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Report to Congressional Addressees

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FINANCIAL REGULATORY REFORM

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

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Highlights

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

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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.

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Abbreviations

ABCP	asset-backed commercial paper
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
HUD	Department of Housing and Urban Development
LEI	legal entity identifier
MBS	mortgage-backed securities
MMFs	money market fund
OCC	Office of the Comptroller of the Currency
OFR	Office of Financial Research
OLA	Orderly Liquidation Authority
OTC	over-the-counter
SEC	Securities and Exchange Commission
SIFI	systemically important financial institution
SRO	self-regulatory organization
Treasury	Department of the Treasury

January 23, 2013

The Honorable Debbie Stabenow
Chairwoman
Committee on Agriculture, Nutrition and Forestry
United States Senate

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate

The 2007-2009 financial crisis threatened the stability of the U.S. financial system and the health of the U.S. economy. Many households suffered as a result of falling asset prices, tightening credit, and increasing unemployment. In response to the crisis, the federal government took unprecedented steps—providing hundreds of billions of dollars of capital and over a trillion dollars of emergency assistance to financial institutions—to stem the unraveling of the financial services sector and restore order to the credit markets. Although many factors likely contributed to the crisis and the relative role of these factors is subject to debate, gaps and weaknesses in the supervision and regulation of the U.S. financial system generally played an important role. In 2009, we designated reforming the financial regulatory system as a high-risk area and also identified characteristics that should be reflected in any new regulatory system.[1]

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which includes numerous reforms to strengthen oversight of the financial services sector.[2] Although the financial services industry, academics, and others generally have supported the Dodd-Frank Act's goal of enhancing the stability of the U.S. financial system, the act's implementation has not been free of

[1]See GAO, *High-Risk Series: An Update*, GAO-09-271 (Washington, D.C.: January 2009) and *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]Pub. L. No. 111-203, 124 Stat. 1376 (2010).

controversy or debate. For example, no consensus exists on the extent to which the act will help to reduce the likelihood and severity of future financial crises. In addition, some market observers have raised concerns about the pace of reform, with some suggesting that reform is occurring too slowly and others arguing that it is moving too quickly.

We prepared this report under the authority of the Comptroller General to conduct work on GAO's initiative to assist Congress with its oversight responsibilities. Specifically, this report examines the (1) overall status of U.S. financial regulatory reforms arising from the act, (2) challenges affecting the implementation of these reforms, and (3) areas that pose continued risk. To address our objectives, we synthesized GAO's body of work on Dodd-Frank Act reforms and other financial regulatory reform efforts and challenges.[3] We also reviewed and analyzed government, academic, and other studies on Dodd-Frank Act reforms and implementation. To examine regulators' efforts to implement the provisions of the Dodd-Frank Act, we focused on eight major reform areas: capital requirements; resolution of financial institutions; proprietary trading; derivatives; consumer protection; mortgage reforms; expanded regulation of institutions and products; and investor protection. We also obtained and analyzed information from a database maintained by the law firm Davis Polk and Wardwell that identified provisions of the Dodd Frank Act that require and authorize regulators to take actions, and tracks the status of regulators' efforts to implement these provisions. We then used various sources and assumptions to compile a list of provisions requiring actions by regulators, including discussing provisions with agency officials who are responsible for implementation of the majority of these efforts. We focused our analysis on provisions that required rulemakings and other key actions, but excluded other requirements, such as those to publish studies. In addition, we used our professional judgment to categorize the information from the law firm and financial regulators. Using different sources, assumptions, and judgments in compiling the list of provisions requiring rulemakings and other key actions could result in different totals, and therefore the information we provide should not be taken as a definitive count of all actions required by the act.

[3]See Related GAO Products at the end of this report.

We also interviewed officials from seven federal financial regulators—Board of Governors of the Federal Reserve System (Federal Reserve), Bureau of Consumer Financial Protection—also known as the Consumer Financial Protection Bureau (CFPB), Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Office of the Comptroller of the Currency (OCC), and Securities and Exchange Commission (SEC), as well as staff from the Financial Stability Oversight Council (FSOC) about their implementation of various Dodd-Frank reforms, challenges they are facing, and areas that continue to pose risk.[4] In addition, we interviewed industry and consumer groups about these issues and obtained the views of market observers and experts who have written about various Dodd-Frank Act reforms. Appendix I contains additional information on our scope and methodology.

We conducted this performance audit from June 2012 to January 2013 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.

Background

The financial regulatory framework in the United States was built over the last 150 years, largely in response to crises and significant market developments. As a result, the regulatory system is complex and fragmented. For some time, we have reported that the U.S. financial regulatory system has not kept pace with major developments in financial markets and products in recent decades.[5] Although the Dodd-Frank Act

[4]For the purposes of this report, the term financial regulators includes the federal financial regulators (the Federal Reserve, OCC, CFTC, SEC, CFPB, FDIC, and FHFA) as well as the Department of the Treasury and FSOC.

[5]See for example, GAO-09-216; *Financial Regulation: Modernization of the Financial Services Regulatory System,* GAO/T-GGD-95-121 (Washington, D.C.: Mar. 15, 1995); *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk,* GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999); and *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure,* GAO-05-61 (Washington, D.C.: Oct. 6, 2004).

has brought additional changes, the U.S. financial regulatory structure largely remains the same.

The U.S. financial regulatory structure is a complex system of multiple federal and state regulators as well as self-regulatory organizations (SRO). In the banking industry, the specific regulatory configuration depends on the type of charter the depository institution chooses. Charter types for depository institutions include commercial banks, savings associations, and credit unions. These charters may be obtained at the state or federal level. The prudential regulators—all of which generally may issue regulations and take enforcement actions against industry participants within their jurisdiction—are identified in table 1.

Table 1: Prudential Regulators and Their Basic Functions, 2012

Agency	Basic function
Office of the Comptroller of the Currency	Charters and supervises national banks and federal savings associations.
Board of Governors of the Federal Reserve System	Supervises state-chartered banks that opt to be members of the Federal Reserve System, bank holding companies, thrift holding companies and the nondepository institution subsidiaries of those institutions, and nonbank financial companies designated for enhanced supervision by the Financial Stability Oversight Council.
Federal Deposit Insurance Corporation	Supervises FDIC-insured state-chartered banks that are not members of the Federal Reserve System, as well as federally insured state savings associations; insures the deposits of all banks and thrifts that are approved for federal deposit insurance; and resolves all failed insured banks and thrifts and has been given the authority to resolve large bank holding companies and certain nonbank financial companies that are subject to supervision by the Board of Governors of the Federal Reserve System and subject to enhanced prudential standards.
National Credit Union Administration	Charters and supervises federally chartered credit unions and insures savings in federally and most state-chartered credit unions.

Source: OCC, Federal Reserve, FDIC, and National Credit Union Administration.

In addition, as will be discussed, the Dodd-Frank Act created CFPB as an independent bureau in the Federal Reserve System that is responsible for regulating the offering and provision of consumer financial products and services under federal consumer financial laws. Under the Dodd-Frank Act, certain authority vested in the prudential regulators and other regulators was transferred to CFPB on July 21, 2011.

The securities and futures industries are regulated under a combination of self-regulation (subject to oversight by the appropriate federal regulator) and direct oversight by SEC and CFTC, respectively. SEC oversees the securities industry's SROs, and the securities industry as a whole, and is responsible for administering federal securities laws and developing regulations for the industry. SEC's overall mission includes protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation. CFTC oversees the futures industry and its SROs. Under the Dodd-Frank Act, CFTC also has extensive responsibilities for the regulation of swaps and certain entities involved in the swaps markets, and SEC has comparable authority for markets in security-based swaps. CFTC and SEC have responsibility for administering federal legislation and developing comprehensive regulations to protect the public from fraud and manipulation, insure the financial integrity of markets, and help to foster better risk management, among other things. Further, state regulators oversee the insurance industry and contribute to the oversight of banks and securities as well.

Certain housing market participants, including the housing finance government-sponsored enterprises—Fannie Mae and Freddie Mac (the enterprises)—and the Federal Home Loan Bank System, are supervised by FHFA. FHFA has authority to take enforcement actions against, appoint itself conservator or receiver for, and resolve these enterprises.

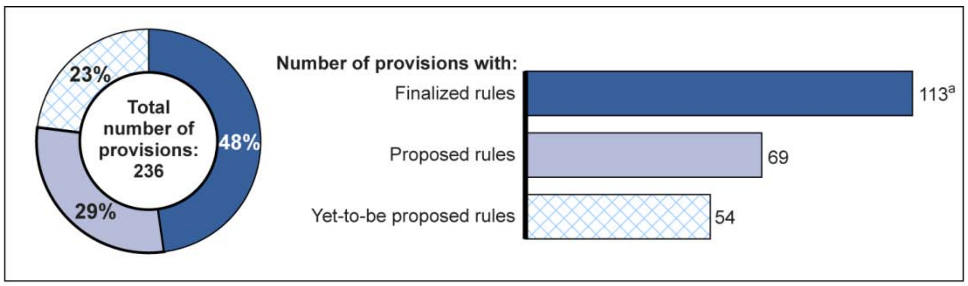
Regulators Have Made Progress in Implementing Dodd-Frank Act Reforms, but Many Efforts Are Ongoing

Federal financial regulators are continuing to implement reforms pursuant to the Dodd-Frank Act. A key goal of the act was to promote the stability of the financial system, and the act puts forward a number of reforms to achieve this goal, such as provisions related to identifying and addressing systemic risk and enhancing supervision of large, complex financial institutions.[6] Other reforms seek to expand protections for consumers and investors and expand oversight to entities that were less regulated. The implementation of the reforms is largely being driven by the rulemakings or other key actions of the various responsible financial regulators, and as figure 1 shows, the status of the regulators' implementation of these reforms varies. As of December 2012, regulators had finalized rules for a little less than half of the 236 required rulemakings and other key

[6]Systemic risk refers to the possibility that a single event could broadly affect the entire financial system, causing widespread losses rather than just losses at one or a few institutions.

rulemakings that we identified. The remaining required rulemakings and other key rulemakings have not been finalized or have yet to be proposed. Additionally, of the 236 provisions we identified, over two-thirds (157) required regulators to take action by a specific date. Among the provisions with deadlines that passed as of December 2012 (a total of 134 provisions), regulators had missed the act's deadlines for the majority (119, or 89 percent) of the provisions.

