What is being done to prevent another financial crisis?

- Fill regulatory gaps
  The crisis revealed major gaps in regulation. Historically, depository institutions such as banks were most at risk from financial shocks and disruptive panics. To reduce the risk, the Federal Deposit Insurance Corporation guaranteed that depositors would be paid back. In exchange, banks faced the toughest regulation and oversight. In recent decades, however, a "shadow banking system" developed that involved a variety of financial firms, securities, and markets. The system replicated core features of banking, including funding longer-term loans and securities using short-term liabilities that are assumed to be highly liquid and safe. In the crisis, the less rigorously regulated shadow banking system was vulnerable to panics and proved to be a major source of credit-market disruption. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 aims to remove gaps in regulation by basing oversight on the function of the firm and its risk to the economy. The Act creates a Financial Stability Oversight Council to keep an eye on overall risks to the financial system and the broader economy. The act also extends authority to the Federal Reserve to regulate all systemically important financial institutions, even those that are not banks.

References:
- Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, United States Senate Committee on Banking, Housing, and Urban Affairs, July 1, 2010.
- Implementation of the Dodd-Frank Act, speech by Ben S. Bernanke, Chairman, Federal Reserve Board of Governors, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., February 17, 2011.

- Establish suitably heightened prudential standards
  Enhanced regulatory requirements aim to stabilize the economy by ensuring that systemically important financial firms are better able to weather severe market downturns. During the pre-crisis boom years, firms that wanted to increase lending reduced their standards and made riskier loans. They financed these loans with borrowed funds and then packaged and sold the loans to investors across the financial landscape. When the financial crisis occurred, investors were unsure who was exposed to the questionable loans. And they feared that many institutions lacked sufficient shareholder funds to protect against losses. As a result, investors began demanding their money back. Debt-laden firms were forced to sell assets quickly. The prices of these assets plunged, creating a vicious cycle and deepening the crisis. The new financial reform reduces this risk by requiring large, complex financial companies to operate with more appropriate levels of shareholder capital, liquidity, and risk.

References:

- Emphasize a macro-prudential perspective
  The most telling lesson of the crisis has been the need to promote safe and sound practices in the financial system as a whole. Regulators need to focus not just on individual firms but on the entire interconnected system. The financial reform legislation mandates that regulators adopt this sort of macro-prudential perspective. It empowers them to act when the practices of an institution (or group of institutions) create risks for the financial system. Understanding this risk requires that regulators collect accurate and up-to-date information on how global financial firms are interconnected. They must also investigate threats from a firm's exposure to common risks. The macro-prudential approach includes oversight of key components of the global financial infrastructure, such as the payments and clearing systems, which had significant weaknesses that made the financial crisis more severe.

References:
- Macroprudential Supervision and Monetary Policy in the Post-crisis World, speech by Janet L. Yellen, Vice Chair, Board of Governors, at the annual meeting of the National Association for Business Economics, Denver, Colorado, October 11, 2010.