Who Regulates Whom? An Overview of U.S. Financial Supervision

Mark Jickling
Specialist in Financial Economics

Edward V. Murphy
Specialist in Financial Economics

December 8, 2010

Congressional Research Service
7-5700
www.crs.gov
R40249

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

This report provides an overview of current U.S. financial regulation: which agencies are responsible for which institutions, activities, and markets, and what kinds of authority they have. Some agencies regulate particular types of institutions for risky behavior or conflicts of interest, some agencies promulgate rules for certain financial transactions no matter what kind of institution engages in it, and other agencies enforce existing rules for some institutions, but not for others. These regulatory activities are not necessarily mutually exclusive.

There are three traditional components to U.S. banking regulation: safety and soundness, deposit insurance, and adequate capital. The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) added a fourth: systemic risk. Safety and soundness regulation dates back to the 1860s when bank credit formed the money supply. Examinations of a bank's safety and soundness is believed to contribute to a more stable broader economy. Deposit insurance was established in the 1930s to reduce the incentive of depositors to withdraw funds from banks during a panic. Banks pay premiums to support the deposit insurance fund, but the Treasury provides full faith and credit for covered deposits if the fund were to run short. Deposit insurance is a second reason that federal agencies regulate bank operations, including the amount of risk they may incur. Capital adequacy has been regulated since the 1860s when "wildcat banks" sought to make extra profits by reducing their capital reserves, which increases their risk of default and failure. Dodd-Frank created the interagency Financial Stability Oversight Council (FSOC) to monitor systemic risk and consolidated bank regulation from five agencies to four. For banks and non-banks designated by the FSOC as creating systemic risk, the Federal Reserve has oversight authority, and the Federal Deposit Insurance Corporation (FDIC) has resolution authority.

Federal securities regulation has traditionally been based on the principle of disclosure, rather than direct regulation. Firms that sell securities to the public must register with the Securities and Exchange Commission (SEC), but the agency generally has no authority to prevent excessive risk taking. SEC registration in no way implies that an investment is safe, only that the risks have been fully disclosed. The SEC also registers several classes of securities market participants and firms. It has enforcement powers for certain types of industry misstatements or omissions and for certain types of conflicts of interest. Derivatives trading is supervised by the Commodity Futures Trading Commission (CFTC), which oversees trading on the futures exchanges, which have self-regulatory responsibilities as well. Dodd-Frank has required more disclosures in the previously unregulated over-the-counter (off-exchange) derivatives market and has granted the CFTC and SEC authority over large derivatives traders.

The Federal Housing Finance Agency (FHFA) oversees a group of government-sponsored enterprises (GSEs)—public/private hybrid firms that seek both to earn profits and to further the policy objectives set out in their statutory charters. Two GSEs, Fannie Mae and Freddie Mac, were placed in conservatorship by the FHFA in September 2008 after losses in mortgage asset portfolios made them effectively insolvent.

Dodd-Frank consolidated consumer protection rulemaking, which had been dispersed among several federal agencies in a new Bureau of Consumer Financial Protection. The bureau is intended to bring consistent regulation to all consumer financial transactions, although the legislation exempted several types of firms and transactions from its jurisdiction.

Contents

Figures

Tables

Appendixes

Contacts

Introduction

Historically, major changes in financial regulation in the United States have often come in response to crisis. Thus, it is no surprise that the turmoil beginning in 2007 led to calls for reform. Few would argue that regulatory failure was solely to blame for the crisis, but it is widely considered to have played a part. In February 2009, Treasury Secretary Timothy Geithner summed up two key problem areas:

> Our financial system operated with large gaps in meaningful oversight, and without sufficient constraints to limit risk. Even institutions that were overseen by our complicated, overlapping system of multiple regulators put themselves in a position of extreme vulnerability. These failures helped lay the foundation for the worst economic crisis in generations.[1]

In this analysis, regulation failed to maintain financial stability at the systemic level because there were gaps in regulatory jurisdiction and because even overlapping jurisdictions—where institutions were subject to more than one regulator—could not ensure the soundness of regulated financial firms. In particular, limits on risk-taking were insufficient, even where regulators had explicit authority to reduce risk.

