. § 9703(b)(2)(C). The four federal grant programs cited on the Web site as of April 2007 were the Department of Education's Excellence in Economic Education program, Department of Health and Human Services' Assets for Independence program, Department of Housing and Urban Development's Housing Counseling program, and National Credit Union Administration's Community Development Revolving Loan Fund program.

[15]A "visit" is defined as all the activity of one visitor to a Web site within a specified period, usually 30 minutes. Because federal government Web sites are generally prohibited from using "cookies" (small files stored on a visitor's computer that can contain identifying information about the visitor), the number of unique visitors to the My Money Web site cannot be counted. Thus, data on total number of visits do not represent the number of users who have visited the Web site because some users may visit the site multiple times. According to a GSA official, because unique visitors cannot be counted, the best measure of the Web site's usage is number of visits.

[16]For example, in fiscal year 2006, the My Money Web site received approximately 628,000 visits. During that same time period, the Employee Benefit Research Institute's "Choose to Save" Web site, the American Institute of Certified Public Accountants' "360 Degrees of Financial Literacy" Web site, and the National Endowment for Financial Education's "Smart about Money" Web site received, respectively, 1,538,000, 437,000, and 229,000 visits.

However, the Commission has not yet conducted usability tests or measured customer satisfaction for the My Money Web site. The federal government's Web Managers Advisory Council provides guidance to help federal Web managers implement recommendations and best practices for their federal sites.[17] The council recommends testing usability and measuring customer satisfaction to help identify improvements and ensure that consumers can navigate the sites efficiently and effectively. Representatives of the General Services Administration (GSA), which operates the site, acknowledged that these steps are standard best practices that would be useful in improving the site. They said they had not yet done so due to competing priorities and a lack of funding.[18] Without usability testing or measures of customer satisfaction, the Commission does not know whether the Web site's content is organized in a manner that makes sense to the public, or whether the site's visitors can readily find the information for which they are looking.

Our report recommended that the Commission (1) conduct usability testing to measure the quality of visitors' experience with the site; and (2) measure customer satisfaction with the site, using whatever tools deemed appropriate, such as online surveys, focus groups, or e-mail feedback. In its April 2007 report to Congress, the Commission said it would conduct usability testing of, and measure customer satisfaction with, its Web site by the second quarter of 2009.

In addition to a Web site, the Financial Literacy Act also required that the Commission establish a toll-free telephone number for members of the public seeking information related to financial literacy.[19] The Commission launched the telephone hotline, 1-888-My Money, simultaneously with the My Money Web site in October 2004. The hotline supports both English-

[17]The Web Managers Advisory Council is an interagency group of about 40 senior Web managers from every cabinet-level agency, several independent agencies, and the judicial and legislative branches. In 2004, the council recommended policies and guidelines for all federal public Web sites. See: Interagency Committee on Government Information, *Recommended Policies and Guidelines for Federal Public Websites,* submitted to the Office of Management and Budget (Washington, D.C.: June 9, 2004).

[18]According to a usability specialist from GSA, it might cost roughly $10,000 to $15,000 for a basic usability study with eight participants and recommendations for redesign of the site. Representatives of the Department of Health and Human Services told us it might be able to offer the Commission use of its Web testing lab at no charge, which would reduce the cost of usability testing.

[19]20 U.S.C. § 9703(c).

and Spanish-speaking callers. A private contractor operates the hotline's call center and GSA's Federal Citizen Information Center oversees the operation and covers its cost. According to GSA, the cost of providing telephone service for the hotline was about $28,000 in fiscal year 2006. The hotline serves as an order line for obtaining a free financial literacy "tool kit"—pamphlets and booklets from various federal agencies on topics such as saving and investing, deposit insurance, and Social Security. The tool kit is available in English and Spanish versions, and consumers can also order it via the My Money Web site. The volume of calls to the My Money telephone hotline has been limited—526 calls in March 2007 and an average of about 200 calls per month between February 2005 and February 2006.

As part of the national strategy, the Financial Literacy Act required the Secretary of the Treasury to develop, implement, and conduct a pilot national public service multimedia campaign to enhance the state of financial literacy in the United States.[20] The department chose to focus the multimedia campaign on credit literacy among young adults. It contracted with the Advertising Council to develop and implement the multimedia campaign, which is expected to be advertised—using donated air time and print space—on television and radio, in print, and online.[21] According to the Commission's April 2007 report to Congress, the launch of the campaign is scheduled for the third quarter of 2007.

The Commission Has Taken Steps to Coordinate Federal Agencies' Efforts and Promote Partnerships but Faces Challenges

The Financial Literacy Act required that the Commission develop a plan to improve coordination of federal financial literacy and education activities and identify areas of overlap and duplication in these activities. The Commission created a single focal point for federal agencies to come together on the issue of financial literacy and education. Some Commission members told us that its meetings—including formal public, working group, and subcommittee meetings—have helped foster interagency communication and information sharing that had previously been lacking. In addition, the Commission's Web site, hotline, and tool kit have helped centralize federal financial education resources for consumers. Further, the national strategy includes a chapter on federal

[20] 20 U.S.C. § 9707.

[21] The Advertising Council (commonly known as the Ad Council) is a private, nonprofit organization that produces, distributes, and promotes public service campaigns on behalf of nonprofit organizations and government agencies.

interagency coordination and several of the strategy's calls to action involve interagency efforts, including joint conferences and other initiatives.

However, the Commission has faced several challenges in coordinating the efforts of the 20 federal agencies that form the Commission. Each of the Commission's participating federal agencies has different missions and responsibilities and thus different perspectives and points of view on issues of financial literacy. The agencies also differ in their levels of responsibility for and expertise on financial literacy and education. Further, because agencies tend to be protective of their resources, it might be very difficult to recommend eliminating individual agencies' programs. Moreover, the Commission's ability to coordinate such major structural change, if it chose to do so, would be constrained by its limited resources in terms of staff and funding. In addition, the Commission has no legal authority to compel an agency to take any action, but instead must work through collaboration and consensus. Given these various constraints, a Treasury official told us that the Commission saw its role as improving interagency communication and coordination rather than consolidating federal financial education programs or fundamentally changing the existing federal structure.

To meet a requirement of the Financial Literacy Act that the Commission identify and propose means of eliminating areas of overlap and duplication, the Commission asked federal agencies to provide information about their financial literacy activities. After reviewing these resources, the Commission said it found minimal overlap and duplication among federal financial literacy programs and did not propose the elimination of any federal activities. Similarly, to meet a requirement of the act that it assess the availability, utilization, and impact of federal financial literacy materials, the Commission asked each agency to evaluate the effectiveness of its own materials and programs—and reported that each agency deemed its programs and resources to be effective and worthy of continuance.

In both cases, we believe that the process lacked the benefit of independent assessment by a disinterested party. Our report recommended that the Secretary of the Treasury, in conjunction with the Commission, provide for an independent third party to carry out the review of duplication and overlap among federal financial literacy activities as well as the review of the availability, utilization, and impact of federal financial literacy materials. In response to these recommendations, the Commission reported in its April 2007 report to Congress that it would identify an independent party to conduct assessments on both of these matters, with the first series of independent assessments to be completed in 2009.

The Financial Literacy Act also charged the Commission with promoting partnerships between federal agencies and state and local governments, nonprofit organizations, and private enterprises. Partnerships between federal agencies and private sector organizations are widely seen as essential to making the most efficient use of scarce resources, facilitating the sharing of best practices among different organizations, and helping the federal government reach targeted populations via community-based organizations.[22] Treasury officials have cited several steps the Commission has taken to promote such partnerships. These have included calls to action in the Commission's national strategy that encouraged partnerships; community outreach and events coordinated by Treasury and other agencies; and public meetings designed to gather input on the national strategy from various stakeholders. In general, the private and nonprofit financial literacy organizations with which we spoke said that these steps had been useful, but that their relationships with federal agencies and other entities have changed little overall as a result of the Commission. Several private and nonprofit national organizations have extensive networks that they have developed at the community level across the country, and some of these organizations suggested the Commission could do more to mobilize these resources as part of a national effort. Some stakeholders told us they also felt the Commission could do more to involve state and local governments. Greater collaboration by the Commission with state and local governments may be particularly important given the critical role that school districts can play in improving financial literacy. The Commission might consider how the federal government can influence or incentivize states or school districts to include financial education in school curriculums, which many experts believe is key to improving the nation's financial literacy.

