GAO Highlights

Highlights of GAO-15-365, a report to congressional addressees

Why GAO Did This Study

Weakness in federal oversight was one of many factors that contributed to the size of federal losses and the number of bank failures in banking-related crises over the past 35 years—including the 1980s thrift and commercial bank crises and the 2007–2009 financial crisis. Resolving the failures of banks and thrifts due to these crises resulted in estimated costs to federal bank and thrift insurance funds over $165 billion, as well as other federal government costs, such as taxpayer-funded assistance during the financial crises.

Ongoing monitoring of banking regulators' efforts to identify and respond to emerging threats to the banking system can provide a starting point for identifying opportunities for more targeted and frequent assessments of these efforts. This report (1) discusses regulatory lessons learned from these past crises and (2) offers a framework that GAO and other oversight bodies, such as inspectors general, can use to provide continuous future oversight of regulatory responses to emerging risks.

To do this work, GAO reviewed its prior studies and those of federal banking regulators, the regulators' inspectors general, and academics that evaluated regulators' efforts to identify and respond to risks that led to bank failures in past crises. In developing an oversight framework, GAO reviewed frameworks for monitoring domestic and global financial systems to identify key areas in which risks to banks can arise. GAO interviewed regulators to identify supervisory actions that can be used to respond to emerging risks.

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BANK REGULATION

Lessons Learned and a Framework for Monitoring Emerging Risks and Regulatory Response

What GAO Found

Past banking-related crises highlight a number of regulatory lessons learned. These include the importance of

- **Early and forceful action.** GAO's past work on failed banks found that regulators frequently identified weak management practices that involved the banks in higher-risk activities early on in each crisis, before banks began experiencing declines in capital. However, regulators were not always effective in directing bank management to address underlying problems before bank capital began to decline and it was often too late to avoid failure. For example, examiners did not always press bank management to address problems promptly or issue timely enforcement actions.

- **Forward-looking assessments of risk.** The crises revealed limitations in key supervisory tools for monitoring and addressing emerging risks. During examinations, examiners did not always incorporate forward-looking information when assigning supervisory ratings based on banks' exposure to risk. For example, ratings did not consistently reflect factors such as poor risk-management practices that while not causing losses in the short term, caused losses in the long term.

- **Considering risks from the broader financial system.** The 2007–2009 financial crisis demonstrated that risks to bank safety and soundness could not be assessed by looking only at the performance and activities of individual banks or groups of banks. Rather, regulators must look across the financial system to identify emerging risks.

In response to these lessons learned, regulators said they have taken a number of steps intended to improve their ability to identify and respond to emerging risks—including instituting more granular tracking of bank compliance with examination recommendations to address emerging problems in a timely manner; incorporating more forward-looking elements into supervisory tools; and participating in systemic risk-monitoring efforts as members of Financial Stability Oversight Council. GAO and others have begun to review some of these initiatives.

GAO has incorporated the regulatory lessons learned into a two-part framework for monitoring regulators' efforts to identify and respond to emerging risks to the banking system. First, the framework incorporates quantitative information in the form of financial indicators that can help users of the framework track and analyze emerging risks and qualitative sources of information on emerging risks—such as regulatory reports and industry and academic studies. Second, the framework monitors regulatory responses to emerging risks, such as agency guidance, with the goal of flagging issues for further review when questions arise about the effectiveness of these responses. Users—oversight bodies such as inspectors general—can analyze regulatory actions taken to address emerging risks and gain insights into regulators' ability to take forceful actions to address problematic behavior at banks. Such ongoing monitoring can provide a starting point for identifying opportunities for more targeted and frequent assessments of these efforts. GAO plans to implement this framework in its future work.