This report attempts to set out the basic principles underlying U.S. financial regulation and to give some historical context for the development of that system. The first section briefly discusses the various modes of financial regulation and includes a table identifying the major federal regulators and the types of institutions they supervise. The table also indicates certain emergency authorities available to the regulators, including those that relate to systemic financial disturbances. The second section focuses on capital requirements—the principal means of constraining risky financial activity—and how risk standards are set by bank, securities, and futures regulators.

The next sections provide brief overviews of each federal financial regulatory agency and discussions of several major financial markets that are not subject to any federal regulation.

What Financial Regulators Do

The regulatory missions of individual agencies vary, partly as a result of historical accident. Here is a rough division of what agencies are called upon to do:

- **Regulate Certain Types of Financial Institutions.** Some firms become subject to federal regulation when they obtain a particular business charter, and several federal agencies regulate only a single class of institution. Depository institutions are a good example: a new banking firm chooses its regulator when it decides which charter to obtain—national bank, state bank, credit union, etc.—and the choice of charter may not greatly affect the institution's business mix. The Federal Housing Finance Authority (FHFA) regulates only three government-sponsored enterprises: Fannie Mae, Freddie Mac, and the Federal Home Loan

[1] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan, February 10, 2009, http://www.ustreas.gov/press/releases/tg18.htm.

Bank system. Regulation keyed to particular institutions has at least two perceived disadvantages: regulator shopping, or regulatory arbitrage, may occur if regulated entities can choose their regulator, and unchartered firms engaging in the identical business activity as regulated firms may escape regulation altogether.

- **Regulate a Particular Market.** The New York Stock Exchange dates from 1793, federal securities regulation from 1934. Thus, when the Securities and Exchange Commission (SEC) was created by Congress, stock and bond market institutions and mechanisms were already well-established, and federal regulation was grafted onto the existing structure. As the market evolved, however, Congress and the SEC faced numerous jurisdictional issues. For example, de minimis exemptions to regulation of mutual funds and investment advisers created space for the development of a trillion-dollar hedge fund industry, which was unregulated until the Dodd-Frank Act.

  Market innovation also creates financial instruments and markets that fall between industry divisions. Congress and the courts have often been asked to decide whether a particular financial activity belongs in one agency's jurisdiction or another's.

- **Regulate a Particular Financial Activity.** When regulator shopping or perceived loopholes appear to weaken regulation, one response is to create a regulator tasked with overseeing a particular type or set of transactions, regardless of where the business occurs or which entities are engaged in it. In 1974, Congress created the Commodity Futures Trading Commission (CFTC) at the time when derivatives were poised to expand from their traditional base in agricultural commodities into contracts based on financial instruments and variables. The CFTC was given "exclusive jurisdiction" over all contracts that were "in the character of" options or futures contracts, and such instruments were to be traded only on CFTC-regulated exchanges. In practice, exclusive jurisdiction was impossible to enforce, as off-exchange derivatives contracts such as swaps proliferated. In 2000, Congress exempted swaps from CFTC regulation, but this exemption was repealed by Dodd-Frank.

  On the view that consumer financial protections should apply uniformly to all transactions, the Dodd-Frank Act created a Bureau of Consumer Financial Protection, with authority (subject to certain exemptions) over an array of firms that deal with consumers.

- **Regulate for Systemic Risk.** One definition of systemic risk is that it occurs when each firm manages risk rationally from its own perspective, but the sum total of those decisions produces systemic instability under certain conditions. Similarly, regulators charged with overseeing individual parts of the financial system may satisfy themselves that no threats to stability exist in their respective sectors, but fail to detect systemic risk generated by unsuspected correlations and interactions among the parts of the global system. The Federal Reserve was for many years a kind of default systemic regulator, expected to clean up after a crisis, but with limited authority to take ex ante preventive measures. Dodd-Frank creates the Financial Stability Oversight Council (FSOC) to assume a coordinating role, with the single mission of detecting systemic stress before a crisis can take hold (and identifying firms whose individual failure might trigger cascading losses with system-wide consequences).

From time to time, the perceived drawbacks to the multiplicity of federal regulators brings forth calls for regulatory consolidation.[2] The legislative debate over Dodd-Frank illustrates the different views on the topic: early versions of the Senate bill would have replaced all the existing bank regulators with a single Financial Institution Regulatory Authority. By the end, however, Dodd-Frank created two new agencies (and numerous regulatory offices), and eliminated only the Office of Thrift Supervision (OTS).