Figure 1: Status of Regulators' Efforts to Implement Dodd-Frank Provisions, as of December 2012



Source: GAO analysis of data from Davis Polk Wardwell, Federal Reserve Bank of St. Louis, and financial regulators.

Notes: We used various sources and assumptions to compile a list of provisions requiring regulators to issue rulemakings and other key actions, including using our professional judgment to categorize information from a private law firm and financial regulators. Using different sources, assumptions, and judgments in compiling the list of provisions could result in different totals, and therefore the information we provide should not be taken as a definitive count of all actions required by the act. See appendix I for information on our methodology.

[a]This amount includes 96 provisions for which regulators have finalized a rule that is also effective; 4 provisions for which multiple regulators are required to issue a rule, and at least one regulator has finalized a rule that is also effective; and 13 provisions for which regulators have issued a final rule, but was not effective as of December 2012.

Various Reforms That Could Enhance System Stability Are Underway but Remain Incomplete

The recent crisis highlighted several sources of systemic risk, including the potential for one financial firm's distress to spill over into the broader financial system and economy and for systemic risk to be generated and propagated outside of the largest financial firms. This was due, in part, to interconnections not only among firms but also among markets. To better monitor and contain the potential for such events to create systemic risk and increase overall system stability, the act mandated various reforms including creating FSOC and the Office of Financial Research (OFR); establishing heightened prudential requirements for certain nonbank financial companies and new capital standards for banks and bank holding companies; establishing the Orderly Liquidation Authority (OLA) to address failures of certain financial institutions; expanding the regulation of the swaps market; and banning banking entities from engaging in certain types of trading and investments. However, the implementation of many of these reforms remains ongoing and the effectiveness of some remains an open question.

Creation of FSOC and OFR

The 2007-2009 financial crisis highlighted the lack of an agency or mechanism responsible for monitoring and addressing risks across the financial system and a shortage of timely information to facilitate this oversight. To address these limitations, the Dodd-Frank Act created FSOC to provide, for the first time, an entity charged with monitoring and identifying risks to financial stability throughout the entire financial system. The act also established OFR to serve FSOC, its member agencies, and the public by improving the quality, transparency, and accessibility of financial data and information; conducting and sponsoring research related to financial stability; and promoting best practices in risk management.[7]

The act tasks FSOC with identifying risks to the financial stability of the United States, promoting market discipline by eliminating expectations of government shields against losses, and responding to emerging threats to the stability of the U.S. financial system. The Dodd-Frank Act provides that FSOC consists of 10 voting members and 5 nonvoting members.[8] The 10 voting members provide a federal regulatory perspective and an independent insurance expert's view. The 5 nonvoting members offer different insights, including state-level representatives from banks, securities, and insurance regulators and directors of some new offices within Treasury—OFR and the Federal Insurance Office—that were established by the Dodd-Frank Act. FSOC is chaired by the Secretary of the Treasury. The Dodd-Frank Act requires that the council meet at least once a quarter; however, FSOC has met more frequently, with FSOC reporting that it met 12 times from July 2011 to July 2012. FSOC has fulfilled statutory requirements for issuing various studies, including those

[7]For additional information on FSOC and OFR, see GAO, *Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions*, GAO-12-886 (Washington, D.C.: Sept. 11, 2012).

[8]The voting members of FSOC include the Secretary of the Treasury and the heads of CFPB, CFTC, FDIC, Federal Reserve, FHFA, National Credit Union Administration, OCC, SEC, and an independent voting member with insurance expertise. The nonvoting members include the director of the Federal Insurance Office, the director of OFR, and a state banking supervisor, a state insurance commissioner, and a state securities commissioner.

on regulating proprietary trading, contingent capital, and concentration limits on large financial companies.[9] FSOC has also issued two annual reports addressing market and regulatory developments across the financial system. In addition, FSOC voluntarily issued rulemakings explaining the processes and criteria that it will follow in designating financial market utilities—entities that provide critical services to the markets such as clearinghouses that process trading information and facilitate payments associated with trades—as systemically important and nonbank financial companies for supervision by the Federal Reserve.

OFR—created by the act to support FSOC, its member agencies, Congress, and the public by improving financial data and conducting research related to financial stability—has taken a number of steps to help fulfill its mission.[10] For example, in July 2012 OFR released its first annual report, which assessed the state of the U.S. financial system.[11] OFR has also begun a process to assemble an inventory of data that FSOC member agencies obtain, which OFR staff described as a first step toward standardizing data, reducing duplication, and eventually lowering costs for industry and regulators. OFR has also collaborated with industry, foreign government entities, and international bodies in efforts to create a legal entity identifier (LEI), which OFR describes as an emerging global standard that will enable regulators and companies around the world to quickly and accurately identify parties to financial transactions. Additionally, OFR has initiated a working paper series in which OFR researchers often collaborate with outside academics. Three papers have been published, including one that catalogs systemic risk monitoring systems and another that describes ways to improve risk management at financial institutions. Several more papers will be published in the coming months.

[9]Although contingent capital can be defined in various ways, it can refer to instruments that (1) are not regulatory capital instruments but convert into a regulatory capital instrument, (2) are regulatory capital instruments but convert into a more subordinate form of regulatory capital (such as common equity capital) that would absorb losses earlier, or (3) contractually require the holder of the instrument to purchase a regulatory capital instrument of the issuer upon the occurrence of a trigger event. In addition, contingent capital is sometimes used to describe a debt instrument subject to the “bail-in” or write-off at the point of failure of an institution to provide capital for an orderly resolution of the institution without government support.

[10]The provisions dealing with OFR are contained primarily in subtitle B of title I, §§ 151-156, codified at 12 U.S.C. §§ 5341-5346.

[11]Office of Financial Research, *2012 Annual Report* (Washington, D.C.: July 20, 2012).

Although the creation of FSOC and OFR could assist the U.S. regulatory system in identifying systemic threats, they will have to overcome various challenges to help ensure that these reforms achieve their intended goals. First, FSOC's key missions—to identify risks to financial stability and respond to emerging threats—are inherently challenging. For example, key indicators, such as market prices, often do not reflect these risks; such threats do not develop in precisely the same way in successive crises; financial innovations are not well understood; and according to experts, effectively monitoring and mitigating systemic risk is a very large and procedurally complex undertaking. Additionally, actions to preemptively mitigate threats may appear unnecessary or too costly at the time they are proposed or taken. Second, FSOC's effectiveness hinges to a large extent on collaboration among its many members, almost all of whom come from federal and state agencies with their own specific statutory missions. In testifying before Congress on Dodd-Frank rulemakings, the chairperson of FSOC recognized this challenge, noting that coordination in the rulemaking process was hard because the act left in place a financial system with a complex set of independent agencies with overlapping jurisdictions and different responsibilities. Third, OFR faces the challenge of trying to build a world-class research organization from the ground up while meeting shorter-term goals and responsibilities. Those researchers who supported the creation of OFR have suggested that it will take many years for the new entity to provide the insights that will ultimately be expected of it.

In addition, in a September 2012 report, we concluded that the ability of FSOC and OFR to fundamentally change the way the federal government monitored threats to financial stability remains to be seen.[12] The uncertainty partly stemmed from the newness of the entities, as both were continuing to develop needed management structures. But we also noted that limits in FSOC's and OFR's transparency contributed to questions about their effectiveness. We made 10 recommendations to FSOC and OFR to strengthen their accountability and transparency. These include FSOC and OFR clarifying their monitoring responsibilities to better ensure that the monitoring and analysis of the financial system are comprehensive and not unnecessarily duplicative, and FSOC systematically sharing key financial risk indicators among member agencies to assist in identifying potential threats for further monitoring or

[12]See GAO-12-886.

analysis. In responding to the recommendations in this report, Treasury emphasized the progress that FSOC and OFR have made since their creation, including preparing rules and guidance, promoting transparency and accountability by testifying before Congress, providing information to oversight bodies, and making information available on websites. Treasury also stated that officials would carefully consider the report's findings and recommendations, and would share them with the council for their review and consideration.

New Heightened Prudential Requirements and Capital Standards

The recent financial crisis revealed weaknesses in the existing regulatory framework for overseeing financial institutions. For example, although large, interconnected financial firms were subject to some form of federal supervision and regulation, the oversight proved inadequate and inconsistent. The crisis also showed that regulators did not require financial firms to hold sufficient capital to cover their trading and other losses or plan for a scenario in which liquidity was sharply curtailed.

To address these shortcomings, the Dodd-Frank Act requires the Federal Reserve to supervise and develop enhanced capital and prudential standards for bank holding companies, including foreign banking organizations, with $50 billion or more in consolidated assets and nonbank financial companies designated by FSOC for supervision by the Federal Reserve.[13] The act also requires the Federal Reserve to establish a regulatory framework for the early remediation of financial weaknesses for these companies. The act requires the enhanced prudential standards to be more stringent than standards applicable to other bank holding companies and financial firms that do not present similar risks to U.S.

[13]The Dodd-Frank Act does not use the term "systemically important financial institution" (SIFI). This term is commonly used by academics and other experts to refer to bank holding companies with $50 billion or more in total consolidated assets and nonbank financial companies designated by FSOC for Federal Reserve supervision and enhanced prudential standards under the Dodd-Frank Act. For purposes of this report, we refer to these bank and nonbank financial companies as bank systemically important financial institutions (bank SIFI) and nonbank systemically important financial institutions (nonbank SIFI), respectively. We also refer to nonbank SIFIs and bank SIFIs collectively as SIFIs when appropriate.

financial stability.[14] The act further requires the enhanced standards to increase in stringency based on the risk characteristics of each firm. In general, the Federal Reserve has authority to tailor the application of the prudential standards, including differentiating among companies on an individual basis or by category.

Some key actions to implement these reforms have not been completed. The Federal Reserve has issued proposed and final rules implementing certain elements of these requirements. In January 2012, the Federal Reserve proposed regulations on enhanced prudential standards and early remediation requirements for U.S. bank holding companies with total consolidated assets of $50 billion or more and U.S. nonbank financial companies supervised by the Federal Reserve. These proposed regulations included risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, overall risk management and risk committee requirements, stress test requirements, early remediation requirements, and debt-to-equity ratio requirements for companies that FSOC has determined pose a grave threat to financial stability. In October 2012, the Federal Reserve issued a final rule implementing the supervisory and company-run stress test requirements included in the December 2011 proposal.[15] In December 2012, the Federal Reserve issued proposed regulations that would implement the enhanced prudential standards and early remediation requirements required to be established by the Dodd-Frank Act for foreign banking organizations and foreign nonbank financial companies supervised by the Federal Reserve. According to the Federal Reserve, the proposed standards for foreign banking organizations are broadly consistent with the standards proposed for large U.S. bank holding companies and U.S. nonbank financial companies.