Given the wide array of state, local, nonprofit, and private organizations providing financial literacy programs, the involvement of the nonfederal sectors is important in supporting and expanding Commission efforts to increase financial literacy. Thus far, the Commission has taken some

[22]For example, see GAO-05-93SP, pp. 6-8. By "partnerships," we refer to shared, or joint, responsibilities between organizations from the public and private sectors where there is otherwise no clear or established hierarchy of lead and support functions.

helpful steps to promote partnerships, consisting mainly of outreach and publicity. As the Commission continues to implement its strategy, we believe it could benefit from further developing mutually beneficial and lasting partnerships with nonprofit and private entities that will be sustainable over the long term. Our report recommended that the Commission consider ways to expand upon current efforts to cultivate sustainable partnerships with nonprofit and private entities. As part of these efforts, we recommended that the Commission consider additional ways that federal agencies could coordinate their efforts with those of private organizations that have wide networks of resources at the community level, as well as explore additional ways that the federal government might encourage and facilitate the efforts of state and local governments to improve financial literacy. In commenting on our report, Treasury noted that it had a long history of partnerships with nonfederal entities and would consult with the Commission about how to work more closely with the types of organizations described in our report. On April 17, 2007, the Commission held the inaugural meeting of the National Financial Education Network, which it said was intended to create an open dialogue and advance financial education at the state and local level.

In conclusion, in the relatively short period since its creation, the Commission has played a helpful role by serving as a focal point for federal efforts and making financial literacy a more prominent issue among the media, policymakers, and consumers. We recognize the significant challenges confronting the Commission—most notably, the inherent difficulty of coordinating the efforts of 20 federal agencies. Given the small number of staff devoted to operating the Commission and the limited funding it was provided to conduct any new initiatives, we believe early efforts undertaken by the Commission represent some positive first steps. At the same time, more progress is needed if we expect the Commission to have a meaningful impact on improving the nation's financial literacy.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

For further information on this testimony, please contact Yvonne D. Jones 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 statement. Individuals making key contributions to this testimony include Jason Bromberg, Assistant Director; Nima Patel Edwards; Eric E. Petersen; William R. Chatlos; Emily R. Chalmers; and Linda Rego.

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February 27, 2004

The Honorable Richard J. Durbin
Ranking Member
Subcommittee on Oversight of Government Management, the
Federal Workforce, and the District of Columbia
Committee on Governmental Affairs
United States Senate

Subject: *Military Personnel: Bankruptcy Filings among Active Duty Service Members*

A declaration of bankruptcy is an extreme example of the failure to manage personal finances. Debtors who file personal bankruptcy petitions usually file under chapter 7 or chapter 13 of the bankruptcy code.[1] Generally, debtors who file under chapter 7 of the bankruptcy code seek a discharge of all their eligible dischargeable debts.[2] Debtors who file under chapter 13 submit a repayment plan, which must be confirmed by the bankruptcy court, for paying all or a portion of their debts over a 3-year period unless, for cause, the court approves a longer period not to exceed 5 years.[3]

This letter responds to your December 16, 2003, request. As agreed with your office, we determined (1) the rate of personal bankruptcy filings among active duty military personnel, and how that rate compared with the rate found in the U.S. population; and (2) factors that should be considered when attempting to compare the rate of bankruptcy filings for active duty military personnel with the rate for the U.S. population.[4]

To respond to this request, we obtained information on the rate of bankruptcies among active duty military personnel from a 1999 Department of Defense (DOD) survey. The survey population included service members from the active duty services and reservists serving on active duty assignments for at least 6 months. We also discussed bankruptcy and compensation with officials in the Office of the Under

[1] Title 11, United States Code.
[2] Eligible debts may be discharged in bankruptcy proceedings. A dischargeable debt is a debt for which the bankruptcy code allows the debtor's personal liability to be eliminated.
[3] See U.S. General Accounting Office, *Personnel Bankruptcy: The Credit Research Center Report on Debtors' Ability to Pay*, GAO/GGD-98-47 (Washington, D.C.: Feb. 9, 1998).
[4] For information on reservists and income changes, see U.S. General Accounting Office, *Military Personnel: DOD Needs More Data to Address Financial and Health Care Issues Affecting Reservists*, GAO-03-1004 (Washington, D.C.: Sept. 10, 2003).

Secretary of Defense for Personnel and Readiness. We used data on bankruptcy filings for the U.S. population from the Administrative Office of the U.S. Courts. We also used findings from GAO; Congressional Budget Office; Congressional Research Service; and Department of Labor, Bureau of Labor Statistics reports on compensation, military housing allowances, other benefits, and unemployment. We conducted our review from January to February 2004, in accordance with generally accepted government auditing standards.

Results in Brief

DOD had limited data on the rate of bankruptcies among active duty military personnel. Responses to DOD's 1999 active duty survey—the most current data available—show that 1.2 percent, or about 16,000, of the 1.3 million active duty members in the survey population said that they had declared personal bankruptcy during the 12 months preceding the survey. This compares with a total of approximately 1.3 million personal bankruptcies filed in the United States in 1999. From 1999 through 2003, the number of personal bankruptcies increased from approximately 1.3 million to over 1.6 million for the U.S. population.

The 23.6 percent increase in personal bankruptcy filings for the U.S. population may not readily translate into a comparable rate of increase for active duty military personnel. Loss of employment and medical-related problems (e.g., medical costs and loss of income during illness or accident) are among the major causes that contribute to personal bankruptcies in the U.S. population, but unemployment and catastrophic medical expenses are factors not confronted by active duty military personnel. In addition, Congress has authorized increased cash compensation—increases in basic pay, housing allowance, and special pays—for active duty military personnel since 1999. For example, average annual military basic pay increases have exceeded average private-sector wage increases for fiscal years 2000 through 2004. DOD has also identified a need to improve the financial literacy and responsibility of military members. And in May 2003, DOD formally launched a financial readiness campaign to address military members' poor financial habits and increase financial management awareness, savings, and protection against predatory practices.

Limited Data Available on Personal Bankruptcies among Active Duty Military Personnel

DOD had limited data on the rate of personal bankruptcies among active duty military personnel. DOD officials indicated that their most recent data on bankruptcies among active duty military personnel (which included reservists on active duty assignments for at least 6 months) were gathered from September through December 1999 as part of a DOD-wide survey.[5] For the survey population, 1.2 percent of the active duty military members said that they (and spouse, if applicable) "went bankrupt (declared personal bankruptcy)" in the 12 months prior to completing the survey. The 1.2 percent rate of personal bankruptcy projected to the 1.3 million military personnel included in the survey population translates into approximately

[5] Defense Manpower Data Center, *Tabulations of Responses from the 1999 Survey of Active Duty Personnel: Volume 2: Programs and Services, Family, Economic Issues, and Background*, DMDC Report No. 2000-006 (Arlington, Va.: September 2000).

16,000 personnel on active duty declaring personal bankruptcy during the 12 months preceding the survey. The survey included neither follow-up items to determine the events that precipitated the bankruptcy nor did it include a breakout of the percentage of reservists serving on active duty assignments for at least 6 months compared with full-time active duty personnel declaring bankruptcy.

In 1999, the total number of personal bankruptcies filed in the United States was 1.3 million.[6] We did not calculate a per capita rate because we could not determine the number of individuals versus households filing for personal bankruptcy. Although trend data from 1999 through 2003 are not available for military personnel, the total number of personal bankruptcy filings in the United States increased by 23.6 percent to 1.6 million from 1999 through 2003.

Changes in Bankruptcy Rate for U.S. Population May Not Be Indicative of Changes for Military Personnel

Changes in the rate of bankruptcy filings for the U.S. population may not readily translate into comparable rate changes for active duty military personnel. Among the factors that suggest caution in generalizing the 23.6 percent increase found in the U.S. population to the active duty military personnel population are changes in civilian unemployment rates and military cash compensation. Also, DOD has reported that it has placed additional emphasis on financial counseling since the 1999 survey data were gathered.

<u>Unemployment and Catastrophic Medical Expenses Not Factors for Active Duty Military Personnel</u>

The 23.6 percent increase in personal bankruptcy filings for the U.S. population may not result in a similar increase in bankruptcies for active duty military personnel because (1) an increase in civilian unemployment for fiscal years 1999 through 2003 was not a factor for active duty military personnel and (2) all active duty military personnel and their families have medical coverage. Unemployment and medical expenses have been shown to be related to bankruptcy filing.