There have always been arguments against regulatory consolidation. Some believe that a fragmentary structure encourages innovation and competition and fear that the "dead hand" of a single financial supervisor would be costly and inefficient. Also, there is little evidence that countries with single regulators fare better during crises or are more successful at preventing them. One of the first proposals by the Conservative government elected in the UK in May 2010 was to break up the Financial Services Authority, which has jurisdiction over securities, banking, derivatives, and insurance.

Table 1 below sets out the federal financial regulatory structure as it will exist once all the provisions of the Dodd-Frank Act become effective. (In many cases, transition periods end a year or 18 months after July 21, 2010, the date of enactment. Thus, OTS does not appear in **Table 1**, even though the agency will continue to operate into 2011.) **Appendix D** of this report contains a pre-Dodd-Frank version of the same table. Supplemental material—charts that illustrate the differences between banks, bank holding companies, and financial holding companies—appears in **Appendix A**.

[2] See, e.g., U.S. Department of the Treasury, *Blueprint for a Modern Financial Regulatory Structure*, March 2008, which called for a three-agency structure: a systemic risk regulator, a markets supervisor, and a consumer regulator.

Table 1. Federal Financial Regulators and Who They Supervise

Regulatory Agency	Institutions Regulated	Emergency/Systemic Risk Powers	Other Notable Authority
Federal Reserve	Bank holding companies[a] and certain subsidiaries, financial holding companies, securities holding companies, savings and loan holding companies, and any firm designated as systemically significant by the FSOC State banks that are members of the Federal Reserve System, U.S. branches of foreign banks, and foreign branches of U.S. banks Payment, clearing, and settlement systems designated as systemically significant by the FSOC, unless regulated by SEC or CFTC	Lender of last resort to member banks (through discount window lending) In "unusual and exigent circumstances" the Fed may extend credit beyond member banks, for the purpose of providing liquidity to the financial system, but not to aid failing financial firms May initiate resolution process to shut down firms that pose a grave threat to financial stability (requires concurrence of 2/3 of the FSOC)	
Office of the Comptroller of the Currency (OCC)	National banks, U.S. federal branches of foreign banks, federally chartered thrift institutions		
Federal Deposit Insurance Corporation (FDIC)	Federally-insured depository institutions, including state banks that are not members of the Federal Reserve System and state-chartered thrift institutions	After making a determination of systemic risk, the FDIC may invoke broad authority to use the deposit insurance funds to provide an array of assistance to depository institutions, including debt guarantees	
National Credit Union Administration (NCUA)	Federally-chartered or insured credit unions	Serves as a liquidity lender to credit unions experiencing liquidity shortfalls through the Central Liquidity Facility	Operates a deposit insurance fund for credit unions, the National Credit Union Share Insurance Fund (NCUSIF)

Regulatory Agency	Institutions Regulated	Emergency/Systemic Risk Powers	Other Notable Authority
Securities and Exchange Commission (SEC)	Securities exchanges, brokers, and dealers; clearing agencies; mutual funds; investment advisers (including hedge funds with assets over $150 million) Nationally-recognized statistical rating organizations Security-based swap (SBS) dealers, major SBS participants, SBS execution facilities Corporations selling securities to the public must register and make financial disclosures	May unilaterally close markets or suspend trading strategies for limited periods	Authorized to set financial accounting standards which all publicly traded firms must use
Commodity Futures Trading Commission (CFTC)	Futures exchanges, brokers, commodity pool operators, commodity trading advisors Swap dealers, major swap participants, swap execution facilities	May suspend trading, order liquidation of positions during market emergencies.	
Federal Housing Finance Agency (FHFA)	Fannie Mae, Freddie Mac, and the Federal Home Loan Banks	Acting as conservator (since Sept. 2008) for Fannie and Freddie	
Bureau of Consumer Financial Protection	Nonbank mortgage-related firms, private student lenders, payday lenders, and larger "consumer financial entities" to be determined by the Bureau Consumer businesses of banks with over $10 billion in assets Does not supervise insurers, SEC and CFTC registrants, auto dealers, sellers of nonfinancial goods, real estate brokers and agents, and banks with assets less than $10 billion		Writes rules to carry out the federal consumer financial protection laws

Source: CRS.

a. See **Appendix A**.