[14]As we previously reported, the act provided that FSOC may determine whether a nonbank financial company shall be supervised by the Federal Reserve and subject to prudential standards if it determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States. The act lists specific factors for FSOC to consider in making these determinations along with any other risk-related factors it deems appropriate. Bank holding companies with $50 billion or more in total consolidated assets are also subject to the Federal Reserve's enhanced supervision and prudential standards. See GAO-12-886.

[15]As required by the act, FDIC and OCC also issued rules in October 2012 mandating stress testing by the institutions they supervise with assets of over $10 billion.

In addition to the enhanced prudential standards for certain U.S. bank holding companies and identified U.S. nonbank financial companies, under the act, the regulators are also required to establish minimum leverage and risk-based capital requirements, on a consolidated basis, that apply to insured depository institutions, bank and thrift holding companies, and systemically important nonbank financial companies.[16] In June 2012, OCC, the Federal Reserve, and FDIC proposed comprehensive revisions to their regulatory capital framework through three concurrent notices of proposed rulemaking. The proposals would revise the agencies' current capital rules to incorporate changes made by the Basel Committee on Banking Supervision—a body that sets international standards for bank capital and liquidity—to the Basel capital framework consistent with relevant provisions of the Dodd-Frank Act.[17] According to the regulators, the reforms contained in the rule would, among other things, improve the resilience of the banking sector in times of stress. The proposed rules, which were published in August 2012, include an extended comment period that ended in October 2012. The provisions in U.S. regulators' implementation of these capital requirements are intended to conform to these international standards and are proposed to phase in over the next 10 years. The agencies received thousands of comment letters from the public, including banking organizations of all sizes, trade groups, academics, public interest advocates, and private individuals, through the comment period. According to testimony before Congress given by the Federal Reserve's banking supervision director, the breadth of the proposed changes has raised concerns among many industry participants that a January 2013

[16]These capital requirements are subject to two floors. Regulators must apply to U.S. bank holding companies and other nonbank financial companies designated for supervision by the Federal Reserve the same minimum leverage capital and risk-based capital requirements that apply to federally insured depository institutions. In addition, the minimum capital requirements may not be quantitatively lower than the capital requirements that were in effect for insured depository institutions as of the date when the act was enacted. The Federal Reserve, FDIC, and OCC also issued Dodd-Frank Act-required rules establishing a minimum capital floor.

[17]The Basel Committee has developed international standards for bank capital and liquidity for its member economies since the 1980s. The latest international proposal, known as Basel III, seeks to improve the quality of regulatory capital and introduces a new minimum common equity requirement, among other things. The Federal Reserve intends to satisfy some aspects of the Dodd-Frank Act requirements for heightened prudential standards for bank SIFIs by implementation of the standards of the Basel Committee on Banking Supervision. The Federal Reserve will separately implement consistent capital and liquidity standards for nonbank SIFIs.

implementation date for the rules would not provide sufficient time for them to understand the rules or make necessary system changes. As a result, the banking agencies announced in November 2012 that they did not expect to finalize the proposal by January 2013—as expected in the Basel Agreement.

Establishment of Resolution Reforms

During the recent crisis, the federal government took unprecedented actions to address the financial difficulties of several large financial firms, including making equity investments in some firms or placing others in government-administered conservatorships. The Dodd-Frank Act provides a new option for resolving failing financial firms whose disorderly resolution would have serious adverse effects on U.S. financial stability by creating a process under which FDIC has the authority to liquidate large financial firms, including nonbanks, outside of the bankruptcy process—called the Orderly Liquidation Authority (OLA). Under this authority, FDIC may be appointed receiver for a financial firm if the Treasury Secretary determines that the firm's failure threatens U.S. financial stability. SIFIs also must formulate and submit to the Federal Reserve, FSOC, and FDIC resolution plans (or "living wills") that detail how they could be resolved in the event of material financial distress or failure.[18]

Progress has been made to implement the reforms related to resolving large, complex financial companies. For instance, FDIC finalized several rules to implement OLA. The Federal Reserve and FDIC finalized and made effective rules relating to resolution plans, and the large financial institutions that were the first firms required to prepare such plans submitted these to regulators as expected in July 2012. However, work remains to be completed in other important areas. Rules that either remain in proposed form or have not yet been proposed include those that establish a program to guarantee obligations of solvent depository institutions and their holding companies and affiliates during times of

[18]As we previously reported this provision requires each nonbank financial company supervised by the Federal Reserve and each bank holding company with total consolidated assets of $50 billion or more to submit periodically to the Federal Reserve, FDIC, and FSOC a plan for the firm's rapid and orderly resolution in the event of material financial distress or failure. Such a firm also must submit a report on the nature and extent of credit exposures the company has to significant bank holding companies and significant nonbank financial firms and the same types of exposures such firms have to the reporting firm. See GAO, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges,* GAO-11-707 (Washington, D.C.: July 19, 2011).

severe economic stress, and implement OLA for broker-dealers. In addition, regulators have not yet completed their reviews of the large bank holding companies' resolution plans.

Although many market observers expect that these resolution reforms will help mitigate threats to the financial system posed by the failure of a SIFI or other large, complex, interconnected financial firm, some questions about their potential effectiveness have been raised. Some observers noted that OLA is new and untested, and its effectiveness in reducing risky behavior by institutions will depend on the extent to which market participants believe that FDIC will use OLA to make an institution's creditors and shareholders bear losses of any SIFI failure. Furthermore, others questioned whether FDIC has sufficient capacity to use OLA to handle multiple SIFI failures and thus prevent further systemic disruption. Others have raised concerns over whether any FDIC-imposed losses on some creditors of a failed firm could threaten the soundness of other important financial institutions or how FDIC would handle the non-U.S. subsidiaries of a failed firm.

Experts also expressed mixed views on the usefulness of the living wills. One market expert expressed doubt that these living wills would prove useful for resolving a complex firm's failure, but was more optimistic that the documents could serve to encourage regulators to make such firms simplify their organizational structures and become more transparent. Experts further noted that resolution plans may provide regulators with critical information about a firm's organizational structure that could aid the resolution process or motivate SIFIs to simplify their structures and this simplification could help facilitate resolution. However, other experts commented that although resolution plans may assist regulators in gaining a better understanding of SIFI structures and activities, the plans may not be useful guides during an actual liquidation—in part because the plans could become outdated or because the plans may not be helpful during a crisis. Resolution plans also may provide limited benefits in simplifying firm structures, in part because tax, jurisdictional, and other considerations may outweigh the benefits of simplification.

Regulation of the Swaps Market

FSOC has found that over-the-counter (OTC) derivatives, particularly credit default swaps, generally were a factor in the propagation of risks during the recent crisis because of their complexity and opacity, which contributed to excessive risk taking, a lack of clarity about the ultimate distribution of risks, and a loss in market confidence.[19] Although some standardized swaps, such as certain interest rate swaps, have been cleared through clearinghouses—which stand between counterparties in assuming the risk of counterparty default—credit default swaps and most other swaps traditionally have been traded in the OTC market where holders of derivatives contracts bear the risk of counterparty default.[20] Title VII of the Dodd-Frank Act establishes a new regulatory framework for swaps to reduce risk, increase transparency, and promote market integrity in swaps markets by, among other things, moving trading to exchanges (or similar trading platforms), requiring that many trades are to be centrally cleared, and providing for greater public dissemination of trading information. To implement the act's reforms, SEC is responsible for any security-based swaps, SEC and CFTC are jointly responsible for mixed swaps, and CFTC is responsible for all other types of swaps.[21]

Progress has been made in implementing derivatives reforms. CFTC officials noted that swap reform has involved multiple rulemakings including rules, such as defining swaps, registering dealers and reporting to CFTC on the size of positions in swaps held by such dealers. The swaps definition rules are in place and effective, and dealer registration is ongoing. As of April 2012, rules requiring dealers to publicly report their

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[19]See Financial Stability Oversight Council, *Financial Stability Oversight Council 2011 Annual Report* (Washington, D.C.: July 2011). OTC credit derivatives are privately negotiated contracts that allow a party to transfer the risk of default on a bond or loan to another party without transferring ownership. For example, in a credit default swap a bond investor agrees to pay a periodic premium to a financial firm in exchange for the firm's agreement to compensate the bond investor for any losses if the bond issuer defaults on the bonds.

[20]A derivatives clearinghouse or similar organization enables each party to a derivatives transaction to substitute the credit of the clearinghouse for the credit of the parties, provides for the settlement or netting of obligations from the transaction, or otherwise provides services mutualizing or transferring the credit risk from the transaction. Dealers participate in the derivatives market by quoting prices to, buying derivatives from, and selling derivatives to end users and other dealers.

[21]Under the Dodd-Frank Act, SEC has regulatory authority over "security-based swaps," which are defined as swaps based on a single security or loan or a narrow-based group or index of securities (including any interest therein or the value thereof), or events relating to a single issuer or issuers of securities in a narrow-based security index. Security-based swaps are included in the definition of "security" under the Securities Exchange Act of 1934 and the Securities Act of 1933. CFTC has primary regulatory authority over all other swaps, such as energy and agricultural swaps. CFTC and SEC share authority over "mixed swaps," which are security-based swaps that have a commodity component.

swaps positions to CFTC were final, and in December 2012 the CFTC Chairman testified that CFTC had finalized approximately 80 percent of Dodd-Frank swaps rules. However, the rules that will specify how much margin—funds posted with a clearinghouse that can serve to absorb losses as the value of the swaps position changes—and how much capital a swaps dealer must hold to absorb losses on its swaps remain incomplete.

Because swaps are globally traded, the regulatory developments in overseas markets also have affected implementation of the swaps reforms. Although many other jurisdictions have been developing new regulatory regimes, the United States has been one of the first jurisdictions to have enacted legislation in this area. The Financial Stability Board (FSB)—which is an organization of representatives of national authorities responsible for financial stability that has been established to coordinate and promote the implementation of effective regulatory, supervisory, and other financial sector policies—reported to the Group of Twenty leaders in October 2012 that regulatory uncertainty remains the largest impediment to timely implementation of swaps regulatory reforms across countries.[22] FSB urged continued discussions to identify and address any conflicts in rules affecting cross-border activities. According to SEC staff, SEC and CFTC have been active participants in these ongoing discussions. In some cases, international bodies have requested the delay of some derivatives-related regulations because of the importance of coordination. For example, CFTC officials noted that one of the reasons their Commission voted to reopen the comment period for the swaps capital and margin requirement rule was to allow European regulators to complete similar rules, potentially by early 2013.