The relationship between filing for bankruptcy and unemployment is illustrated by the findings from one study in which over two-thirds of the individuals filing for bankruptcy had job-related financial stress, with layoffs being identified as a major factor.[7] For each of the fiscal years from 1999 through 2003, an increase or a decrease in the total number of U.S. personal bankruptcy filings was accompanied by an increase or a decrease in the unemployment rate for the same fiscal year (see table 1). In contrast to the changing unemployment picture for civilians, active duty

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[6] Administrative Office of the U.S. Courts, *Personal Bankruptcy Filings Continue to Rise in Fiscal Year 2003* (Washington, D.C.: Nov. 14, 2003).
[7] See Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* (New Haven, Conn.: Yale University Press, 2000). The authors noted that job-related financial stress was implicated in over two-thirds of the more than 2,400 bankruptcy filings they examined. They also noted that while layoffs were a major factor in the decision to file for bankruptcy, other serious job-related trouble could result even if workers had a job, because the job may change and both income and benefits may erode.

military members—by definition—were employed for each of the 5 years, in the sense that each military member received a regular salary while on active duty.[8]

Table 1: Changes in Bankruptcy Filings and Overall Unemployment in the U.S. Population for Fiscal Years 1999–2003

	Personal bankruptcy		Overall unemployment	
Fiscal year	Number of bankruptcy filings	Percent change from fiscal year 1999	Unemployment rate on September 30	Percent change from fiscal year 1999
2003	1,625,813	23.6	6.0	39.5
2002	1,508,578	14.7	5.7	32.6
2001	1,398,864	6.3	4.3	0.0
2000	1,226,037	-6.8	4.0	-7.0
1999	1,315,751		4.3	

Sources: Administrative Office of the U.S. Courts for number of bankruptcy filings; GAO's analysis of court data for the percent change in bankruptcies; and GAO's analysis of unemployment rates from the U.S. Department of Labor, Bureau of Labor Statistics.

DOD provides employee benefits that include health coverage to more than 1.3 million active duty service members and their nearly 2 million spouses and other dependents. The health care for active duty service members and their dependents costs the federal government about $9 billion per year. For active duty service members, this benefit offers care in military treatment facilities and does not require enrollment fees or co-payments for care or drugs obtained from military treatment facilities.[9] In addition, legislation in 2000 eliminated co-payments for the families of many active duty military personnel. Medical coverage for all DOD active duty personnel and dependents is unlike the coverage for the population in a study that found approximately one household in five citing medical-related problems (e.g., medical costs and loss of income during illness or accident) as a reason for filing bankruptcy.[10] Given that health coverage can be a benefit offered as part of employment compensation, a higher unemployment rate may indicate that more of the U.S. population was placed at risk for medical expenses.

<u>Increases in Cash Compensation for Military Personnel Greater Than Those for Average Civilians</u>

The Congressional Budget Office noted that cash compensation for military personnel consists of basic pay, allowances for things like housing and food, special pays and bonuses, and the tax advantages that military members receive because some allowances are not subject to federal income tax.[11] During the period from 2000 through 2004, Congress authorized increases in the pays and allowances to active duty military personnel.

[8] Active duty military families may, however, be influenced by civilian unemployment trends if spouses of military personnel become unemployed.
[9] If military treatment facilities are not available or if service member families choose to use civilian doctors or medical facilities, two other health care programs provide service member families with extensive coverage for medical costs, including a $1,000 annual catastrophic cost cap.
[10] See Sullivan et al., *The Fragile Middle Class: Americans in Debt.*
[11] Congressional Budget Office, *Military Compensation: Balancing Cash and Noncash Benefits* (Washington, D.C.: Jan. 16, 2004).

Military Pay Increases Exceed Civilian Wage Increases

For fiscal years 2000 through 2004, Congress provided average raises in military basic pay that exceeded the average wage increases found for all private-sector employees (see table 2).[12] For example, in fiscal year 2002, raises for active duty personnel increased 0.4 to 5.4 percentage points more than did the raises of the average private-sector worker, and in fiscal years 2003 and 2004, the military averaged 0.7 and 0.45 percentage points more in their raises, respectively, than did those working in the private sector. For fiscal year 2005, DOD's budget request includes a 3.5 percent increase in basic pay, which matches the raise determined by the statutory formula. Thus, military basic pay raises have been greater than the raises in wages for the average private-sector employee for the 5 years since the 1999 data on bankruptcies among active duty military were gathered.

Table 2: Changes in Military Basic Pay for Fiscal Years 2000–2005

	Annual percent increase in active duty military pay	
Fiscal year	**Percent indicated by statutory formula**	**Percent actually provided**
2005	3.5	3.5 requested
2004	3.7	4.15 average, with a range of 3.7 to 6.25
2003	4.1	4.8 average, with a range of 4.1 to 6.5
2002	4.6	6.9 average, with a range of 5.0 to 10.0
2001	3.7	4.1 average, with an initial 3.7 across the board, plus a later targeted raise that averaged 0.4
2000	4.8	6.2 average, with an initial 4.8 across the board, plus a later targeted raise that averaged 1.4

Sources: Congressional Research Service and DOD.

Note: The Congressional Research Service noted that targeted and variable increases were typically keyed to pay grade groups. In fiscal years 2000 and 2001, Congress authorized additional targeted increases and they became effective on July 1 of those respective years, whereas the other raises took effect earlier in the fiscal years.

Smaller Out-of-Pocket Housing Expenses for Active Duty Military Members

Out-of-pocket housing expenses for active duty military members living in private-sector housing have decreased during the period since 1999. In fiscal year 2000, housing allowances did not cover about 19 percent of the typical active duty military member's housing and utility costs.[13] For fiscal year 2002, DOD plans called for increasing this allowance so that the out-of-pocket costs for obtaining private-sector

[12] See Congressional Research Service, The Library of Congress, *Military Pay and Benefits: Key Questions and Answers*, Order Code IB10089 (Washington, D.C.: Jan. 15, 2004). That report noted that upward adjustments to military basic pay are linked—but not identical—to the raises calculated with the statutory formula for determining pay increases for federal General Schedule employees. 37 U.S.C. section 1009 requires the President to increase military basic pay to match any annual pay increase for federal General Service employees as mandated by the statutory formula specified in 5 U.S.C. section 5303(a). This statutory formula is based on the Employment Cost Index, which is calculated by the Department of Labor's Bureau of Statistics and measures annual percentage increases in wages for all private-sector employees.

[13] About two-thirds of the married and one-third of the single military members in the United States live in private housing in the communities surrounding military installations. They receive a cash housing allowance to help defray the cost of renting or purchasing a home and the cost of utilities. The remaining military families live in government-owned or privatized housing. These latter families pay no out-of-pocket expenses for housing or utilities. Families in government housing receive no housing allowance, while families in privatized housing use their housing allowance to pay rent and normal utility costs.

housing would decrease to 8 percent in 2003 and 4 percent in 2004.[14] The 2005 budget request for DOD seeks to totally eliminate out-of-pocket expenses for housing for the average active duty military member.

The decreases in out-of-pocket expenses are equivalent to increases in total compensation. This point can be illustrated using the $910 per month that DOD identified as the January 2003 national median cost of obtaining civilian equivalent housing for the most junior level of enlisted military personnel (i.e., E1-E4) with dependents. The median monthly out-of-pocket expense in 2003 was $68 (or 7.5 percent), but it would have been about $173 (19 percent) had the out-of-pocket percentage remained at the fiscal year 2000 level. This difference of $105 per month translates into $1,260 per year being available for other needs, and the yearly housing allowance of $10,104 would have been tax exempt.

The intent of the basic allowance for housing program is to provide active duty service members with accurate and equitable housing compensation when on-base or other government housing is not provided.[15] The legislation establishing the program required that rates be based on the cost of adequate housing for civilians with comparable incomes, and that the rates vary by a member's rank or pay grade; by dependency status—that is, either having or not having dependents; and by geographic location.[16]

Special Pays and Tax Treatment for Deployed Active Duty Military Personnel Enhanced

Relative to their peers who deployed in 1999 when the bankruptcy data for military personnel were gathered, more recently deployed active duty military personnel may be eligible to receive higher special pays.[17] Since April 2003, Congress has temporarily increased the family separation allowance[18] by 150 percent and imminent danger pay by 50 percent (see table 3). The April 2003 increases in these special pays would result in deployed active duty personnel's having relatively higher cash incomes today than would their peers who were deployed during the 12 months prior to the 1999 active duty survey.

