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Highlights

Highlights of GAO-13-195, a report to congressional addressees

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FINANCIAL REGULATORY REFORM

Regulators Have Faced Challenges Finalizing Key Reforms and Unaddressed Areas Pose Potential Risks

Why GAO Did This Study

The 2007-2009 financial crisis resulted in unprecedented government actions to respond to the unfolding turmoil in the markets, including providing capital to many financial institutions and government conservatorship for others. Although many factors likely contributed to the crisis, gaps and weaknesses in the supervision and regulation of the U.S. financial system generally played an important role. In recognition of the need to improve the regulation of financial markets and institutions to minimize the potential for future crises, in 2009 GAO designated reform of the U.S. financial regulatory system as one of the high-risk issues facing the federal government. In July 2010, the Dodd-Frank Act directed regulators to implement reforms across a range of areas. To assess these efforts, GAO examined the (1) overall status of U.S. financial regulatory reforms arising from the act, (2) challenges affecting the implementation of the act, and (3) areas that pose continued risk.

GAO analyzed data from private and regulatory sources on the status of required rulemakings, synthesized GAO's body of work on Dodd-Frank Act reforms, and interviewed financial regulators and industry and consumer groups on the status of and challenges to implementing reforms.

What GAO Recommends

GAO is not making any new recommendations in this report, but has previously made over 25 recommendations to the federal financial regulators related to Dodd-Frank reforms implementation.

View GAO-13-195. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

What GAO Found

Implementation of financial regulatory reform is ongoing. Although regulators have made progress in implementing some key reforms required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), others remain incomplete. Moreover, the effectiveness of some implemented reforms, as illustrated below, remains to be seen.

- The Financial Stability Oversight Council (FSOC) was established to, among other things, identify systemic threats, and it has taken steps to carry out its responsibilities. However, GAO recently made a number of recommendations to enhance the accountability and transparency of FSOC's decisions and activities and improve collaboration among its members.
- Regulators have taken actions to implement some key reforms intended to reduce systemic risk. For example, FSOC developed—and is currently implementing—a process and criteria to determine whether certain nonbank financial institutions should be designated for supervision. But, to date, no such designations have been made. Although not directly required by the act, regulators have also proposed rules implementing international standards to enhance capital requirements for banks. These also are not yet final and their protections are proposed to phase in over the next 10 years.
- Key aspects of new liquidation authorities and other reforms for resolving troubled financial firms have been implemented, with certain institutions having submitted required resolution plans—"living wills"— that would guide their rapid and orderly resolution in a bankruptcy, if needed. However, market observers noted the effectiveness of these provisions would not be known until the first large failure.

Overall, GAO identified 236 provisions of the act that require regulators to issue rulemakings across nine key areas. As of December 2012, regulators had issued final rules for about 48 percent of these provisions; however, in some cases the dates by which affected entities had to comply with the rules had yet to be reached. Of the remaining provisions, regulators had proposed rules for about 29 percent, and rulemakings had not occurred for about 23 percent.

A variety of challenges affected regulators' progress in implementing the act's reforms. Regulators noted that completing rules has taken time because of the number and complexity of the issues, and because many rules are interconnected. For example, to implement the act's ban on proprietary trading—trading activities conducted by financial institutions for their own accounts as opposed to those of their clients—the regulators issued draft rules that contained over 750 questions for the public's input and spurred over 19,000 comment letters. Further, regulators said that implementing the act's reforms requires a great deal of coordination at the domestic and international levels. Although regulators have established mechanisms to facilitate coordination and believe coordination efforts have improved the quality of the rulemakings, several regulators indicated that coordination increased the amount of time needed to finalize rulemakings. Finally, regulators noted that they have prioritized developing responsive, appropriate rules over meeting tight statutory deadlines. As a result, some important rules may take the longest to develop.

Although the act addressed a number of weaknesses of the regulatory system that were exposed by the recent financial crisis, some risks remain and others have emerged. In 2009, GAO established a framework for evaluating financial regulatory reform proposals; it outlines nine characteristics that should be reflected in any new regulatory system (see table). This framework provides a useful lens through which to consider how weaknesses were addressed through the act and where additional work remains. For example, the creation of the Consumer Financial Protection Bureau could help to ensure broader and more consistent oversight of firms and issues affecting consumers. Additionally, the creation of FSOC could help to provide a systemwide view and identify potential threats before they create a disruption. In contrast:

- The efficiency of the regulatory system was not materially changed as a large, fragmented regulatory structure with numerous regulators remains. This requires regulators to coordinate actions and try to reconcile or balance differing approaches to ensure that regulated entities are subject to appropriate scrutiny.
- GAO and others have raised concerns about the failed housing government-sponsored enterprises—Fannie Mae and Freddie Mac—that have operated under federal conservatorships since 2008, and as of December 2012 have received $187 billion in federal assistance. Until their status is resolved, these entities continue to represent financial exposures for the federal government, a risk to taxpayers, and an impediment to the transition to a housing market that functions effectively without the current level of substantial federal support.
- Although the act took steps to increase the regulatory system's focus on systemic threats, regulators have expressed concerns that the current structure of money market mutual funds may represent an unresolved risk. These funds provide short-term funding to many financial institutions but lack capital buffers and other protections that could reduce the likelihood of destabilizing runs on their holdings. However, some have questioned the need for additional recent reforms affecting these funds.
- Certain credit risk concentrations also pose potential systemic implications, such as the failure of one of the two institutions that provide credit to facilitate transactions in the tri-party repurchase (repo) market that provides short-term funding to many institutions. While these concentrations of credit risks create potential threats to stability, some observers caution that threats also can emerge from other sources, such as from risky products or large numbers of failures among smaller institutions.

Although various proposals for action to address these risks have been put forward, definitive actions have yet to be taken to implement them.

GAO 2009 Framework for Evaluating Financial Regulatory Reforms

Characteristic	Description
Clearly defined regulatory goals	Goals should be clearly articulated and relevant.
Appropriately comprehensive	Financial regulations should cover all activities that pose risks or are otherwise important to meeting regulatory goals.
Systemwide focus	Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk.
Flexible and adaptable	A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes.
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.
Consistent consumer and investor protection	Consumers and investors should receive consistent, useful information, as well as legal protections for similar financial products and services.
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.
Consistent financial oversight	Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency.
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.

Source: GAO.