Banking Regulation

Absent regulation, the banking system tends to multiply the supply of credit in good times and worsen the contraction of credit in bad times. Bank profits in good times and losses in bad times amplify the cycle of credit in the aggregate economy even in the presence of a lender-of-last resort. One policy goal of bank regulation is to lessen the tendency of banks to feed credit bubbles and magnify credit contractions. The regulation of the funding and activities of individual banks, including capital requirements, is one policy tool that has been used to try to stabilize the aggregate credit cycle in the United States.

There are three traditional components to U.S. banking regulation: safety and soundness, deposit insurance, and adequate capital. Dodd-Frank added a fourth: systemic risk. Safety and soundness regulation dates back to the 1860s when bank credit formed the money supply, and recent events have demonstrated that bank safety and soundness remains an important component of the aggregate credit cycle. Deposit insurance was established in the 1930s to reduce the incentive of depositors to withdraw funds from banks during a panic. Banks pay premiums to support the deposit insurance fund, but the Treasury provides full faith and credit for covered deposits if the fund were to run short. Deposit insurance is a second reason that federal agencies regulate bank operations, including the amount of risk they may incur. Capital adequacy has been regulated since the 1860s when "wildcat banks" sought to make extra profits by reducing their capital reserves, which increased their risk of default and failure. Dodd-Frank created a council to monitor systemic risk, and consolidated bank regulation from five agencies to four. For banks and non-banks designated as creating systemic risk, the Federal Reserve has oversight authority, and the Federal Deposit Insurance Corporation (FDIC) has resolution authority.

Safety and Soundness Regulation

As a general concept, safety and soundness authority refers to examining and regulating the probability of a firm's default, and the magnitude of the losses that its owners and creditors would suffer if the firm defaulted. One public policy justification for monitoring the safety and soundness decisions of banks is that bank risk decisions suffer from the fallacy of composition—the consequences to a single bank acting in its own interests diverge from the aggregate consequences that occur if many banks choose similar risk strategies simultaneously. The fallacy of composition is sometimes illustrated by the stadium example—a single person standing up at a ballgame is able to see the field better, but if everyone stands up at the same time, few people will be able to see the field better, yet most people are less comfortable. In the case of banks and bank regulation, a single bank may be able to increase profits by making more risky loans or failing to insure against counterparty default, without significantly increasing the probability of losing its own access to liquidity should events turn out badly. However, if many banks simultaneously make more risky loans, or fail to insure against counterparty default, then no single bank may gain market share or be more profitable. Yet in the aggregate, interbank liquidity is more likely to collapse, and the broader economy can suffer a precipitous contraction of credit. Since the 1860s, federal bank regulators have had some authority to examine and regulate the riskiness of individual banks' activities because the decisions of individual banks can affect the availability of aggregate credit and the size of aggregate financial losses.

If there is more than one agency with examination powers, then there may be a race to the bottom in banking supervision. Some observers have claimed that the multiplicity of banking regulators allowed some banks to shop for their regulator prior to the financial crisis of 2008. To the extent that this is true, regulators that are funded by chartering fees may have had an incentive to allow their covered institutions to engage in more risky behavior at the margin because at least some of the cost of risky lending would be borne by people outside the examining agency's jurisdiction. Dodd-Frank consolidated the Office of the Comptroller of the Currency (OCC) and the OTS into a single banking regulator within Treasury, although the Federal Reserve, the FDIC, and the National Credit Union Administration (NCUA) retained their respective examination authorities for their covered lenders.

Subsequent to a financial crisis, individual banks may be more cautious than would be optimum in the aggregate; the fallacy of composition also applies to lending standards that are too tight. Federal regulator's guidance will in some circumstances encourage banks to maintain the flow of credit to creditworthy borrowers in a challenging environment. In the extreme case in which credit markets completely collapse, the Federal Reserve has the ability to perform a lender-of-last-resort role—the Fed may expand its lending facilities at its discount window. Dodd-Frank included a council of regulators to facilitate coordination among agencies with examination authority. In addition, Dodd-Frank required that any future Federal Reserve emergency lending be of a general character, rather than limited to single institutions.

Deposit Insurance

Deposit insurance is designed to make the funding of banks more stable and to protect some of the savings of American households. Prior to the 1930s, American financial crises were often accompanied by rapid withdrawal of deposits from banks rumored to be in trouble. Even prudent, well-managed banks would often have difficulty surviving these runs by depositors. Federal deposit insurance assures depositors that the full faith and credit of the federal government guarantees their deposits up to a preset level. Banks with insured deposits have suffered almost no depositor runs since the establishment of deposit insurance; and banks have been assessed an insurance premium by the FDIC based on the amount of their insured deposits.