Table 3: Changes in Two Special Pays for Deployed Active Duty Military Personnel—Before and After April 2003

	Monthly pay before and after April 2003		
Special pay	**Before**	**After**	**Percent increase**
Family separation allowance	$100	$250	150
Imminent danger pay	$150	225	50

Source: GAO

[14] See U.S. General Accounting Office, *Military Housing: Management Improvements Needed as the Pace of Privatization Quickens*, GAO-02-624 (Washington, D.C.: June 21, 2003).
[15] See U.S. General Accounting Office, *DOD Personnel: Improvements Made to Housing Allowance Rate Setting Process*, GAO-01-508 (Washington, D.C.: Apr. 16, 2001).
[16] See 37 U.S.C. 403.
[17] Public Law 108-11, section 1316 (Apr. 16, 2003) and Public Law 108-136, sections 606, 619 (Nov. 24, 2003).
[18] Military families may incur additional expenses such as an increased need for childcare when active duty military members are separated from their families during deployments.

Some or all of the income that active duty military personnel earn while serving in combat zones is also tax-free.[19] The military pay, up to prescribed amounts, received while in these combat zones is excluded from gross income and is not subject to federal income tax.

Other special pays may be tax-free as the result of service in a combat zone. For example, service members who reenlist while serving in a combat zone are typically eligible to receive any applicable selective reenlistment bonus tax-free. For fiscal years 1999 through 2003, DOD's budget for that program grew from $418 million to an estimated $734 million, a 76 percent increase.[20]

DOD Efforts Under Way to Improve Financial Literacy and Responsibility of Military Members

We recently reported that DOD identified a need to improve the financial literacy and responsibility of military members in its July 2002 human capital strategic plan.[21,22] As part of DOD's balanced scorecard, the Under Secretary of Defense for Personnel and Readiness reviews issues affecting force management risk. One of the indicators used in the review is personal finances, which is evaluated in terms of the self-reported financial condition of junior enlisted personnel (E1-E4) and their self-reported ability to pay bills on time. Data to support these evaluations are supplied on an annual basis through Defense Manpower and Data Center surveys of active duty service members. Among other things, DOD is reviewing a draft personal financial management policy that seeks to establish a uniform approach to educating and training all military service members.

In May 2003, DOD formally launched a "financial readiness campaign" to address military service members' poor financial habits and to increase financial management awareness, savings, and protection against predatory practices. DOD has also entered into a number of partnerships with nonprofit organizations and government agencies that have agreed to support counselors who offer financial assistance programs to military service members. The services have also made improvements. For example, the Navy has raised its mandatory number of personal financial management training hours, and it is using mobile financial management teams to train financial specialists, including those in geographically remote regions where

[19] Department of the Treasury, Internal Revenue Service, *Armed Forces' Tax Guide: For Use in Preparing 2003 Returns*, Publication 3, Cat. No. 46072M. This publication noted that all military pay for the month is excluded from income when an enlisted service member, warrant officer, or commissioned warrant officer served in a combat zone during any part of a month or while hospitalized as a result of service in the combat zone. The amount of the exclusion for a commissioned officer (other than a commissioned warrant officer) is limited to the highest rate of enlisted pay, plus imminent danger/hostile fire pay, for each month during any part of which an officer served in a combat zone or while hospitalized as a result of service there.
[20] See U.S. General Accounting Office, *Military Personnel: DOD Needs More Effective Controls to Better Assess the Progress of the Selective Reenlistment Bonus Program*, GAO-04-86 (Washington, D.C.: Nov. 13, 2003).
[21] See GAO-03-1004.
[22] Department of Defense, Deputy Assistant Secretary of Defense (Military Community and Family Policy), *A New Social Compact: A Reciprocal Partnership between the Department of Defense Service Members, and Families* (July 2002).

there are no financial educators to provide training. The services also provide financial planning information on their Web sites.

Agency Comments

DOD did not provide formal agency comments. Program officials from the Office of the Under Secretary of Defense for Personnel and Readiness and the military services did, however, review a draft of this report and provided technical comments, which we incorporated as appropriate.

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As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 14 days from its issue date. At that time, we will send copies of this report to the Secretary of Defense. We will also make copies available to appropriate congressional committees and to other interested parties on request. In addition, the report will be available at no charge at the GAO Web site at http://www.gao.gov.

If you or your staff have questions about this report, please call me at (202) 512-5559 (stewartd@gao.gov) or Jack Edwards at (202) 512-8246 (edwardsj@gao.gov).

Sincerely yours,

Derek B. Stewart

Derek B. Stewart
Director, Defense Capabilities and Management

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Testimony

Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives

For Release on Delivery
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MILITARY PERSONNEL

DOD Has Taken Steps to Address Servicemembers' Financial Needs, but Additional Effort Is Warranted

Statement of Valerie C. Melvin, Acting Director
Defense Capabilities and Management

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Highlights

Highlights of GAO-06-749T, a testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives

May 18, 2006

MILITARY PERSONNEL

DOD Has Taken Steps to Address Servicemembers' Financial Needs, but Additional Effort Is Warranted

Why GAO Did This Study

The finances of servicemembers and their families have been an ongoing concern of Congress and the Department of Defense (DOD), especially in light of more frequent deployments to support conflicts in Iraq and Afghanistan. Adverse effects that may result when servicemembers experience financial problems include loss of security clearances, criminal or nonjudicial sanctions, adverse personnel actions, or adverse impacts on unit readiness. To decrease the likelihood that servicemembers will experience financial problems, DOD has requested and Congress has granted annual increases in military basic pay for all active duty servicemembers and increases in special pays and allowances for deployed servicemembers. The military has also developed personal financial management (PFM) programs to help avoid or mitigate adverse effects associated with personal financial problems. However, studies published in 2002 showed that servicemembers continue to report financial problems.

This testimony provides a summary of GAO's prior work examining (1) the extent to which deployments have affected the financial conditions of active duty servicemembers and their families, and (2) steps that DOD has taken to assist servicemembers with their financial needs.

www.gao.gov/cgi-bin/getrpt?GAO-06-749T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Valerie C. Melvin at (202) 512-6304 or MelvinV@gao.gov.

What GAO Found

DOD data suggests that deployment status does not affect the financial condition of active duty servicemembers, although some deployed servicemembers faced certain problems. Data from a 2003 DOD-wide survey suggests that servicemembers who were deployed for at least 30 days reported similar levels of financial health or problems as those who had not deployed. For example, of junior enlisted personnel, 3 percent of the deployed group and 2 percent of the nondeployed group indicated that they were in "over their heads" financially; and 13 percent of the deployed group and 15 percent of the nondeployed group responded that they found it "tough to make ends meet but keeping your head above water" financially. However, problems receiving family separation allowance and communicating with creditors may result in financial difficulties for some deployed servicemembers. Based on DOD pay data for January 2005, almost 6,000 of 71,000 deployed servicemembers who had dependents did not obtain their family separation allowance in a timely manner. Furthermore, problems communicating with creditors—caused by limited Internet access, few telephones and high fees, and delays in receiving ground mail—can affect deployed servicemembers' abilities to resolve financial issues. Additionally, some financial products marketed to servicemembers may negatively affect their financial condition.

DOD has taken a number of steps to assist servicemembers with their financial needs, although some of this assistance has been underutilized. These steps include PFM training for servicemembers, which is required by all four military services. DOD also provides free legal assistance on purchase contracts for large items and other financial documents. However, according to the attorneys and other personnel, servicemembers do not make full use of available legal services because they may not take the time to visit the attorney's office or they fear information about a financial problem would get back to the command and limit their career progression. In addition, each service has a relief or aid society designed to provide financial assistance through counseling and education as well as financial relief through grants or no-interest loans. Some servicemembers in our focus groups stated that they would not use relief from a service society because they take too long, are intrusive, require too much in-depth financial information, or may be career limiting if the command found out. Servicemembers may use non-DOD resources if they do not want the command to be aware of their financial conditions or they need products or support not offered through DOD, the services, or the installation. Although DOD has taken these steps to assist servicemembers with their financial needs, it does not have the results-oriented departmentwide data needed to assess the effectiveness of its PFM programs and provide necessary oversight. Without an oversight framework requiring evaluation and a reporting relationship between DOD and the services, DOD and Congress do not have the visibility or oversight needed to assess the effectiveness of DOD's financial management training and assistance to servicemembers.