Restrictions on Proprietary Trading

The role that proprietary trading—trading activities conducted by banking entities for their own accounts as opposed to those of their clients—played in the recent crisis is a matter of debate. Some experts have stated that the ability of banking entities to use federally insured deposits to seek profits for their own accounts provides incentives for them to take on excessive risks. In particular, academics have noted that commercial banks benefit from government-insured deposits that subsidize their

[22]The Group of Twenty is a forum for international cooperation on the important issues of the global economic and financial agenda and consists of the finance ministers and central bank governors from 19 countries and the European Union.

funding and thus do not bear the full risks of their proprietary activities.[23] We previously reported that proprietary trading provided revenues but also produced large losses for some financial institutions during the recent crisis.[24] However, others dispute that proprietary trading creates significant risks. For example, one market observer questioned the role of proprietary trading in the crisis—noting that losses by banks came from holdings of mortgage-related securities and not their proprietary trading activities. In addition, he noted that banks have expertise and add value in conducting trading activities and that such trading is likely not more risky than lending.

To address potential risks of proprietary activities, the act generally prohibits proprietary trading by insured depository institutions and their affiliates and restricts the extent to which these companies can sponsor or invest in hedge and private equity funds. Regulators have taken some steps to implement this reform. For instance, the Federal Reserve issued the final rule and subsequent policy statement on the time frame for the effective dates (beginning in July 2014 unless extended by the Federal Reserve) after which banking entities must fully conform their activities and investments with these requirements. FSOC also issued a study recommending the types of monitoring metrics that regulators could use to help ensure compliance. In addition, the regulators responsible for issuing a rule specifying how affected institutions must comply—the Federal Reserve, FDIC, OCC, SEC, and CFTC—issued proposed rules in November 2011 and February 2012.[25] The proposed rules have generated debate and interest from thousands of commenters, and some in Congress have called for a repeal of the law or delay of its implementation, and others have called for regulators to issue a revised proposal. As of November 2012, staff from some of the regulators responsible for preparing the rules related to proprietary trading and fund investment restrictions told us that they were considering the public

[23]Arnoud W.A. Boot and Lev Ratnovksi, *Banking and Trading,* IMF working paper, October 2012.

[24]See GAO, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented,* GAO-11-529 (Washington, D.C.: July 13, 2011).

[25]The banking regulators and SEC published their proposed rule on November 7, 2011, and CFTC published a substantially similar rule on February 14, 2012.

comments and next steps, but could not estimate when the next action would occur. In our 2011 report on proprietary trading, we recommended that regulators collect and review more comprehensive information on the nature and volume of activities potentially covered by the act.[26]

Reforms to Address Consumer and Investor Protection and Other Areas Have Begun but Remain Incomplete

Regulators have also been implementing Dodd-Frank Act reforms to improve protections for consumers and investors. In addition to creating a new regulatory body—CFPB—that will consolidate certain rulemaking, supervision, and enforcement authorities relating to various consumer financial laws, including many of those relating to mortgage lending, the act also included changes to securitization practices to better protect investors. In addition, the act expands regulatory oversight of credit rating agencies and advisers of private funds.

Creation of CFPB

Many bank and nonbank mortgage lenders weakened their underwriting standards and made mortgage loans to homebuyers who could not afford them or engaged in abusive lending practices before the crisis. After many homeowners were unable to make their mortgage payments, many of these mortgages went into default and led to widespread foreclosures. To address these consumer financial protection failures, the act created CFPB, among other reforms. Before the passage of the act, consumer financial protection responsibilities were vested in multiple agencies across the federal government. The creation of CFPB brought many of the consumer financial protection rulemaking and other authorities of the federal government into one agency, with the purpose of increasing accountability for such responsibilities. The authority for many of these responsibilities transferred to CFPB in July 2011, but staff told us that it was not allowed to move forward with its full regulatory responsibilities until the appointment of its director in January 2012. CFPB has issued rules and begun taking enforcement actions, including obtaining refunds for consumers and imposing penalties on certain credit card issuers for practices that violated the law. For example, in January 2012, CFPB issued rules, which were formally published in February 2012, to protect consumers who send money electronically to foreign countries. In January 2013, the CFPB issued two rules that established numerous mortgage servicing requirements.

[26] GAO-11-529.

Although CFPB's mission extends beyond the mortgage market, many of its initial rulemaking efforts have focused on this market as the bureau works to implement the act's reforms. For example, the act prohibits a creditor from making a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is made, the consumer has a reasonable ability to repay the loan according to its terms. When making that determination, the creditor must consider, among other things, the consumer's income and assets, debt obligations, and credit history. The act created a presumption of compliance with the repayment ability requirement when creditors make "qualified mortgages."[27] The Federal Reserve issued a proposed rule in May 2011 that would implement the act's ability-to-repay and qualified mortgage provisions; however, due to certain transfers of authority under the Dodd-Frank Act CFPB has responsibility for finalizing the proposal. After seeking additional public comments on new data and information related to this proposal in June 2012, CFPB issued a final rule in January 2013 that defines qualified mortgages using the criteria specified in the Dodd-Frank Act. This rule is to be effective in January 2014. Although intended to encourage responsible lending, many market observers (including consumer advocates and lenders) previously have expressed concern that the rule, as proposed, could result in overly restrictive requirements (such as debt service-to-income ratios) that would limit the availability of mortgages to lower-income and minority borrowers. However, in a prior report, we examined five of the nine qualified mortgage criteria specified in the Dodd-Frank Act for which sufficient data were available and generally found that, for each year from 2001 through 2010, most mortgages would likely have individually met each specific criterion.[28]

[27]A qualified mortgage, generally, is a mortgage based on verified and documented borrower income, that is typically a 30-year fixed or adjustable rate loan with points, with fees that do not exceed 3 percent of the total loan, and with payments that do not result in an increase in the principal balance.

[28]These criteria address payment of loan principal, length of the mortgage term, scheduled lump-sum payments, documentation of borrower resources, and borrower debt burden. We were unable to determine the proportion of mortgages that would have met all of the criteria we examined due to data limitations. See GAO, *Mortgage Reform: Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market*, GAO-11-656 (Washington, D.C.: July 19, 2011).

New Securitization Practices and Disclosures

The act also attempts to improve investor protections through a variety of reforms, including reforming securitization practices and requiring additional disclosures. According to some market observers, institutions that created mortgage-backed securities in the lead-up to the crisis engaged in a number of practices that undermined the quality of their securities, including not adequately monitoring the quality of the underlying mortgages, because they did not bear the risk of significant losses if those mortgages defaulted.[29] To address this risk and protect investors, the act imposes certain risk-retention obligations on securitizers to retain an economic interest of no less than 5 percent of the credit risk of any securitized asset (such as a residential mortgage) that they created unless the asset meets criteria (to be defined by the regulators) associated with a lower risk of default. Securitized mortgages that meet the criteria are exempt from the risk-retention requirement and are referred to as qualified residential mortgages. The act directs the Federal Reserve, FDIC, OCC, SEC, FHFA, and the Department of Housing and Urban Development (HUD) to jointly prescribe rules to implement these requirements. The act also requires additional disclosures to be made to investors about these asset-backed securities. Some market participants have expressed concern that restrictive criteria for qualified residential mortgages would subject some mortgages with relatively low default risks to risk retention and make mortgage credit less affordable for many borrowers, because the increased securitization costs would be passed on to borrowers in the form of higher mortgage interest rates and fees.[30] However, FDIC officials have stated that risk retention should not result in substantially higher interest rates for non qualified residential mortgage borrowers and comes with the benefit of safer and sounder lending practices. Additionally, rulemaking agencies have indicated that a more restrictive definition could help ensure that a sufficient volume of non qualified residential mortgages subject to risk retention would be available for an active, liquid securitization market for such mortgages.

[29]To securitize mortgage loans, mortgage lenders or originators can sell their loans to third parties—either directly to securitizing institutions or loan aggregators that serve as intermediaries between originators and securitizers—generating funds that could be used to originate more loans. In addition to Fannie Mae and Freddie Mac, securitizing institutions include investment banks, retail banks, mortgage companies, and real estate investment trusts that bundle mortgages and sell them as investment products.

[30]Restrictive criteria would limit qualified residential mortgages to mortgages with high credit quality, while less restrictive criteria would include mortgages with a wider range of credit quality

Although regulators have finalized some rules in this area, they have not yet completed all of the rules that would implement the reforms described above. In January 2011, SEC published final rules that will require an issuer to perform a due diligence analysis of the underlying assets and disclose the results.[31] However, other key reforms, such as the joint rulemaking requirement to define a qualified residential mortgage as well as the rulemaking requiring greater disclosure of information related to the loans backing specific portions of an asset-backed security remain incomplete.[32] These rules likely will have a significant impact on the volume of private (non-enterprise) mortgage-backed securitizations. As a result, the rules likely will affect competition in the housing finance market, which is currently dominated by the enterprises. We discuss reforming the enterprises later in the report.

Regulation of Credit Rating Agencies and Advisers of Private Funds

As the financial crisis unfolded in 2007 and 2008, questions were raised about the role that credit rating agencies played in the securitization of high-risk mortgages into investment-grade securities, the accuracy of the credit ratings assigned to these securities, and the integrity of these ratings processes. Critics of credit rating agencies also pointed to the conflict of interest created by the industry's predominant compensation model in which issuers of securities pay the rating agencies for their ratings as a contributing factor to the poor quality of ratings. In response, the Dodd-Frank Act mandated additional oversight over the credit rating agencies that issued these ratings. For example, the act created an Office of Credit Ratings within SEC, which is to provide oversight and enhanced regulation of the credit rating agencies registered with SEC as Nationally Recognized Statistical Rating Organizations. The act also requires that SEC study, among other things, an alternative means for compensating

[31]In January 2011, SEC published final rules requiring nationally recognized statistical rating organizations and issuers to provide additional disclosure about representations and warranties in asset-backed transactions. In August 2011, SEC adopted final rules regarding ongoing reporting by asset-backed issuers. In September 2011, SEC proposed rules to prohibit material conflicts of interest in asset-backed transactions.