The financial crisis of 2008 revealed a number of lessons related to bank runs and deposit insurance. Several non-banks suffered the equivalent of depositor runs, including money market mutual funds and the interbank repo market. Because the equivalent of depositor runs can occur in other financial activities, Dodd-Frank expanded the assessment base for FDIC premiums to include a bank's entire balance sheet, not just its insured deposits. Furthermore, creditors of systemically important institutions may, under extreme circumstances, be provided with additional guarantees should a firm fail if the new systemic risk council believes that the firm's failure could cause the equivalent of a non-bank run.

Capital Regulation

In general, capital requirements in the context of banking regulation refer to the portion of a bank's total assets that is available to absorb losses. Capital requirements are technically a subset of safety and soundness regulation, but their special place in limiting bank activity and insulating the banking system from widespread losses warrants special attention. There are several categories of capital and of minimum capital requirements, but the general effect of a minimum capital requirement is to limit the ability of a bank to fund itself by relying on borrowing from other institutions. Higher capital requirements tend to make a bank able to survive higher levels of borrower defaults, but also limit the amount of credit that the bank will make available to businesses, households, and governments. If there are multiple potential regulators, banks may attempt to shop for the least strict capital requirements. Coordination of capital requirements in Dodd-Frank and through international negotiations is discussed in more detail below.

Systemic Risk

Systemic risk generally refers to risks to the financial system as a whole that are not readily apparent by examining individual institutions or markets. Such risks may be concentrated in a few large firms, or evidenced in firms that play key roles in connecting disparate markets. Furthermore, such risks might be independent of individual firms altogether, and instead lie in unsustainable market imbalances, such as trade relationships or government fiscal policies. Although several agencies recognized their role in monitoring some forms of systemic risk prior to the financial crisis of 2008, no single agency was responsible for coordinating government regulations or had the authority to address all forms of financial systemic risk that built up in the economy.

Dodd-Frank creates the FSOC to designate firms that might pose systemic risks and to monitor systemic risk in the overall economy. Although the FSOC will have a permanent staff and access to financial data collection, the Federal Reserve will act as the systemic risk regulator and the FDIC will serve as the resolution authority for firms designated by the FSOC. These powers are discussed in more detail under each agency below.

Capital Requirements

As a general accounting concept, capital means the equity of a business—the amount by which its assets exceed its liabilities.[3] The more capital a firm has, the greater its capacity to absorb losses and remain solvent. Financial regulators require the institutions they supervise to maintain specified minimum levels of capital—defined in various ways—in order to reduce the number of failing firms and to minimize losses to investors, customers, and taxpayers when failures do occur. Capital requirements represent a cost to businesses because they reduce the amount of funds that may be loaned or invested in the markets. Thus, there is a perpetual tension: firms structure their portfolios to reduce the amount of capital they must hold, while regulators continually modify capital standards to prevent excessive risk-taking.

In U.S. banking regulation, capital standards are based on the Basel Accords, an international framework developed under the auspices of the Bank for International Settlements.[4] The guiding principle of the Basel standards is that capital requirements should be risk-based. The riskier an asset, the more capital a bank should hold against possible losses. The Basel Accords provide two broad methodologies for calculating risk-based capital: (1) a standardized approach to credit risk determinations, based on external risk assessments (such as bond ratings), and (2) an alternative approach that relies on banks' internal risk models and rating systems. Adoption of the latter method—set out in the 2004 Basel II framework—in the United States has been slow, and thus far is limited to a few large banks.[5] In July 2010, in response to the global financial crisis, the Basel

[3] Regulatory uses of "capital" include more specific definitions and classifications.

[4] See CRS Report RL33278, *The Basel Accords: The Implementation of II and the Modification of I*, by Walter W. Eubanks.

[5] See CRS Report RL34485, *Basel II in the United States: Progress Toward a Workable Framework*, by Walter W. (continued...)

Committee proposed a more stringent set of capital requirements, called Basel III. These proposals are discussed below.