Madam Chairwoman and Members of the Subcommittee:

I am pleased to be here today to discuss the financial service needs of military personnel and their families. The finances of servicemembers and their families have been an ongoing concern of Congress and the Department of Defense (DOD), especially in light of more frequent deployments to support the war on terrorism and conflicts in Iraq and Afghanistan. DOD's Social Compact, which is part of its human capital strategic plan, notes that mission readiness and quality of life depend on whether servicemembers use their financial resources responsibly. Some adverse effects that may result when servicemembers experience serious financial problems include loss of security clearances, criminal or nonjudicial sanctions, or adverse personnel actions including possible discharge from the military. Servicemembers with serious financial issues may also have an adverse impact on the readiness of the unit. For example, servicemembers' financial problems may take the servicemembers and possibly their unit commanders away from their primary duties in order to address problems with creditors. In a 2002 report to Congress, the Navy identified an estimated $250 million in productivity and salary losses due to servicemembers' poor personal financial management.[1]

Congress and DOD have taken steps to decrease the likelihood that deployed and nondeployed servicemembers will experience financial problems. DOD has requested and Congress has granted annual increases in military basic pay for all active duty servicemembers and increases in special pays and allowances for deployed servicemembers, such as the family separation allowance and hostile fire/imminent danger pay. The military also has developed personal financial management (PFM) programs to provide servicemembers with financial literacy training, financial counseling, and other assistance to avoid or mitigate the adverse effects associated with personal financial problems."

Despite the added compensation and the assistance provided through the PFM programs, studies in recent years by DOD and others show that active duty servicemembers continue to report financial problems. For

[1] See Department of Defense, *Report on Personal and Family Financial Management Programs* (Mar. 31, 2002) in response to a House Committee on Armed Services requirement in the National Defense Authorization Act for Fiscal Year 2002.

example, a 2002 study[2] noted that 20 percent of junior enlisted servicemembers reported that they struggled to make ends meet financially and another 4 percent regarded themselves as "in over their heads" with respect to their finances.

In this context, my testimony today will summarize our prior work examining (1) the extent to which deployments have affected the financial conditions of active duty servicemembers and their families and (2) steps that DOD has taken to assist servicemembers with their financial needs.

My statement is based primarily on our work completed in April 2005[3] and our institutional knowledge from prior reviews examining financial issues of servicemembers and their families (see GAO Related Products at the end of this testimony statement). Other information, such as the current status of our recommendations to DOD that were pending at the time when the reports were issued, will also be discussed. We conducted our work in accordance with generally accepted government auditing standards during May 2006.

Summary

DOD-wide survey data suggest that deployment status does not affect active duty servicemembers' financial conditions, although some deployed servicemembers faced additional problems with receiving family separation allowances and communicating with creditors and family. DOD data based on servicemember responses to a 2003 DOD-wide survey suggest that servicemembers who were deployed for at least 30 days reported similar levels of financial health or problems as those who had not deployed. For example, of the junior enlisted personnel, 3 percent of the deployed group and 2 percent of the nondeployed group indicated that they were in "over their heads" financially; and 13 percent of the deployed group and 15 percent of the nondeployed group responded that they found it "tough to make ends meet but keeping your head above water"

[2] See RAND, *Assessing the Personal Financial Problems of Junior Enlisted Personnel*, MR-1444-OSD (2002). This report defines junior enlisted as those enlisted servicemembers with fewer than 10 years of service. Our report defines junior enlisted as servicemembers in pay grades E1 to E4.

[3] The findings cited in this testimony were primarily taken from GAO, *Military Personnel: More DOD Actions Needed to Address Servicemembers' Personal Financial Management Issues*, GAO-05-348 (Washington, D.C.: Apr. 26, 2005); and GAO, *Military Personnel: DOD's Tools for Curbing the Use and Effects of Predatory Lending Not Fully Utilized*, GAO-05-349 (Washington, D.C.: Apr. 26, 2005).

financially. These responses are consistent with the findings that we obtained in a survey of all PFM program managers and in focus groups conducted during our 13 site visits. However, problems receiving family separation allowance promptly and communicating with creditors and families may result in financial difficulties for some deployed servicemembers. Based on DOD pay data for January 2005, almost 6,000 of 71,000 deployed servicemembers who have dependents did not obtain their family separation allowance in a timely manner. The family separation allowance of $250 per month is designed to compensate servicemembers for extra expenses (e.g., childcare costs) that result when they are involuntarily separated from their families. Not receiving this compensation each month to help defray household costs can place a financial strain on the family when the servicemembers are deployed. Furthermore, problems communicating with creditors—caused by limited Internet access, few telephones and high fees, and delays in receiving ground mail—can affect deployed servicemembers' abilities to resolve financial issues. Failure to avoid or promptly correct serious financial problems can result in consequences for these servicemembers, such as bad credit ratings or adverse effects on unit readiness and morale. Additionally, some financial products marketed to servicemembers may negatively affect their financial conditions.

DOD has taken a number of steps to assist servicemembers with their financial needs; however, some of this assistance is underutilized. One step is PFM training for servicemembers, which is required by all four military services, although the extent to which the training is not received is unknown because servicewide totals are not always collected. DOD also provides legal assistance on purchase contracts for large items and other financial documents. According to the attorneys and other personnel, servicemembers do not make full use of available legal services because they may not take the time to visit the attorney's office or they fear information about their financial problems would get back to the command and limit their career progression. In addition, each service has a relief or aid society designed to provide financial assistance through counseling and education as well as financial relief through grants or no-interest loans. Some servicemembers in our focus groups stated that they would not use grants or no-interest loans from a society because they take too long, are intrusive because the financial institution or relief/aid society requires in-depth financial information in the loan or grant application, or could be career limiting if the command found out the servicemember was having financial problems. Servicemembers may choose to use non-DOD resources if they do not want the command to be aware of their financial conditions or they need products or support not offered through DOD, the services, or the installation. Furthermore, DOD established Armed Forces Disciplinary Control Boards that can make recommendations to place businesses off-limits to servicemembers, which can be an effective tool for avoiding or correcting unfair practices, but data gathered during some of our site visits revealed few times when boards were used to address predatory lending practices. Although DOD has taken these many steps to assist servicemembers with their financial needs, it does not have the results-oriented, departmentwide data needed to assess the effectiveness of its PFM programs and provide necessary oversight. Without an oversight framework requiring evaluation and a reporting relationship between DOD and the services, DOD and Congress do not have the visibility or oversight needed to assess the effectiveness of DOD's financial management training and assistance to servicemembers.

Background

Because large numbers of Americans lack knowledge about basic personal economics and financial planning, U.S. policymakers and others have focused on financial literacy, i.e., the ability to make informed judgments and to take effective actions regarding the current and future use and management of money.[4] While informed consumers can choose appropriate financial investments, products, and services, those who exercise poor money management and financial decision making can lower their family's standard of living and interfere with their crucial long-term goals.

One vehicle for promoting the financial literacy of Americans is the congressionally created Financial Literacy and Education Commission.[5] Created in 2003, the Commission is charged with (1) developing a national strategy to promote financial literacy and education for all Americans; (2) coordinating financial education efforts among federal agencies and among the federal, state, and local governments; nonprofit organizations; and private enterprises; and (3) identifying areas of overlap and duplication among federal financial literacy activities.

[4] See GAO, *Highlights of a GAO Forum: The Federal Government's Role in Improving Financial Literacy*, GAO-05-93SP (Washington, D.C.: Nov. 15, 2004) for an overview of financial literacy issues. This report resulted from a July 28, 2004, forum that GAO hosted to develop recommendations on the role of the federal government in improving financial literacy. The forum's participants included a select group of individuals with expertise in financial literacy and education. They included representatives of federal and state agencies, the financial industry, nonprofit organizations, and academic institutions.

[5] Pub. L. No. 108-159, Title V, (2003).

Since at least the 1980s, the military services have offered PFM programs to help servicemembers address their financial conditions. Among other things, the PFM programs provide financial literacy training to servicemembers, particularly to junior enlisted personnel during their first months in the military. The group-provided financial literacy training is supplemented with other types of financial management assistance, often on a one-on-one basis. For example, servicemembers might obtain one-on-one counseling from staff in their unit or legal assistance attorneys at the installation.