[32]The joint rule could not be finalized until CFPB issued its rule because its definition of a qualified residential mortgage cannot be broader than CFPB's definition of a qualified mortgage.

credit rating agencies that would create incentives for accurate ratings.[33] SEC issued its study on alternative means for compensating credit rating agencies in December 2012.[34] However, as of December 2012, SEC had yet to issue key rules related to credit rating agencies, several of which had statutory deadlines. For example, a rule preventing sales and marketing considerations of credit rating agencies from influencing the production of credit ratings and a rule that will require these entities to submit annual internal control reports to SEC remain in proposed form.

Over the last decade, private funds—such as hedge funds and private equity funds—proliferated but generally were less regulated, raising questions about investor protection and systemic risk to financial markets. To address this gap, the act expands regulatory oversight to hedge and private equity funds by requiring the investment advisers to these funds to register with SEC. This would result in any such advisers that had not previously registered to begin providing reports to SEC on their activities and being subject to examinations by regulatory staff. SEC has completed all of its rulemaking requirements related to private fund oversight. SEC and CFTC also issued a joint rule, in consultation with FSOC, to establish the form and content of the reports required to be filed with SEC and CFTC by investment advisers that are registered under both the Investment Advisers Act of 1940 and the Commodity Exchange Act. The completion of these rules helps to bring a largely unregulated part of the financial markets under regulatory supervision.

[33]See GAO, *Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations*, GAO-12-240 (Washington, D.C.: Jan. 18, 2012). Among other things, this report discusses alternative models for compensating nationally recognized statistical rating organizations that issue credit ratings. GAO identified seven alternative models for compensating these entities.

[34]See SEC, *Report to Congress on Assigned Credit Ratings* (Washington, D.C.: December 2012).

Regulators Have Faced Various Challenges Implementing Reforms

A variety of challenges have affected regulators' progress in executing rulemaking requirements intended to implement the act's reforms. Regulators to whom we spoke indicated that the primary challenges affecting the pace of implementing the act's reforms include the number and complexity of the rulemakings required and the time spent coordinating with regulators and others. In addition, some regulators identified additional challenges, including extensive industry involvement through comment letters and litigation resulting from rulemakings, concurrently starting up a new regulatory body and assuming oversight responsibilities, and resource constraints.

Number and Complexity of Rulemakings Has Delayed the Implementation of Certain Reforms

The regulators identified the number and complexity of the required rulemakings as a primary impediment to their implementation of financial regulatory reforms. In particular, regulators were tasked with a large volume of rulemakings and other key actions; in many cases, the act mandated their completion in relatively short time frames compared to the typical rulemaking process. For example, we identified more than 80 provisions of the act for which SEC is responsible for (solely or jointly) developing rules or taking other key actions. As of December 2012, SEC had proposed or finalized rulemakings for at least 70 of these provisions. Similarly, we identified more than 50 provisions for which CFTC is responsible for (solely or jointly) developing rules, all but one of which CFTC had proposed or finalized. According to SEC and CFTC staff, this represents a significant increase in their rulemaking agendas.

In many cases, the rulemakings also involved complex issues, such as developing regulation for a previously unregulated market function. Implementing such complex regulatory reforms through the rulemaking process has resulted in delays, as the following examples illustrate.

- One of the major reform areas of the act requires that previously unregulated OTC swaps be brought under the regulatory umbrella. Regulators indicated this presented a unique set of challenges because the swaps market is complex and involves a large number of domestic and international participants. According to SEC staff, they had to research and acquire expertise on a range of issues. To acquire diverse perspectives and information, staff also held meetings and roundtables with industry participants and other agencies and foreign regulators before proposing the rules.

- Regulators responsible for implementing the restrictions on proprietary trading and hedge and private equity fund investing also indicated that developing rules on these topics has been challenging because of the knowledge they had to acquire and the multiple perspectives and interests of market participants they had to consider. The complexities of implementing the proprietary trading ban was highlighted in the rule proposed in November 2011 and February 2012, which included more than 750 questions seeking input from market participants to help inform regulators' decision making.

- In other cases, the complexity involved identifying and developing new frameworks or standards for market participants. For example, regulators must replace references to credit ratings in their regulations (that is, to regulated entities' use of or dependence on ratings) and substitute alternative standards of creditworthiness.[35] According to the regulators, creating objective and consistent standards for creditworthiness and defining such standards by regulation is difficult and finding an alternative to the ratings these agencies produce requires a thorough understanding of how the process has functioned in capital markets. Additionally, replacing the credit ratings with an alternative standard affects other regulations and policies that rely on credit ratings. Because of the broad effects that removal of the references to credit ratings would have, regulators stated that they had to approach this task with great care to avoid unintended consequences, which is why some of these rules have yet to be finalized.

Although the regulators have missed statutory deadlines to complete rulemakings, regulators told us that some of the mandated time frames were ambitious. For example, CFTC staff described the statutory timetable as a challenge, noting that they were required to issue a significant number of rules within the first year of the act's passage. According to some of the regulators with whom we spoke with, their staffs have prioritized "getting it right" over meeting statutory deadlines, which has resulted in missing a number of the act's deadlines.

[35] GAO-12-240.

Although Coordination among Regulators Improves Rules, It Has Delayed Implementation of Some Reforms

Regulators' progress in implementing the act's reforms also has been delayed because of the need to coordinate with other domestic and foreign regulators. We identified 58 provisions in which the act specifically mandates that regulators issue joint rules or consult with other federal financial regulators during rulemakings or other key actions. In other cases, reforms require regulators to implement rules that impact or are impacted by the rulemakings of other regulators. For example, rules related to what constitutes a "qualified residential mortgage" for securitizations have been awaiting CFPB's issuance of the rule on what constitutes a "qualified mortgage" because the act stipulates that the definition of a "qualified residential mortgage" cannot be broader than the definition of a "qualified mortgage." CFPB issued the final "qualified mortgage" rule in January 2013.

According to many regulators with whom we spoke, coordination among domestic regulators and between domestic and foreign regulators has improved the quality of the rulemakings. For example, these efforts likely have eliminated duplication and helped fill regulatory gaps to limit risks migrating to unregulated markets, according to the regulators. Nevertheless, coordination with other regulatory bodies lengthens the time required to implement reform. To facilitate domestic coordination, while financial regulators employed some formal communication methods, they mostly used informal communications strategies and tools. Regulators generally held formal interagency meetings early in the rulemaking process, then held recurring meetings at different staff levels and facilitated coordination through informal communications (e-mail, telephone conversations, and one-on-one staff conversations). For example, FDIC, OCC, and the Federal Reserve held a principal-level meeting to discuss the major issues relating to development of risk-based capital rules. Afterwards, the agencies formed an interagency working group at the staff level that continues to work on these rules.[36] In addition, FSOC has established a framework for consultation when it is required to be consulted or may make recommendations.

[36]As we previously reported, agencies can use different types of collaborative mechanisms, such as interagency groups. Our report discusses key considerations for implementing these groups. See GAO, *Managing for Results: Key Considerations for Implementing Interagency Collaborative Mechanisms*, GAO-12-1022 (Washington, D.C.: Sept. 27, 2012).

On the international level, U.S. regulators also have coordinated with foreign regulators and with international standard-setting bodies. For example, in December 2012, FDIC and the Bank of England issued a joint paper that discusses their common view about how to resolve failures of large financial institutions. Also, CFTC and SEC coordinated with securities and futures regulators in other countries on various derivatives reform provisions by participating in several international groups as well as numerous conference calls and meetings.[37] OFR staff have also coordinated with international regulators and financial market participants through the FSB to develop standards for a LEI that is intended to accurately identify parties to financial transactions.[38] OFR played a key role leading work streams and working with other regulators and industry to provide recommendations to the Group of Twenty to guide the governance, development, and implementation of a global LEI system. During the implementation phase, OFR is serving as a vice-chair on the LEI Implementation Group and will continue to provide leadership and support as this group works towards meeting the March 2013 target for launching the LEI system.

Although the federal financial regulators have developed and fostered several mechanisms to facilitate coordination and believe these efforts have improved the quality of the rulemakings, several regulators said that interagency coordination has increased the amount of time needed to develop and finalize several rulemakings. Regulators stated that working with other agencies—both domestically and internationally—can be difficult for a variety of reasons. For example, each regulator has different statutory authorities and obligations, jurisdictions, and missions. Each regulator has unique expertise and experience with the financial products or services it regulates and the supervisory structures of each agency are different. These differences can make reaching consensus (for instance, by aligning or reconciling regulations) difficult and time consuming. For example, although CFTC and SEC reached consensus on the text for the jointly issued swap entities rule, the regulators outlined different approaches in certain parts of the rule due to their regulatory jurisdiction

[37]See GAO, *Dodd Frank Act: Agencies' Efforts to Analyze and Coordinate Their Rules*, GAO-13-101 (Washington, D.C.: Dec. 18, 2012).

[38]For additional information on the legal entity identifier, see GAO, *Bankruptcy: Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority,* GAO-12-735 (Washington, D.C.: July 12, 2012).

over different products. In addition, regulators told us that they had to allow extra time for other regulators to review draft rules, hold discussions, and reach consensus.

Volume of Comments and Industry Challenges Also Have Affected Pace of Implementation

The volume of comments that regulators have received on some rules also affected the pace of rule development. For example, regulatory staff told us that they had received more than 19,000 comment letters on the proposed proprietary trading ban rules, further complicating the rulemaking process. According to these staff, the volume of comments from market participants and consumer groups has presented challenges for deciding the content of a final rule—as in the case of market participants advocating opposing or disparate positions, which regulators then needed to consider and perhaps reconcile. CFTC staff cited the example of comments relating to the amount of business that could be done before an entity would be required to register as a swaps dealer. Suggested amounts for the *de minimus* exception ranged from the millions to the billions of dollars. Although some comments regulators received on rules were multiple versions of similar form letters, in other cases the letters were unique and could be lengthy (more than 200 pages). OCC staff noted that the proprietary trading rule received more than 400 nonform letters with substantive comments, some of which were more than 100 pages each. The capital rules generated fewer comments, but these letters were very lengthy and had to be carefully considered. Regulator staff told us that high comment volume lengthens the rulemaking process and requires more staff review and analyze because each regulator is legally required to consider every comment it receives.

