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# Highlights

Highlights of GAO-10-555T, a report to Subcommittee on Oversight and Investigations, House Committee on Financial Services

## FINANCIAL MARKETS REGULATION

# Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System

## Why GAO Did This Study

In 2009 GAO conducted a study on the role of leverage in the recent financial crisis and federal oversight of leverage, as mandated by the Emergency Economic Stabilization Act. This testimony presents the results of that study, and discusses (1) how leveraging and deleveraging by financial institutions may have contributed to the crisis, (2) how federal financial regulators limit the buildup of leverage; and (3) the limitations the crisis has revealed in regulatory approaches used to restrict leverage and regulatory proposals to address them.

To meet these objectives, GAO built on its existing body of work, reviewed relevant laws and regulations and academic and other studies, and interviewed regulators and market participants.

## What GAO Recommends

As Congress considers establishing a systemic risk regulator, it should consider the merits of assigning such a regulator with responsibility for overseeing systemwide leverage. As U.S. regulators continue to consider reforms to strengthen oversight of leverage, we recommend that they assess the extent to which reforms under Basel II, a new risk-based capital framework, will address risk evaluation and regulatory oversight concerns associated with advanced modeling approaches used for capital adequacy purposes. In their written comments, the regulators generally agreed with GAO's conclusions and recommendation.

View GAO-10-555T or key components.
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## What GAO Found

Some studies suggested that leverage steadily increased in the financial sector before the crisis began in mid-2007 and created vulnerabilities that have increased the severity of the crisis. In addition, subsequent disorderly deleveraging by financial institutions may have compounded the crisis. First, the studies suggested that the efforts taken by financial institutions to deleverage by selling financial assets could cause prices to spiral downward during times of market stress and exacerbate a financial crisis. Second, the studies suggested that deleveraging by restricting new lending could slow economic growth. However, other theories also provide possible explanations for the sharp price declines observed in certain assets. As the crisis is complex, no single theory is likely to fully explain what occurred or rule out other explanations. Regulators and market participants we interviewed had mixed views about the effects of deleveraging. Some officials told us that they generally have not seen asset sales leading to downward price spirals, but others said that asset sales have led to such spirals.

Federal regulators impose capital and other requirements on their regulated institutions to limit leverage and ensure financial stability. Federal bank regulators impose minimum risk-based capital and leverage ratios on banks and thrifts and supervise the capital adequacy of such firms through on-site examinations and off-site monitoring. Bank holding companies are subject to similar capital requirements as banks, but capital levels of thrift holding companies are individually evaluated based on each company's risk profile. The Securities and Exchange Commission uses its net capital rule to limit broker-dealer leverage and used to require certain broker-dealer holding companies to report risk-based capital ratios and meet certain liquidity requirements. Other important market participants, such as hedge funds, also use leverage. Hedge funds typically are not subject to regulatory capital requirements, but market discipline, supplemented by regulatory oversight of institutions that transact with them, can serve to constrain their leverage.

The crisis has revealed limitations in regulatory approaches used to restrict leverage. First, regulatory capital measures did not always fully capture certain risks, which resulted in some institutions not holding capital commensurate with their risks and facing capital shortfalls when the crisis began. Federal regulators have called for reforms, including through international efforts to revise the Basel II capital framework. The planned U.S. implementation of Basel II would increase reliance on risk models for determining capital needs for certain large institutions. The crisis underscored concerns about the use of such models for determining capital adequacy, but regulators have not assessed whether proposed Basel II reforms will address these concerns. Such an assessment is critical to ensure that changes to the regulatory framework address the limitations the crisis had revealed. Second, regulators face challenges in counteracting cyclical leverage trends and are working on reform proposals. Finally, the crisis has revealed that with multiple regulators responsible for individual markets or institutions, none has clear responsibility to assess the potential effects of the buildup of systemwide leverage or the collective effect of institutions' deleveraging activities.