In May 2003, the Office of the Under Secretary of Defense for Personnel and Readiness, DOD's policy office for the PFM programs, established its Financial Readiness Campaign, with objectives that include increasing personal readiness by, among other things, (1) increasing financial awareness and abilities and (2) increasing savings and reducing dependence on credit. The campaign attempted to accomplish these objectives largely by providing on-installation PFM program providers with access to national-level programs, products, and support.

To minimize financial burdens on servicemembers, DOD has requested and Congress has increased cash compensation for active duty military personnel. For example, the average increases in military basic pay exceeded the average increases in private-sector wages for each of the 5 years prior to when we issued our April 2005 report. Also, in April 2003, Congress increased the family separation allowance from $100 per month to $250 per month and hostile fire/imminent danger pay from $150 per month to $225 per month for eligible deployed servicemembers. The family separation allowance is designed to provide compensation to servicemembers with dependents for the added expenses (e.g., extra childcare costs, automobile maintenance, or home repairs) incurred because of involuntary separations such as deployments in support of contingency operations like Operation Iraqi Freedom. Hostile fire/imminent danger pay provides special pay for "duty subject to hostile fire or imminent danger" and is designed to compensate servicemembers for physical danger. Iraq, Afghanistan, Kuwait, Saudi Arabia, and many other nearby countries have been declared imminent danger zones. In addition to these special pays, some or all income that active duty servicemembers earn in a combat zone is tax free.[6]

Financial Conditions Similar for Deployed and Nondeployed Servicemembers, but Pay Administration and Communication Problems Existed for Deployed Members

Data from DOD suggest that the financial conditions for deployed and nondeployed servicemembers and their families were similar. However, deployed servicemembers faced problems with the administration of an allowance as well as an inability to communicate with creditors. Additionally, some financial products marketed to servicemembers may negatively affect their financial condition.

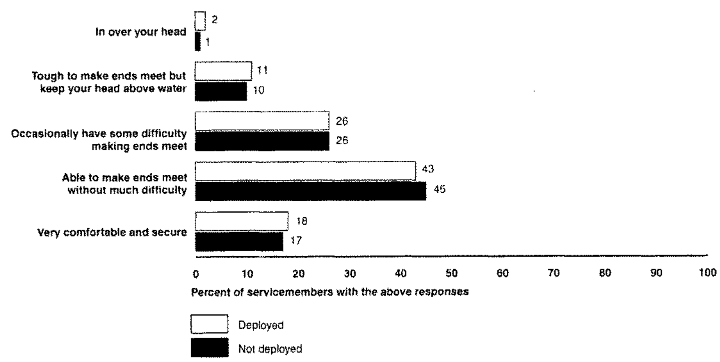
Data Suggest Financial Conditions of Deployed Servicemembers and Their Families Similar to Nondeployed Servicemembers and Their Families

In a 2003 DOD-wide survey, servicemembers who were deployed for at least 30 days reported similar levels of financial health or problems as those who had not deployed. For example, an analysis of the responses for only junior enlisted personnel showed that 3 percent of the deployed group and 2 percent of the nondeployed group indicated that they were in "over their heads" financially; and 13 percent of the deployed group and 15 percent of the nondeployed group responded that they found it "tough to make ends meet but keeping your head above water" financially. Figure 1 shows estimates of financial conditions for all servicemembers based on their responses to this survey.[7]

[6] Department of Treasury, Internal Revenue Service, *Armed Forces' Tax Guide: For Use in Preparing 2005 Returns*, Publication 3, Cat. No. 46072M. This publication noted that all military pay for the month is excluded from income when an enlisted servicemember, a warrant officer, or commissioned officer served in a combat zone during any part of a month or while hospitalized as a result of service in the combat zone. The amount of the exclusion for a commissioned officer (other than a warrant officer) is limited to the highest rate of enlisted pay, plus hostile fire/imminent danger pay for each month during any part of which an officer served in a combat zone or while hospitalized as a result of service there.

[7] DOD's March 2003 survey sample consisted of 34,929 individuals identified by stratified random sampling procedures. DOD reported that completed surveys were received from 10,828 respondents, which resulted in an overall weighted response rate for eligible servicemembers, corrected for nonproportional sampling of 35 percent.

Figure 1: Self-Reported Financial Condition of Servicemembers Who Were and Were Not Deployed for at Least 30 Days at the Time They Completed the 2003 DOD Survey[a]



Source: GAO analysis of DOD data.

[a]Sampling errors of estimates for servicemembers who were not deployed do not exceed +/-2 percentage points. Sampling errors of estimates for servicemembers who were deployed do not exceed +/-5 percentage points. These sampling errors do not include errors due to other sources, such as potential bias attributable to the overall 35 percent response rate. DOD conducted research to assess the impact of this response rate on overall estimates. We have no reason to believe that potential nonresponse bias not otherwise accounted for by DOD's research is substantial for the variables we studied in this report.

These responses are consistent with the findings that we obtained in a survey of all PFM program managers and during our 13 site visits. In the survey of PFM program managers, about 21 percent indicated that they believed servicemembers are better off financially after a deployment; about 54 percent indicated that the servicemembers are about the same financially after a deployment; and about 25 percent believed the servicemembers are worse off financially after a deployment. Also, 90 percent of the 232 recently deployed servicemembers surveyed in our focus groups said that their financial situations either improved or remained about the same after a deployment.

The 2003 DOD survey also asked servicemembers whether they had experienced three types of negative financial events: pressure by creditors, falling behind in paying bills, and bouncing two or more checks. Again, the findings for deployed and nondeployed servicemembers were similar. For example, 19 percent of the deployed group and 17 percent of the nondeployed group said they were pressured by creditors; 21 percent of the deployed group and 17 percent of the nondeployed group said they fell behind in paying bills; and 16 percent of the deployed group and 13 percent of the nondeployed group said they had bounced two or more checks.[8]

The special pays and allowances that some servicemembers receive when deployed, particularly to dangerous locations, may be one reason for the similar findings for the deployed and nondeployed groups. Deployment-related special pays and allowances can increase servicemembers' total cash compensation by hundreds of dollars per month. Moreover, some or all income that servicemembers earn while serving in a combat zone is tax free.

Deployed Servicemembers Faced Problems Receiving Family Separation Allowance and Communicating with Creditors

Deployed servicemembers experienced problems receiving their family's separation allowance promptly and communicating with creditors and families. Regarding family separation allowance, DOD pay data for January 2005 showed that almost 6,000 of 71,000 deployed servicemembers who have dependents did not receive their family separation allowance in a timely manner. The family separation allowance of $250 per month is designed to compensate servicemembers for extra expenses (e.g., childcare costs) that result when they are involuntarily separated from their families. Delays in obtaining this allowance could cause undue hardship for some families faced with such extra expenses. We previously reported similar findings for the administration of family separation allowance to Army Reserve soldiers and recommended that the Secretary of the Army, in conjunction with the DOD Comptroller, clarify and simplify procedures and forms for implementing the family separation allowance entitlement policy.[9]

The services had different, sometimes confusing, procedures that servicemembers performed to obtain their family separation allowance. DOD officials suggested other factors to explain why some eligible servicemembers had not received their family separation allowance on a

[8] The sampling errors cited for fig. 1 also apply for these findings.

[9] See GAO, *Military Pay: Army Reserve Soldiers Mobilized to Active Duty Experienced Significant Pay Problems*, GAO-04-911 (Washington, D.C.: Aug. 20, 2004).

monthly basis. These factors included servicemembers might not have been aware of the benefit, they may not have filed the required eligibility form, or errors or delays might have occurred when their unit entered data into the pay system. In response to our recommendation that DOD take steps to correct the delayed payment of this allowance, DOD notified finance offices that they should emphasize the prompt processing of such transactions so that payment for the entitlement would begin within 30 days of deployment.

Servicemembers may also experience financial difficulties as a result of communication constraints while deployed. For example, individuals in the focus groups for our April 2005 report suggested that deployed junior enlisted personnel sometimes had less access to the Internet than did senior deployed personnel, making it difficult for the former to keep up with their bills. In addition, some Army servicemembers told us that they (1) could not call stateside toll-free numbers because the numbers were inaccessible from overseas or (2) incurred substantial costs—sometimes $1 per minute—to call stateside creditors. Furthermore, in our March 2004 testimony,[10] we documented some of the problems associated with mail delivery to deployed troops.