In addition, industry involvement, including filing legal challenges, has delayed some regulatory efforts. According to one public interest association, intense industry lobbying efforts and the threat of lawsuits have been roadblocks to successful implementation of consumer protection reforms. Also, an industry-sponsored study has criticized the impending reforms, such as the ban on proprietary trading. In other cases, legal challenges filed by the industry have affected the pace of reforms. For example, in October 2011, CFTC approved a final rule on position limits for futures, options, and swaps related to 28 physical commodities, such as agricultural and energy products or metals, an action that the agency believed the act mandated.[39] However, in September 2012, the United States District Court for the District of Columbia overturned the final rule after finding that the agency did not prove that the Dodd-Frank Act granted CFTC authority to issue the regulations without first determining the regulation was "necessary" or "appropriate" and therefore the regulations were vacated.[40] CFTC appealed the District Court's decision in November 2012, but until the appeal is completed CFTC's requirements are not in effect for market participants.[41] In another example, in July 2011 the United States Court of Appeals for the District of Columbia Circuit overturned SEC's rule on proxy access requirements on the basis that SEC had failed to perform an adequate cost-benefit analysis of the rule's impact.[42] Although this rule was not mandated by the Dodd-Frank Act, SEC staff told us that because of this decision, they have been spending additional time on developing cost-benefit analyses for the rules they must develop under the act, which has lengthened the time needed for rulemaking.

Other Challenges to Reform Implementation Included Establishing New Entities

The need to establish new regulatory bodies or offices mandated by the act affected the pace of implementation of some reforms, as illustrated by the following examples:

- The staff responsible for establishing the new federal consumer financial protection agency—CFPB—faced the challenge of simultaneously forming its agency structure, initiating supervision and oversight responsibilities, and creating rules mandated by the act. After the act was passed in July 2010, staff detailed from Treasury

[39]Futures are standard agreement contracts to buy or sell a particular amount of a commodity or financial instrument at a specific time in the future. An option is a contract that gives the holder of the option the right, but not the obligation, to buy (call option) or sell (put option) a specified amount of the underlying reference item at a predetermined price (strike price) at or before the end of the contract. A swap is a contract that typically obligates one party to make a stream of payments to another in exchange for a stream of payments from the other party, such as an interest rate swap in which one party agrees to exchange a stream of fixed interest-rate payments for a stream of variable interest-rate payments.

[40]International Swap and Derivatives Assoc. et al. v. CFTC, 2012 U.S. Dist. LEXIS 139788 (D.C. Dist., Sept. 28, 2012).

[41]The case was appealed to the United States Court of Appeals for the District of Columbia Circuit on November 16, 2012.

[42]Business Roundtable and Chamber of Commerce of United States of America v. SEC, 647 F. 3d 114, 1148-1149 (D.C. Cir. 2011).

offices and other federal agencies began hiring new staff and establishing internal administrative procedures and structures. Although rulemaking and other authorities relating to the consumer financial laws transferred to CFPB in July 2011, the agency did not have a director until January 2012. Until then, it was limited in its ability to issue certain rules and conduct certain oversight of entities other than banks. As of October 2012, the agency had about 1,000 staff and anticipates reaching approximately 1,300 staff sometime in 2013. While establishing regulatory operations, its staff also had to develop various rulemakings required by the act. As noted previously, CFPB had been working on a complex rule that would promote responsible mortgage lending by requiring creditors to consider a consumer's repayment ability before making a residential mortgage loan. CFPB staff acknowledged that establishing their agency, conducting its operations, and developing various rulemakings has been challenging and likely slowed progress in some areas.

- The creation of new offices in SEC also has affected the pace of that agency's rulemakings. More specifically, the Dodd-Frank Act required the creation of five new offices in SEC—including an Office of Credit Ratings.[43] This office was established when SEC named its director in June 2012. As a result, some activities were started by other SEC divisions and offices—including finalizing rules for credit rating agencies that require them to disclose the information and assumptions used in ratings they issue—according to SEC officials.
- OFR also has faced the challenge of trying to build a world-class research organization from the ground up while meeting shorter-term goals and responsibilities. For example, as a new, relatively unknown entity OFR had to overcome a lack of name recognition as it has sought to hire researchers and other staff. OFR officials told us that the organization has been making steady progress to overcome this challenge, and has attracted highly qualified researchers and others to senior staff positions. The absence of a Senate-confirmed director for the organization until January 2013 slowed the process. While establishing itself, OFR also has been conducting work to further its mission to provide ongoing support to FSOC and standardize the types and format of data collected and reported by financial regulators.

[43]The other four new offices within SEC are the Office of the Investor Advocate, Office of Minority and Women Inclusion, Office of the Whistleblower Protection, and Office of Municipal Securities.

According to some regulators, their efforts to fully implement the reforms also have been delayed due to resource constraints their agencies face. For example, the Dodd-Frank Act increased SEC's and CFTC's responsibilities, including their rulemaking responsibilities. However, according to SEC and CFTC staff, their agencies did not receive commensurate increases in appropriations. As a result, staff from both CFTC and SEC told us that attempting to finalize so many interrelated and often complex rules with their existing staffing levels has been challenging. CFTC staff told us that personnel responsible for some rulemakings have had to do the work of more than one person, which increases the potential for errors and delays that interrupt the normal flow of rulemaking. Looking forward, CFTC and SEC staff expressed concerns about their ability to carry out rule enforcement. To mitigate these concerns, CFTC requested 305 additional full-time equivalent positions in its 2013 budget request. Likewise, SEC requested an additional 196 full-time equivalent positions in its 2013 budget request.

Various Areas Continue to Pose Risks, and Regulatory Actions to Mitigate These Risks Have Not Been Finalized or Implemented

Although the act addressed a number of weaknesses of the regulatory system that were exposed by the recent or past financial crises, some risks remain and others have emerged. In 2009, we reported on many of the limitations in the U.S. financial regulatory system that the 2007-2009 crisis once again revealed.[44] For example, we noted that regulators had struggled, and often failed, to mitigate the systemic risks posed by large or interconnected financial conglomerates and to help ensure they adequately manage their risks. Problems in financial markets also resulted from the activities of less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which played significant roles in the financial markets. In addition, we noted that the increasing prevalence of new and more complex investment products posed challenges for regulators, investors, and consumers. In our report, we offered a framework for evaluating regulatory reform proposals that described characteristics that should be reflected in any new regulatory system (see table 2). This framework can serve as a useful lens for examining how weaknesses were addressed through the act and where additional work remains.

[44] GAO-09-216.

Table 2: GAO's 2009 Framework for Evaluating Financial Regulatory Reform

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 reexamining 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.

In a number of ways, the act's reforms—if implemented effectively—could address many characteristics of our framework. For example, the consistency of consumer protection could be increased through the establishment of CFPB, which consolidated certain of the consumer protection rulemaking, supervision, and enforcement authorities possessed by seven different federal agencies.[45] The creation of FSOC could help to address the framework's call for a systemwide focus on risks. Other Dodd-Frank Act reforms also address additional areas on which the framework touches. For example, if the new resolution authority—OLA—is effective, it could reduce the potential for additional taxpayer exposure arising from the failure of large financial institutions. Furthermore, regulations that will expand disclosures about mortgage-backed securities and require issuers to retain a portion of the credit risk of these securities could improve investor protection.

Nevertheless, some potential risks remain and others have emerged in the years following the 2007-2009 crisis, including the following:

Regulatory structure. In the framework, we called for a more effective and efficient regulatory system. Specifically, we noted several characteristics of effective and efficient oversight, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. To this end, the Dodd-Frank Act abolished the Office of Thrift Supervision, transferring its functions to OCC, FDIC, and the Federal Reserve. However, the act did not otherwise extensively consolidate the roles and responsibilities of the financial regulators and created new entities, such as OFR and CFPB. Consequently, multiple regulators may oversee different components of the same large, complex financial institutions while retaining their independence, differing approaches, and specific statutory duties and authorities, including rulemaking and enforcement.[46]

[45]The agencies are the Federal Reserve, FDIC, HUD, OCC, NCUA, Federal Trade Commission, and the now defunct Office of Thrift Supervision.

[46]In November 2012, a bill was introduced into Congress that would have combined SEC and CFTC into a new regulatory agency called the Securities and Derivatives Commission, which would have jurisdiction over securities, derivatives, options, futures, and related markets and instruments. This bill was not acted upon before the Congressional term ended, and therefore would need to be newly introduced in another Congressional term to be considered again.

Given the fragmented regulatory structure, regulators must continue to coordinate actions across multiple agencies and try to reconcile differing approaches and authorities to better ensure effective oversight of large financial firms. Without sufficient coordination, financial institutions could seek to take advantage of variations in how agencies implement regulatory responsibilities in order to be subject to less scrutiny. We have previously noted the role that FSOC could play in promoting coordination among its member agencies, including during the rulemaking process.[47] However, FSOC's Chairperson has noted that he does not have the authority to force agencies to coordinate, and neither he, nor FSOC as a whole, can force agencies to adopt compatible policies and procedures.

Fannie Mae and Freddie Mac. Our 2009 framework emphasizes that effective reform would minimize taxpayer exposure to financial risk, particularly when market participants encounter financial difficulties. However, the act did not address the futures of Fannie Mae and Freddie Mac that together support the majority of single-family mortgage loans. Given mounting losses, in September 2008 the enterprises were put into conservatorship and provided access to federal assistance through Senior Preferred Stock Purchase Agreements with the U.S. Treasury; together they have received over $187 billion in federal assistance as of the end of fiscal year 2012. Although recently the enterprises began earning profits that are being returned to the U.S. Treasury, the act did not address the existing taxpayer exposure from the enterprises or provide a road map to mitigate potential future losses related to them.[48]

Although policymakers, regulators, and others have developed proposals for the future structure and operations of the enterprises, they have not taken any final actions to resolve their status. In February 2011, Treasury and HUD issued a plan that outlines a vision for the government's role in housing finance, including reducing the activities of the enterprises over time until they are eventually fully wound down. In addition, in February 2012, FHFA, which supervises and regulates the enterprises' operations, issued a strategic plan that identified three strategic goals for the next phase of the conservatorships. The goals were building a new

[47] GAO-12-886.

