Financial Services Regulatory Practice

Regulatory Practice Letter

ADVISORY

RPL Number 09-04

GAO Framework for Proposals to Modernize the U.S. Financial Regulatory System

Executive Summary

On January 8, the United States ("U.S.") Government Accountability Office ("GAO") issued a report to Congress on the current state of. and potential enhancements to, the U.S. financial regulatory system. The report, GAO 09-216, *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, finds the existing regulatory system to be fragmented and complex and ill-suited to efficiently respond to the challenges of the current markets.

The GAO report outlines not only the origins of the current U.S. financial regulatory system but highlights what GAO sees as five significant limitations in the existing regulatory system. To assist policymakers in efforts to reform the system, the report puts forth a framework for crafting and assessing modernization proposals. The framework consists of nine elements that the GAO says should be reflected in any new regulatory system.

Background

GAO states that the U.S. is in the midst of the worst financial crisis in over 75 years, and this crisis has exposed potentially significant limitations and gaps in the existing regulatory system and highlighted areas in need of reform.

The call for reform, however, is not an outgrowth of this particular crisis. In its report, GAO noted that as early as 1994 it had identified the need to examine the federal financial regulatory structure and since that time it has released numerous reports on the need for regulatory reform. In March 2008, the Department of the Treasury released a *Blueprint for a Modernized Financial Regulatory Structure* (Refer to RPL 08-02) that presented a series of recommendations for reform of the U.S. financial regulatory structure. The Treasury cited significant developments in the last decade, including the globalization of capital markets, the rate and sophistication of new product innovation, and the convergence of financial products and providers as necessitating reform on a broad scale.

Subject:
Report to Congressional Addressees: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

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The GAO report similarly found that market developments in recent decades have outpaced the regulatory system, and significant reforms are critically and urgently needed. Its framework is intended to help policymakers identify gaps, locate trade-offs and balance competing goals when evaluating new or existing reform proposals to ensure they address current system limitations.

Description

The GAO has highlighted the following five key limitations and gaps in the existing regulatory system that have been brought to light by the major changes in the financial markets and products in recent decades.

- Regulators have failed to mitigate systemic risk posed across the entire financial system, in which some firms operate as conglomerates across multiple financial sectors.
- Regulators have had to address problems resulting from market participants that are less-regulated but play a significant role in today's market.
- Regulators have been challenged to keep track of the increasing prevalence of new and more complex financial products.
- Regulators have been challenged to ensure that accounting and auditing standards respond appropriately to market developments and address the convergence of global accounting and auditing standards.
- The fragmented U.S. regulatory structure has complicated efforts to coordinate with other international regulators.

GAO suggests that to address these limitations and improve the efficiency of a reformed system, the following nine characteristics, and the associated key issues, should be considered.

1. Clearly defined regulatory goals

- Goals should be clearly articulated and provide sufficient information on prioritizing conflicting goals.
- An appropriate balance of broad principles and specific rules should be determined to maximize effectiveness and flexibility in regulatory goal implementation.

2. Appropriately comprehensive

- The appropriate level of regulation for financial activities and institutions should be determined using a risk-based approach.
- Regulations should avoid hampering innovation, capital formation and economic growth, while still providing protection.

3. System-wide focus

- The regulatory system should broaden the focus of individual regulators, or establish new mechanisms for identifying and acting on systemic risk.
- Any additional authorities required by regulators to monitor and act on systemic risk should be determined.

4. Flexible and adaptable

- A method for monitoring market developments and identifying potential risks should be developed and a responsible entity identified.
- The regulatory system should strike a balance between new product innovation and potential risks.

5. Efficient and effective

Efficient oversight of financial services may be achieved by:

- Eliminating overlapping federal regulatory missions;
- Consolidating agencies with similar roles;
- Minimizing unnecessary regulatory burden; and
- Better aligning federal and state roles in regulatory responsibilities.

6. Consistent consumer and investor protection

Consumer and investor protection should be part of the regulatory mission. In addition, consideration should be given to:

- Any need for consolidation of responsibility to enhance and harmonize consumer protection;
- The need for regulatory distinctions between retail and wholesale products; and
- Financial literacy.

7. Regulators provided with independence, prominence, authority, and accountability

- The regulatory system should ensure regulatory agencies have adequate independence, prominence, tools, and authority to meet their regulatory goals.
- A mechanism should be in place to ensure the regulators have adequate accountability.

8. Consistent financial oversight

- Institutions, products, and services that pose similar risks should be subjected to consistent regulation, oversight, and transparency.

- The level of consolidation necessary to streamline financial regulatory activities across the financial services industry should be determined.
- International coordination should be considered.

9. Minimal taxpayer exposure

- The regulatory system should have adequate safeguards to prevent financial instability while minimizing moral hazard, and to effectively minimize taxpayer loss related to financial instability.

Besides the nine framework elements, GAO also advised Congress and the financial services regulatory agencies to ensure effective communication among all affected parties, including regulators, financial institutions, investors and consumers, and attract additional quality staff during the transition period.

KPMG Commentary

The current credit and market liquidity crisis, which has been ongoing since mid-2007 and promises to continue throughout 2009, has added momentum to the call for regulatory restructuring in the financial services industry. With the advent of a new administration, expectations are high that meaningful reforms are on the horizon. The Treasury's Blueprint is only one of a number of possible approaches that policymakers, including Congress and the regulatory agencies themselves, will be considering.

The North America Securities Administrators Association has published (November 2008) its own Core Principles for regulatory reform that are similar to those elements identified by GAO. They include:

- Improving state and federal collaboration;
- Closing regulatory gaps by subjecting all financial products and markets to regulation;
- Strengthening standards of conduct, and use "principles" to complement rules, not replace them;
- Improving oversight through better risk assessment; and
- Strengthening enforcement.

Regardless of the regulatory reform to come, financial institutions must prepare for:

- Higher expectations for increased transparency of formal documentation of enterprise-wide risk management controls, including firm-wide risk assessments, monitoring, reporting, training, testing/auditing and ongoing assessment of the effectiveness of the controls;
- Board and executive management demonstration of accountabilities with respect to managing enterprise-wide risk;
- Higher expectations on fulfilling not only the technical requirements but also meeting the intent and the spirit of the regulations;
- Increased levels of communication with the regulators in describing financial products and verifying consumers' understanding of those products; and,
- Heightened scrutiny from the regulators, including the risks associated with securitizations and consumer compliance, as well as, liquidity risk, credit risk, reputation risk and counterparty risk.

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