Table 2 shows how the standardized approach works in assessing the amount of capital to be held against credit risk in various types of financial instruments.[6] The Basel accords call for a basic capital requirement of 8% of the value of an asset; the risk-weighting then determines what percentage of that 8% baseline will apply to a given asset. For example, if the risk-weighting is 0%, no capital must be held (i.e., 8% X 0% = 0). A risk weighting of 100% means that the full 8% requirement applies. Assets weighted above 100% require that a multiple of the 8% capital requirement be held.

Table 2. The Basel Accords: Risk Weightings for Selected Financial Assets Under the Standardized Approach

(percentages of the 8% baseline capital requirement)

Asset	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereign Debt	0%	20%	50%	100%	150%	100%
Bank Debt	20%	50%	50%	100%	150%	100%
Corporate Debt	20%	50%	100%	NA	150% (below BB-)	100%
Assets not Assigned Ratings by Standard & Poor's or other Credit Rating Agencies						
Residential Mortgages	35%					
Commercial Real Estate	100%					
Past Due Loans	100%-150% (depending on specific provisions made to cover loan losses)					
Securitization Tranches rated between BB+ and BB-	350%					

Source: Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, BIS, November 2005, pp. 15-22.

Basel III

In July 2010, the Basel Committee announced a set of measures strengthening existing capital requirements, which became known as Basel III.[7] Under the new standards, banks will be required to hold common equity in the amount of 4.5% of risk-weighted assets, up from 2% under Basel II. In addition, there will be a supplemental capital conservation buffer of 2.5%, meaning that common equity must total at least 7% of assets. If the capital conservation buffer is breached, banks will face limits on the payment of bonuses and dividends until it is restored.

(...continued)

Eubanks.

[6] Note that Section 939A of Dodd-Frank requires all federal agencies to remove references to credit ratings in their regulations. U.S. banking agencies will need to substitute another measure of credit-worthiness to comply with the requirement.

[7] Bank for International Settlements, "Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Requirements," September 12, 2010, at http://www.bis.org/press/p100912.htm.

Risk measurement for some assets will become more stringent—capital requirements for trading book assets will be linked to a measure of stressed value at risk. In addition, capital standards will reflect liquidity risk, and banks will be required to maintain reserves of liquidity sufficient to cope with a 30-day systemic liquidity shock.

Banks that are "globally systemic" will have to carry an extra layer of loss-absorbing capacity. The Dodd-Frank Act already enacted a similar provision related to all firms (including nonbanks) that are designated as systemically important by the FSOC. These firms will be subject to higher capital standards—the precise amounts will be determined by the Federal Reserve by rule.

The Basel III proposals call for a lengthy transition period: some requirements will not take effect until 2019. The schedule for implementation of new capital regulations is determined at the national level, and is likely to be a lengthy process, for at least some countries.

Federal banking regulators use versions of the Basel accords as the basis for their capital requirements. **Table 3** sets out the specific standards imposed by each.

Capital Provisions in Dodd-Frank

The Dodd-Frank Act includes numerous provisions that seek to strengthen capital requirements, especially for systemically important institutions. The general thrust of these provisions is that systemically significant firms should be required to hold extra capital to compensate for the risk that their failure might pose to the system at large. Title I requires banking regulators to establish minimum risk-based capital requirements and leverage requirements on a consolidated basis for depository institutions, depository holding companies, and firms designated as systemically significant by the Financial Stability Oversight Council that are no lower than those were set for depository institutions as of the date of enactment. Under this provision, no longer will holding companies be authorized to include trust-preferred securities in Tier I capital. These requirements are phased in, and certain small firms are exempted.

Title VI requires the federal banking regulators to make capital "requirements countercyclical, so that the amount of capital required to be maintained … increases in times of economic expansion and decreases in times of economic contraction, consistent with … safety and soundness."[8]

Section 115(c) requires the Financial Stability Oversight Council to study the feasibility of implementing a contingent capital requirement for systemically significant firms. Contingent capital is debt that can be converted into equity by the issuing firm under certain circumstances. Following the study, if the FSOC recommends, the Fed may impose contingent capital requirements on systemically significant firms.

Section 165(j) requires the Federal Reserve to impose leverage limits on bank holding companies with assets over $50 billion and on the systemically important nonbank financial companies that it will supervise. When this section is implemented, such firms will be required to maintain a debt-to-equity ratio of no more than 15-to-1.