[48] In late 2008, a combination of government-led actions ensured the secondary mortgage market kept functioning, including Treasury's financial backstop of these enterprises' debt and mortgage-backed securities (MBS) holders; and MBS purchases by Treasury and the Federal Reserve.

infrastructure for the secondary mortgage market, gradually contracting the enterprises' dominant presence in the marketplace while simplifying and shrinking their operations, and maintaining foreclosure prevention activities and credit availability for both new and refinanced mortgages.

In August 2012, FHFA took two actions affecting the enterprises. First, to encourage greater participation in housing markets by private firms, FHFA directed the enterprises to raise the fees they charge lenders for securitizing their mortgage loans to reduce the cost difference between securitizations done by the enterprises and those done by private firms. Second, FHFA, in conjunction with Treasury, revised the senior preferred stock purchase agreements to have the enterprises pay dividends to the U.S. Treasury based on their net worth (when positive) rather than a fixed percentage of the outstanding senior preferred stock. Among other things, this change should eliminate the need for the enterprises to borrow from Treasury to pay such dividends. In October 2012, FHFA also sought public comment on a proposal for developing a new mortgage securitization platform to process payments and perform other functions that could be used by multiple issuers that would replace the enterprises' proprietary systems. Although such proposals and plans have been put forward, as of December 2012, no definitive plan had been developed and the enterprises remain in conservatorship, which places taxpayers at continued risk. Furthermore, given the large role that the enterprises play in the mortgage market, the future of mortgage lending depends, in part, on how the enterprises are resolved. The Treasury and HUD plan acknowledges that changes in the role of the enterprises will also require changes in the activities of HUD's mortgage insurance and guarantee programs to ensure that the private market rather than the government expands its market share.

Money market funds. The framework calls for improving the regulatory system by ensuring a focus on risks that could affect the system as a whole. However, one risk that continues to raise significant concerns is the potential systemic risk posed by money market funds (MMF). MMFs are mutual funds that seek to offer investors three primary features: return of principal, liquidity, and a market-based rate of return. During the financial crisis, runs on MMFs led to severe disruptions in the short-term credit markets in which the funds played a significant role. After a number of MMFs recorded significant decreases in the value of portfolio holdings when the market for asset-backed commercial paper collapsed in the summer and fall of 2007, these funds' sponsors absorbed these losses.[49] However, in 2008, the sponsor of the Reserve Primary Fund did not provide support for the relatively small losses incurred by this MMF, which led to a general run of investors withdrawing their money from money market funds, creating severe funding pressures for issuers of commercial paper. The run was stopped by unprecedented interventions by Treasury and the Federal Reserve to provide guarantees and liquidity support to the industry.[50] The former SEC Chairman—Mary Schapiro—stated that the events of the financial crisis highlighted that the risks posed by MMFs stem from flaws inherent in the structure of these funds (such as valuation methods that make funds susceptible to runs and a reliance on discretionary sponsor support for stability). She further stated that she considers the structural reform of money market funds one of the pieces of unfinished business from the financial crisis.

In 2010, the Commission adopted the first round of reforms to boost the resilience of MMF portfolios. For example, SEC required MMFs to hold more highly liquid assets and to disclose their portfolio holdings monthly. Some market observers contend these reforms are sufficient to address any risk from these funds and that further reforms are unnecessary. However, regulators and others continue to be concerned. According to a paper issued by the International Monetary Fund, strengthening the

[49]For an asset-backed commercial paper issuance, a company may sell receivables to a bank, that, in turn, will issue them to investors as commercial paper. Commercial paper securities are short-term investment vehicles with a maturity that is typically between 90 and 180 days and are backed by the expected cash inflows from the receivables. As the receivables are collected, the originators are expected to pass the funds to the bank or conduit, which then passes these funds to the note holders.

[50]On September 19, 2008, Treasury announced the Temporary Guarantee Program for Money Market Funds, which temporarily guaranteed certain investments in participating MMFs. Under this program, Treasury guaranteed that upon liquidation of a participating MMF, the fund's shareholders would receive the fund's stable share price of $1 for each fund share owned as of September 19. On the same day, the Board of Governors of the Federal Reserve System authorized the creation of the Asset-Backed Commercial Paper (ABCP) Money Market Mutual Fund Liquidity Facility under section 13(3) of the Federal Reserve Act of 1913 to provide liquidity support to MMFs facing redemption pressures and to promote liquidity in the asset-backed commercial paper markets. To quickly support this market, the Board authorized loans to depository institutions eligible to borrow from the discount window and their primary dealer affiliates to purchase ABCP from MMFs. The Board provided these funds the option to sell their asset-backed commercial paper at amortized cost—the carrying value of the investment—rather than at deeply discounted prices. This program was intended to help MMFs raise cash in a way that did not exacerbate market stresses.

regulation of MMFs is critical especially because U.S. regulators are now prohibited from using the types of emergency authorities they employed in the recent crisis, such as the government-backed guarantees of MMFs' obligations to shareholders that prevented further problems.

In June 2012, the SEC Chairman discussed the need for SEC to pursue additional reforms, including potentially requiring funds to have a floating net asset value per share or to maintain a capital buffer of assets to absorb day-to-day fluctuations in the value of the funds' portfolio securities. The group that represents mutual funds—the Investment Company Institute—issued a letter noting that SEC's 2010 reforms improved the credit quality, maturity, liquidity, and transparency of money market funds and arguing that the additional changes contemplated by the SEC Chairman would effectively put an end to money market funds as an investment vehicle, which would harm investors and eliminate a funding source for many businesses. In August 2012, a majority of the SEC commissioners informed the SEC Chairman that they would not support a staff proposal to reform the structure of money market funds without further study. In September 2012, these commissioners posed several questions to SEC staff regarding various aspects of money market funds, which were addressed in a study issued in November 2012.[51] However, as of December 2012, no official agency action had occurred.

FSOC has urged SEC and other members to take certain actions to address the risks posed by cash management vehicles similar to MMFs. For instance, in July 2012 FSOC recommended that its members align regulation of cash management vehicles within their regulatory jurisdiction to limit the susceptibility of these vehicles to the risk of runs. Furthermore, at a November 2012 meeting, FSOC—under its authority to recommend that a primary financial regulatory agency apply new or heightened standards or safeguards to financial activities or practices conducted by bank holding companies or nonbank financial companies that create or increase the risk of significant liquidity, credit, or other problems—issued several proposed recommendations for reforming MMFs for a 60-day

[51]The study addresses the commissioners' specific questions related to MMFs including the funds' role in the 2008 crisis, changes in MMF characteristics around the 2010 reforms, and how future reforms could affect the demand for investments in MMFs.

public comment period.[52] Similar to those proposed by the SEC Chairman, these proposed alternatives for reform include requiring MMFs to have a floating net asset value per share, maintain a buffer of assets of up to 1 percent of net asset value to absorb day-to-day fluctuations in the value of the funds' portfolio securities and allow the funds to maintain a stable net asset value.[53] At the November meeting, the FSOC Chairman also noted that it was still preferable for the responsible regulator—SEC—to take the appropriate actions but absent such SEC actions, other regulators might have to act. However, although FSOC can make such recommendations and agencies must respond to such recommendations, FSOC cannot require that such changes be implemented.

Concentration of risks. The framework also calls for the U.S. regulatory system to subject all activities posing risks to appropriate oversight and protections. However, market observers have raised concerns that key areas—the tri-party repurchase (repo) market and swaps clearinghouses—in which financial risks have been concentrated lack adequate protections.[54] The financial crisis revealed weaknesses in the design of the U.S. tri-party repo market, a funding mechanism used by major broker-dealers to finance their inventories of securities. However, currently only two institutions provide credit to facilitate transactions in this market. According to the Federal Reserve Bank of New York, these

[52]FSOC's recommendations were published in the *Federal Register* on November 19, 2012 with a 60-day comment period. *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, 77 Fed. Reg. 69455 (Nov. 19, 2012).

[53]The 1 percent of net asset value requirement would be paired with a requirement that 3 percent of a shareholder's highest account value in excess of $100,000 during the previous 30 days be made available for redemption on a delayed basis. As an alternative, FSOC also proposed requiring MMFs to have a buffer of assets of up to 3 percent to provide explicit loss-absorption capacity that could be combined with other measures to enhance the effectiveness of the buffer and potentially increase the MMFs' resiliency. 77 Fed. Reg. 69455, 69456. After the comment period closes FSOC, will consider the comments and may issue a final recommendation to SEC, which pursuant to the Dodd-Frank Act, would be required to impose the recommended standards, or similar standards that FSOC deems acceptable, or explain in writing to FSOC within 90 days why it has determined not to follow the recommendation. If SEC decides to accept FSOC's recommendation, it is expected that SEC would implement the recommendation through its own rulemaking process.

[54]A repo is the sale of a security, or a portfolio of securities, by one party to another party, combined with an agreement to repurchase the security or portfolio on a specified future date at a prearranged price. A tri-party repo is distinguished by the involvement of a third party, a clearing bank that provides custody and settlement services related to the transaction.

weaknesses could rapidly elevate and propagate systemic risk. For instance, it became apparent during the crisis that the market's infrastructure to settle transactions had fundamental flaws that could lead to serious instability during periods of market stress. In its 2012 Annual Report, FSOC notes that the elimination of most intraday credit exposure and the reform of collateral practices in this market continue to be areas of intense focus for the council.

The resiliency of the tri-party repo market is important for a number of reasons. First, the market serves as a tool for cash and liquidity management and for short-term borrowing for a range of financial intermediaries, including money market funds, insurance companies, banks, and securities dealers, all of which play an important role in supporting the savings and investment programs of households, small businesses, and nonfinancial corporations. Second, the tri-party repo market is currently the source of funding for some $1.8 trillion in securities held by securities dealers and only two banks currently act as agents and clearing organizations in the vast majority of tri-party repurchase agreements.[55] Managing the interdependency of financial products is an important factor in reducing systemic risk and enhancing the stability of the U.S. financial system.

Market participants and regulators have made some progress in addressing the tri-party repo market shortcomings and enhancing protections. For instance, the current tri-party repo market is smaller than at its peak and generally funds higher-quality collateral than it did before the crisis. However, certain vulnerabilities remain. According to testimony by a Federal Reserve official, the reliance on discretionary intraday credit in the tri-party settlement process poses difficult dilemmas for cash lenders, borrowers, and clearing banks during periods of market stress, which could result in securities dealers experiencing a sudden and acute loss of funding. Furthermore, key stakeholders believe that not as much progress has been made—or made as quickly—as warranted by the seriousness of the risks this market poses. Consequently, a task force of market participants that regulators convened issued a final report in February 2012 calling for a settlement process that relies less on extensions of credit. The Federal Reserve also has acted to reduce the reliance of market participants on this form of funding by encouraging market participants over

[55]The two clearing banks are JPMorgan Chase and The Bank of New York Mellon.

which it has direct authority to implement the task force recommendations in a timely fashion. However, in congressional testimony, a Federal Reserve official acknowledged continued work is needed to generate additional solutions for reducing systemic risk.