Failure to avoid or promptly correct financial problems can result in negative consequences for servicemembers. These include increased debt for servicemembers, bad credit histories, and poor performance of their duties when distracted by financial problems. In our April 2005 report, we recommended and DOD partially concurred that DOD identify and implement steps to allow deployed servicemembers better communications with creditors. In their comments, DOD cited operational requirements as a reason that communications with creditors may not be appropriate. In addition, DOD noted that servicemembers should have extended absence plans for their personal finances to ensure that their obligations are covered.

[10] See GAO, *Military Personnel: Observations Related to Reserve Compensation, Selective Reenlistment Bonuses, and Mail Delivery to Deployed Troops*, GAO-04-582T (Washington, D.C.: Mar. 24, 2004).

Some Financial Products May Negatively Affect Servicemembers' Financial Conditions

Some financial products may also negatively affect servicemembers' financial conditions. For example, although servicemembers already receive substantial, low-cost government-sponsored life insurance, we found that a small group of companies sold products that combine life insurance with a savings fund.[11] These products promised high returns but included provisions that reduced the likelihood that military purchasers would benefit. These products usually provided a small amount of additional death benefits and had much higher premiums than those for the government insurance. These products also had provisions to use accumulated savings to pay the insurance premiums if the servicemembers stopped making payments. Moreover, servicemembers were being marketed a securities product, known as a mutual fund contractual plan, which features higher up-front sales charges than other mutual fund products and has largely disappeared from the civilian marketplace. For both types of products, the servicemembers who stopped making regular payments in the early years paid higher sales charges and likely received lower returns than if they had invested in other products.

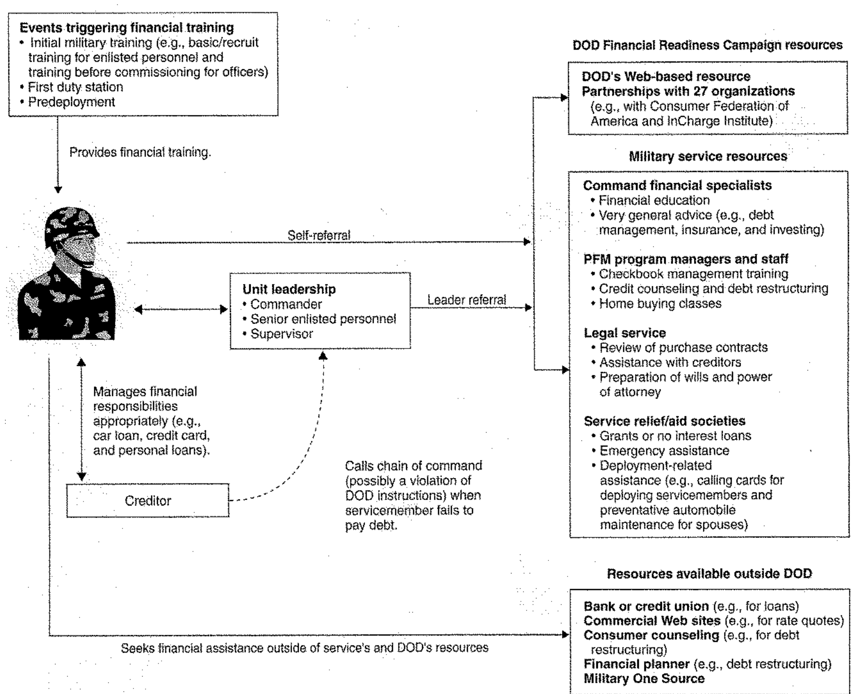
Our November 2005 report made recommendations that included asking Congress to consider banning contractual plans and direct regulators to work cooperatively with DOD to develop appropriateness or suitability standards for financial products sold to servicemembers. We also recommended that regulators ensure that products being sold to servicemembers meet existing insurance requirements and that DOD and financial regulators take steps to improve information sharing between them. In response to the concerns over the products being marketed to servicemembers, securities and insurance regulators have begun cooperating with DOD to expand financial literacy.

[11] See GAO, *Financial Product Sales: Actions Needed to Protect Military Members*, GAO-06-245T (Washington, D.C.: Nov. 17, 2005) and *Financial Product Sales: Actions Needed to Better Protect Military Members*, GAO-06-23 (Washington, D.C.: Nov. 2, 2005).

DOD Has Taken Steps to Assist Servicemembers with Financial Concerns, but Some Assistance Is Underutilized

DOD has taken a number of steps to assist servicemembers with their financial concerns, including providing military-sponsored PFM training, establishing a Financial Readiness Campaign, providing command financial specialists, and using Armed Forces Disciplinary Control Boards. Servicemembers can also access resources available outside of DOD (see fig. 2). However, servicemembers and DOD are not fully utilizing some of this assistance. In addition, DOD does not have an oversight framework to assess the effectiveness of the steps taken to assist servicemembers.

Figure 2: Financial Management Assistance and Training Available to Servicemembers



Sources: GAO analysis of DOD data; Imago Art Explosion.

Services Require Financial Management Training

All four military services require PFM training for servicemembers, and the timing and location of the training varies by service. The Army begins this training at initial military, or basic, where soldiers receive 2 hours of

PFM training. The training continues at Advanced Individual Training schools, where soldiers receive an additional 2 hours of training and at the soldiers' first duty station, where they are to receive an additional 8 hours of PFM training. In contrast, Navy personnel receive 16 hours of PFM training during Advanced Individual Training; while, the Marine Corps and the Air Force begin training servicemembers on financial issues at their first duty stations.

Events, such as deployments or permanent changes of station, can trigger additional financial management training for servicemembers. The length of this additional training and the topics covered can vary by installation and command. Unit leadership also may refer a servicemember for financial management training or counseling if the command is aware of an individual's financial problems (e.g., abusing check-cashing privileges).

Despite these policies, some servicemembers have not received the required training, but the extent to which the training is not received is unknown because servicewide totals are not always collected. The Army, which is the only service that collected installation-level PFM data, estimated that about 82 percent of its junior enlisted soldiers completed PFM training in fiscal year 2003. Some senior Army officers at visited installations acknowledged the need to provide PFM training to junior enlisted servicemembers, but also noted that deployment schedules limited the time available to prepare soldiers for their warfighting mission (e.g., firing a weapon). While some services reported taking steps to improve their monitoring of PFM training completion—an important output—they still do not address the larger issue of training outcomes, such as whether PFM training helps servicemembers manage their finances better.[12]

[12] The DOD Instruction 1342.27, dated November 2004, states that "within 3 months after arriving at the first permanent duty station, a servicemember shall demonstrate a basic understanding of pay and entitlements, banking and allotments, checkbook management, budgeting and saving (to include the thrift savings plan), insurance, credit management, car buying, permanent change of station moves . . . and information on obtaining counseling or assistance on financial matters." The instruction, however, does not specify how this is to be measured. It simply says that such an understanding means to comprehend the underlying principles of a subject and apply them to everyday life situations.

DOD's Financial Readiness Campaign Provides Resources Developed with Assistance from External Organizations

DOD's Financial Readiness Campaign, which was launched in May 2003, supplements PFM programs offered by the individual services through Web-based sources developed with assistance from external organizations. The Under Secretary of Defense for Personnel and Readiness stated that the department initiated the campaign to improve the financial management resources available to servicemembers and their families and to stimulate a culture that values financial health and savings. The campaign allows installation-level providers of PFM programs to access national programs and services developed by federal agencies and nonprofit organizations.

The primary tool of the Financial Readiness Campaign has been a Web site designed to assist PFM program managers in developing installation-level campaigns to meet the financial management needs of their local military community. This Web site is linked to the campaign's 27 partner organizations (e.g., federal agencies, Consumer Federation of America, and service relief/aid societies) that have pledged to support DOD in implementing the Financial Readiness Campaign. DOD's May 2004 assessment of the campaign[13] noted, however, that installation-level PFM staffs had made minimal use of the campaign's Web site. DOD campaign officials stated that it was early in implementation of campaign efforts and that they had been brainstorming ideas to repackage information given to PFM program managers, as well as servicemembers and their families.

Command Financial Specialists and PFM Program Staff Are Available for Financial Education and Counseling

At the installation level, the military services provide command financial specialists, who are usually senior enlisted personnel trained by PFM program managers, to assist servicemembers with financial issues. These noncommissioned officers may perform the education and counseling role of the command financial specialist as a collateral or full-time duty. The Navy, Marine Corps, and Army use command financial specialists to provide unit assistance to servicemembers in financial difficulties. The Air Force does not use command financial specialists within the unit, but has the squadron First Sergeant provide first-level counseling.