[8] Dodd-Frank Act, Section 616.

Table 3.Capital Standards for Federally Regulated Depository Institutions

Agency	Capital Standard	Source
OCC	Minimum risk-based capital ratio of 8%. (The ratio measures bank capital against assets, with asset values risk-weighted, or adjusted on a scale of riskiness.) In addition, banks must maintain Tier 1 capital[a] in an amount equal to at least 3.0% of adjusted total assets. (A simple definition of Tier 1 capital is stockholders' equity, or the net worth of the institution.) The 3% total assets leverage ratio applies to the most highly rated banks, which are expected to have well-diversified risks, including no undue interest rate risk exposure; excellent control systems; good earnings; high asset quality; high liquidity; and well managed on-and off-balance sheet activities; and in general be considered strong banking organizations, with a rating of 1 under CAMELS[b] rating system of banks. For other banks, the minimum Tier 1 leverage ratio is 4%.	12 CFR § 3.6 ("Minimum capital ratios")
FDIC	The FDIC requires institutions to maintain the same minimum leverage capital requirements (ratio of Tier 1 capital to assets) as the OCC, that is, 3% for the most highly-rated institutions and 4% for others.	12 CFR § 325.3 ("Minimum leverage capital requirement")
Federal Reserve	State banks that are members of the Federal Reserve System must meet an 8% risk-weighted capital standard, of which at least 4% must be Tier 1 capital (3% for strong banking institutions rated "1" under the CAMELS rating system of banks). In addition, the Fed establishes levels of reserves that depository institutions are required to maintain for the purpose of facilitating the implementation of monetary policy by the Federal Reserve System. Reserves consist of vault cash (currency) or deposits at the nearest regional Federal Reserve branch, held against the bank's deposit liabilities, primarily checking, saving, and time deposits (CDs). The size of these reserves places a ceiling on the amount of deposits that financial institutions can have outstanding, and ties deposit liabilities to the amount of assets (loans) these institutions can acquire.	12 CFR § 208.4, Regulation H ("Membership of State Banking Institutions in the Federal Reserve System") and 12 CFR § 204.9 (Reserve requirements)
OTS (abolished by Dodd-Frank)	Risk-based capital must be at least 8% of risk-weighted assets. Federal statute requires that OTS capital regulations be no less stringent than the OCC's. Tangible capital must exceed 1.5% of adjusted total assets. The leverage ratio (Tier 1 capital to assets) must be 4% of adjusted total assets (3% for thrifts with a composite CAMELS rating of 1).	12 CFR §567
NCUA	Credit unions must maintain a risk-based net worth of 7%, as a minimum to be considered well-capitalized.	NCUA Regulations (Section 702, Subpart A)

Source: CRS.

a. Tier 1 capital or core capital means the sum of common stockholders' equity, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries, minus all intangible assets, minus identified losses, minus investments in certain financial subsidiaries, and minus the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from Tier 1 capital.

b. See **Appendix B**.

Non-Bank Capital Requirements

The SEC's Net Capital Rule

The SEC's net capital rule, set out in17 CFR 240.15c3-1, imposes an "Aggregate Indebtedness Standard." No broker/dealer shall permit its aggregate indebtedness to all other persons to exceed 1500% of its net capital (or 800% of its net capital for 12 months after commencing business as a broker or dealer). The 1500% (or 15-to-1) ratio of debt to liquid capital, is arithmetically equivalent to a 6⅔% capital requirement.

To calculate liquid capital, SEC rules require that securities and other assets be given a "haircut" from their current market values (or face value, in the case of bonds), to cover the risk that the asset's value might decline before it could be sold. The haircut concept is essentially the same as the standardized risk weights in the Basel Accords. The riskier the asset, the greater the haircut. For example, U.S. Treasury securities might have a haircut of zero to 1%; municipal securities, 7%; corporate bonds, 15%; common stock, 20%; and certain assets, such as unsecured receivables or securities for which no ready market exists, receive a haircut of 100%. As discussed below, the intent of the net capital rule is not the same as that of banking capital requirements, because the SEC is not a safety and soundness regulator. The net capital rule is meant to ensure that brokerages cease operations while they still have assets to meet their customers' claims.

The Dodd-Frank Act requires the SEC to set capital standards for major security-based swap dealers and major security-based swap participants. The specific standards will be promulgated in the form of regulations, probably in 2011.