Another source of concentrated financial risks arises from the activities of clearinghouses for financial products, and some of the reforms of the act could expand this risk. For instance, by requiring that most swaps be cleared through clearinghouses rather than the OTC market, the act attempts to reduce the vulnerability of the financial system to the failure of one or a few of the major swap dealers by transferring credit risk from the swap counterparties to the clearinghouse. However, some experts noted this reform concentrates credit risk at the clearinghouses and, in effect, creates a source of systemic risk. For example, a former regulatory official told us that clearinghouses in the new swaps market will be “too big to fail” and pose the same moral hazard problem as large financial institutions because the Dodd-Frank Act includes a provision allowing the Federal Reserve to assist certain clearinghouses. In addition, experts commented that clearinghouses that become engaged in clearing less-standardized swaps could expose themselves to greater risks and more complex risk-management challenges. Regulators have taken some actions that could mitigate the risk posed by these clearinghouses. In July 2012, FSOC designated several clearinghouses as systemically important financial market utilities, which will subject these entities to heightened prudential oversight by the Federal Reserve.

Although many of the Dodd-Frank Act’s reforms and these other regulatory efforts seek to address risks arising from large institutions and other concentrations of risk, some market observers noted that risks that could have systemic implications could also arise from other sources. For example, one academic noted that during the crisis the activities of some smaller institutions, such as those involved with asset-backed securitizations, were not individually problematic but became so as numerous institutions experienced losses, which, in turn, spread to affect others due to the interconnectedness of the system. Such threats to financial stability could stem from a large number of institutions that encounter trouble with certain risky products or from soundness problems that arise at a group of smaller institutions, such as regional banks. The act includes some reforms that, if effectively implemented, could minimize such threats, such as minimum capital standards for banks and FSOC’s ability to monitor and respond to a broad range of threats. However, their effectiveness will be greatly affected by how they are implemented and the vigorousness of regulators’ oversight efforts.

Overall, the federal financial regulators have considerable work under way to implement reforms that could improve the financial system in many of the ways that our 2009 framework envisions. However, much work remains to implement the Dodd-Frank Act reforms. As of December 2012, regulators had finalized a little less than half of the provisions we identified as requiring rulemakings or other key actions. Moreover, completing the rulemaking process does not mean that reforms are fully implemented. Rather, it will take time—beyond the time spent on finalizing the rulemakings—for regulators and industry to adopt the reforms contained in the rulemakings, and even longer to determine whether the reforms have had their intended outcomes.

Agency Comments and Our Evaluation

We provided a draft of this report to CFPB, CFTC, FDIC, the Federal Reserve, FHFA, FSOC, OCC, OFR, and SEC for their review and comment. The SEC Chairman provided written comments on our draft. The Chairman's letter notes that implementation of the Dodd-Frank Act continues to be a major undertaking of SEC and other agencies. She also describes progress SEC has made in issuing required rules and studies. These comments are reprinted in appendix II. We also obtained technical comments from CFPB, FDIC, FSOC, OCC, OFR, and SEC, which we have incorporated as appropriate. The Federal Reserve, FHFA, and CFTC did not provide comments.

We are sending copies of this report to CFPB, CFTC, FDIC, the Federal Reserve, FHFA, FSOC, OCC, OFR, and SEC, interested congressional committees, members, and others. This report will also be available at no charge on our website at http://www.gao.gov.

Should you or your staff have questions concerning this report, please contact me at (202) 512-8678 or clowersa@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.

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Appendix I: Objectives, Scope, and Methodology

Our objectives in this report were to examine what is known about the (1) the overall status of U.S. financial regulatory reforms arising from the act, (2) challenges affecting the implementation of these reforms, and (3) areas that pose continued risk.

To address our first two objectives, we synthesized GAO's body of work on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) reforms and other financial regulatory reform efforts and challenges. We also reviewed and analyzed government, academic, and other studies on Dodd-Frank Act reforms and implementation. To examine regulators' efforts to implement the provisions of the Dodd-Frank Act, we focused on eight major reform areas: capital requirements; resolution of financial institutions; proprietary trading; derivatives; consumer protection; mortgage reforms; expanded regulation of institutions and products; and investor protection. We also obtained and analyzed information from a database maintained by the law firm Davis Polk and Wardwell LLP that identified provisions of the Dodd Frank Act that require or authorize regulators to take actions, and tracks the status of regulators' efforts to implement these provisions. We focused our analysis on provisions that required rulemakings or other key actions, but excluded other requirements, such as those to publish studies.

We took several steps to determine the number of provisions requiring regulators to issue rulemakings or take other key actions as well as the status of regulators' efforts to implement the provisions. For example, after we identified provisions that we believed required regulators to issue rulemakings or take other key actions, we discussed these provisions with staff from eight agencies that are responsible for implementation of the majority of these efforts.[1] In some cases, the law firm's staff had identified provisions in the act as requiring separate actions, but which regulators saw as the same required action and had responded to the provisions by issuing a single rule. In other cases, regulators acknowledged that the act had called for separate actions but they had chosen to respond to these provisions in a single rule. For purposes of our report, we counted a provision as calling for a separate requirement if it appeared in our

[1]The eight regulators were the Board of Governors of the Federal Reserve System (Federal Reserve), Bureau of Consumer Financial Protection(CFPB), Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Financial Stability Oversight Council (FSOC), Office of the Comptroller of the Currency (OCC), and Securities and Exchange Commission (SEC),

professional judgment to be a distinct requirement, regardless of how an agency combined or separated it for rulemaking purposes. In cases in which multiple regulators were required to implement one provision, we counted the provision as being finalized when at least one regulator had finalized a rule, and we counted a rule as having been proposed when at least one of the regulators had proposed a rule. Finally, our analysis focused on regulators' progress implementing rulemakings and taking other key actions from the act's passage through December 2012. Using different sources, assumptions, and judgments in compiling the list of provisions could result in different totals, and therefore the information we provide should not be taken as a definitive count of all actions required by the act.

During the course of our work, staff from several regulatory agencies noted that the private law firm's data we used as the initial source to identify provisions of the Dodd-Frank Act that required rulemakings and other key actions by regulators overstates the number of required actions. This is because the database presents as separate requirements various Dodd-Frank Act provisions that regulators may view as one requirement with multiple elements and thus may be addressed through a single rule. However, because we have used various additional sources, including input from the relevant regulators, to compile the list of provisions requiring regulatory action, we maintain that the total we present in this report—which is significantly less than the total required actions reported by the original source—has been compiled using reasonable methods and treats requirements consistently across agencies. Moreover, we have disclosed the steps we took to compile the list of provisions and the limitations of our analysis.

For our first two objectives, we also interviewed officials from seven financial federal regulators—Board of Governors of the Federal Reserve System (Federal Reserve), Bureau of Consumer Financial Protection (CFPB), Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Office of the Comptroller of the Currency (OCC), and Securities and Exchange Commission (SEC)—as well as staff from the Financial Stability Oversight Council (FSOC) about their implementation of various Dodd-Frank reforms, challenges they are facing, and areas that continue to pose risk. In addition, we interviewed industry and consumer groups about these same issues and obtained the views from market observers and experts who have written about various Dodd-Frank Act reforms.

For the third objective, we compared key reforms (as identified for objective one) of the act against GAO's 2009 framework for evaluating regulatory reform.[2] We analyzed documentation and reports issued by federal regulators, market participants and observers, GAO, and congressional committees that identify areas of the U.S. financial system that undermine its stability and were not addressed by recent reforms. Finally, we interviewed regulatory officials, market participants, and observers to obtain their viewpoints about what areas, issues, or products could decrease the stability of the financial system that would benefit from additional or enhanced reforms, and any progress taken by the regulators to address these issues.

We conducted this performance audit from June 2012 to January 2013 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.

[2] GAO-09-216.

Appendix II: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

January 9, 2013

A. Nicole Clowers
Director, Financial Markets and Community Investment
United States Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Clowers:

Thank you for providing us with the opportunity to review and comment on GAO's draft report entitled *Financial Regulatory Reform: Regulators Have Faced Challenges Finalizing Key Reforms and Unaddressed Areas Pose Potential Risks* (GAO-13-195). We appreciate GAO's work on this important matter and the courtesy and consideration you have shown to the SEC staff in conducting this study.

Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") continues to be a major undertaking for the SEC and other government regulatory agencies. The Dodd-Frank Act requires or authorizes federal financial regulatory agencies, including the SEC, to promulgate hundreds of regulations. As the draft report notes, "a variety of challenges have affected regulators' progress in executing rulemaking requirements intended to implement the act's reforms." Those challenges include the number and complexity of the required rulemakings, as well as the relatively short timeframes imposed by the Dodd-Frank Act. Notwithstanding these challenges, we have made substantial progress in fulfilling our statutory obligations. Of the more than 90 mandatory rulemaking provisions that apply to the SEC, the SEC has proposed or adopted rules for over 80% of them -- not including rules stemming from the dozens of other provisions that give the SEC discretionary rulemaking authority. Additionally, the SEC has finalized 17 of the more than 20 studies and reports that it is required to complete under the Act. While we have achieved a great deal, we are continuing to work diligently to implement all provisions of the Act for which we have responsibility, even as we continue to perform our longstanding core responsibilities as well as new responsibilities such as those under the Jumpstart Our Business Startups ("JOBS") Act.

Thank you once again for the opportunity to review and comment on the draft report. I am committed to completing the challenging task of fully implementing the Dodd-Frank Act.

Sincerely,

Elisse B. Walter
Chairman

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

A. Nicole Clowers, (202) 512-8678 or clowersa@gao.gov

Staff Acknowledgments

In addition to the contact named above, Cody J. Goebel (Assistant Director), Anne A. Akin, William R. Chatlos, Camille K. Jennings, Waterankwa Kadzai, Jon D. Menaster, Marc W. Molino, Barbara M. Roesmann, and Jessica M. Sandler made significant contributions to this report.

Related GAO Products

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