Individual servicemembers who require counseling beyond the capability of the command financial specialists or First Sergeants in the Air Force

[13] Office of the Deputy Under Secretary of Defense (Military Community and Family Policy), *Initial Assessment and Follow-on Plan for the Department of Defense Financial Readiness Campaign* (May 27, 2004).

can see the installation's PFM program manager or PFM staff. The PFM program manager is a professional staff member designated and trained to organize and execute financial planning and counseling programs for the military community. PFM program managers and staff offer individual financial counseling as well as group classes on financial issues.

Free Legal Assistance Offered, but Servicemembers Do Not Make Full Use of This Assistance

DOD provides free legal assistance on contracts and other financial documents at installations, but servicemembers do not make full use this assistance. For example, legal assistance attorneys may review purchase contracts for large items such as homes and cars. In addition, the legal assistance attorneys offer classes on varying financial issues including powers of attorney, wills, and divorces. However, legal assistance attorneys at the 13 installations we visited for our April 2005 report stated that servicemembers rarely seek their assistance before entering into financial contracts for goods or services such as purchasing cars or lifetime film developing.

Instead, according to the attorneys, servicemembers are more likely to seek their assistance after encountering problems. For example, used car dealers offered low interest rates for financing a vehicle, but the contract stated that the interest rate could be converted to a higher rate later if the lender did not approve the loan. Servicemembers were later called to sign a new contract with a higher rate. By that time, some servicemembers found it difficult to terminate the transaction because their trade-in vehicles had been sold.

Legal assistance attorneys, as well as other personnel in our interviews and focus groups, noted reasons why servicemembers might not take greater advantage of the free legal assistance before entering into business agreements. They stated that junior enlisted servicemembers who want their purchases or loans immediately may not take the time to visit the attorney's office for such a review. Additionally, the legal assistance attorneys noted that some servicemembers feared information about their financial problems would get back to the command and limit their career progression.

Service Relief/Aid Societies Provide Financial Assistance

Each service has a relief or aid society designed to provide financial assistance to servicemembers. The Army Emergency Relief Society, Navy-Marine Corps Relief Society, and the Air Force Aid Society are all private, nonprofit organizations. These societies provide counseling and education as well as financial relief through grants or no-interest loans to eligible servicemembers experiencing emergencies. Emergencies include funds needed to attend the funeral of a family member, repair a primary vehicle, or buy food. For example, in 2003, the Navy-Marine Corps Relief Society provided $26.6 million in interest-free loans and $4.8 million in grants to servicemembers for emergencies.

Some servicemembers in our focus groups stated that they would not use grants or no-interest loans from a service society because they take too long, are intrusive because the financial institution or relief/aid society requires in-depth financial information in the loan or grant application, or could be career limiting if the command found out the servicemembers were having financial problems. The Army Emergency Relief Society attempted to address the time and intrusiveness concerns with its test program, Commander's Referral, for active duty soldiers lacking funds to meet monthly obligations of $500 or less. After the commander approves the loans, the servicemembers can expect to receive funds quickly. However, noncommissioned officers in our individual interviews and focus groups said the program still did not address servicemembers' fears that revealing financial problems to the command could jeopardize their careers.

Non-DOD Resources May Be Used When Sevicemembers Need Additional Financial Support or Confidentiality

Servicemembers may choose to use non-DOD resources if they do not want the command to be aware of their financial conditions or they need financial products or support not offered through DOD, the services, or the installation. In such cases, servicemembers may use other financial resources outside of DOD, which are available to the general public. These can include banks or credit unions for competitive rates on home or automobile loans, commercial Web sites for interest rate quotes on other consumer loans, consumer counseling for debt restructuring, and financial planners for advice on issues such as retirement planning.

Armed Forces Disciplinary Control Boards Can Help Curb Predatory Lending Practices

DOD has used Armed Forces Disciplinary Control Boards to help curb predatory lending practices and minimize their effects. These boards and the recommendations that they make to an installation commander to place businesses off-limits to servicemembers can be effective tools for avoiding or correcting unfair practices. However, data gathered during some of our site visits to the various installations revealed few times when the boards were used to address predatory lending practices. For example, the board at Fort Drum, New York, had not met in about 4 years, and the board's director was unaware of two lawsuits filed by the New York Attorney General that involved Fort Drum servicemembers.

- The Attorney General settled a lawsuit in 2004 on behalf of 177 plaintiffs—most of whom were Fort Drum servicemembers—involving a furniture store that had improperly garnished wages pursuant to unlawful agreements it had required customers to sign at the time of purchase.
- The Attorney General filed a lawsuit in 2004 involving catalog sales stores. He characterized the stores as payday-lending firms that charged excessive interest rates on loans disguised as payments toward catalog purchases. Some servicemembers and family members at Fort Drum fell prey to this practice. The Attorney General stated that he found it particularly troubling that two of the catalog stores were located near the Fort Drum gate.

In contrast to the Fort Drum situations, businesses near two other installations we visited changed their lending practices after boards recommended that commanders place or threaten to place the businesses on off-limits lists. Despite such successes, boards might not be used as a tool for dealing with predatory lenders for a variety of reasons. For example, as a result of high deployments, commanders may minimize some administrative duties, such as convening the boards, to use their personnel for other purposes. In addition, the boards may have little basis to recommend placing or threatening to place businesses on the list if the lenders operate within state laws. Furthermore, significant effort may be required to put businesses on off-limits lists. While recognizing these limitations, in our April 2005 report we nonetheless recommended that all Armed Forces Disciplinary Control Boards be required to meet twice a year. In responding to our recommendation, DOD indicated that it intended to establish a requirement for the boards to meet even more frequently—four times a year—and direct that businesses on the off-limits list for one service be off-limits for all services.

DOD Lacks Oversight Framework for Assessing and Monitoring PFM Program Effectiveness

Although DOD has made resources available to assist servicemembers, it lacks the results-oriented, departmentwide data needed to assess the effectiveness of its PFM programs and provide necessary oversight. The November 2004 DOD instruction that provides guidance to the services on servicemembers' financial management does not address program evaluation or the reports that services should supply to DOD for its oversight role.[14] In our 2003 report,[15] we noted that an earlier draft of the instruction emphasized evaluating the programs and cited metrics such as the number of servicemembers with wages garnished. DOD officials said that these metrics were eliminated because the services did not want the additional reporting requirements.

The only DOD-wide evaluative data available for assessing the PFM programs and servicemembers' financial conditions were obtained from a general-purpose annual survey that focuses on the financial conditions of servicemembers as well as a range of other unrelated issues. The data were limited because (1) DOD policy officials for the PFM programs can only include a few financial-related items to this general purpose survey, (2) a response rate of 35 percent on a March 2003 active duty survey leads to questions about the generalizability of the findings, and (3) DOD has no means for confirming the self-reported information for survey items that ask about objective events such as filing for bankruptcy. Without an oversight framework requiring common evaluation DOD-wide and reporting relationships among DOD and the services, DOD and Congress do not have the visibility or oversight they need to assess the effectiveness of DOD's financial management training and assistance to servicemembers. In response to a recommendation in our April 2005 report for DOD to develop a DOD-wide oversight framework and formalize its oversight role for the PFM programs, the department indicated that it is pursuing management information that includes personal finances to support its implementation of the President's Management Agenda and to comply with the Government Performance Results Act.

Concluding Observations

In summary, as mentioned earlier in my testimony, Congress and DOD have taken steps to decrease the likelihood that deployed and nondeployed servicemembers will experience financial problems. The prior increases in compensation, efforts to increase the financial literacy of servicemembers, and fuller utilization of the tools that DOD has provided for addressing the use of predatory lenders should positively affect the financial conditions of military personnel. While additional efforts are warranted to implement our recommendations on issues such

[14] DOD Instruction 1342.27, *Personal Financial Management for Service Members* (Nov. 12, 2004).

[15] See GAO, *Military Personnel: DOD Needs More Data to Address Financial and Health Care Issues Affecting Reservists*, GAO-03-1004 (Washington, D.C.: Sept. 10, 2003).

as improving DOD's oversight framework for assessing its PFM programs, some of these efforts to address the personal financial conditions of servicemembers and correct past programmatic shortcomings are well underway. Sustaining this momentum will be key to minimizing the adverse effects that personal financial management problems can have on the servicemember, unit, and service.

Madam Chairwoman and Members of the Subcommittee, this concludes my prepared statement. I would be happy to respond to any questions you may have.

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