CFTC Capital Requirements

Futures commission merchants (or FCMs, the futures equivalent of a securities broker/dealer) are subject to adjusted net capital requirements. Authority to enforce the capital rules is delegated by the CFTC to the National Futures Association (NFA), a self-regulatory organization created by Congress.

Each NFA Member that is required to be registered with the CFTC as a Futures Commission Merchant (Member FCM) must maintain "Adjusted Net Capital" (as defined in CFTC Regulation 1.17) equal to or in excess of the greatest of:

> (i) $500,000;
>
> (ii) For Member FCMs with less than $2,000,000 in Adjusted Net Capital, $6,000 for each remote location operated;
>
> (iii) For Member FCMs with less than $2,000,000 in Adjusted Net Capital, $3,000 for each associated person;
>
> (iv) For securities brokers and dealers, the amount of net capital specified by SEC regulations;

(v) 8% of domestic and foreign domiciled customer and 4% of non-customer (excluding proprietary) risk maintenance margin/performance bond requirements for all domestic and foreign futures and options on futures contracts excluding the risk margin associated with naked long option positions;

(vi) For Member FCMs with an affiliate that engages in foreign exchange (FX) transactions and that is authorized to engage in those transactions solely by virtue of its affiliation with a registered FCM, $7,500,000; or

(vii) For Member FCMs that are counterparties to FX options, $5,000,000, except that FX Dealer Members must meet the higher requirement in Financial Requirements Section 11.[9]

The Dodd-Frank Act requires the CFTC to set capital standards for major security-based swap dealers and major security-based swap participants. The specific standards will be promulgated in the form of regulations, probably in 2011.

Federal Housing Finance Agency

FHFA is authorized to set capital classification standards for the Federal Home Loan Banks, Fannie Mae, and Freddie Mac that reflect the differences in operations between the banks and the latter two government-sponsored enterprises.[10] The law defines several capital classifications, and prescribes regulatory actions to be taken as a GSE's condition worsens.

FHFA may downgrade the capital classification of a regulated entity (1) whose conduct could rapidly deplete core or total capital, or (in the case of Fannie or Freddie) whose mortgage assets have declined significantly in value, (2) which is determined (after notice and opportunity for a hearing) to be in an unsafe or unsound condition, or (3) which is engaging in an unsafe or unsound practice.

No growth in total assets is permitted for an *undercapitalized* GSE, unless (1) FHFA has accepted the GSE's capital restoration plan, (2) an increase in assets is consistent with the plan, and (3) the ratio of both total capital to assets and tangible equity to assets is increasing. An undercapitalized entity is subject to heightened scrutiny and supervision.

If a regulated entity is *significantly undercapitalized*, FHFA must take one or more of the following actions: new election of Directors, dismissal of Directors and/or executives, and hiring of qualified executive officers, or other actions. Without prior written approval, executives of a significantly undercapitalized regulated entity may not receive bonuses or pay raises. In addition, FHFA may appoint a receiver or conservator for several specified causes related to financial difficulty and/or violations of law or regulation.

When a GSE becomes *critically undercapitalized*, mandatory receivership or conservatorship provisions apply. For example, FHFA must appoint itself as the receiver if a regulated entity's assets are (and have been for 60 days) less than its obligations to its creditors, or if the regulated entity has (for 60 days) not been generally paying its debts as they come due. The FHFA

---

[9] National Futures Association, *NFA Manual/Rules*, Section 7001, http://www.nfa.futures.org/nfaManual/manualFinancial.asp#fins1.

[10] See Sections 1142 and 1143 of the Housing and Economic Recovery Act of 2008, P.L. 110-289.

appointed itself conservator for both Fannie and Freddie in September 2008, before either GSE had failed to make timely payments on debt obligations.

The Federal Financial Regulators

Banking Regulators

Banking regulation in United States has evolved over time into a system of multiple regulators with overlapping jurisdictions. There is a dual banking system, in which each depository institution is subject to regulation by its chartering authority: state or federal. In addition, because virtually all depository institutions are federally insured, they are subject to at least one federal primary regulator (i.e., the federal authority responsible for examining the institution for safety and soundness and for ensuring its compliance with federal banking laws). The primary federal regulator of national banks is their chartering authority, the OCC. The primary federal regulator of state-chartered banks that are members of the Federal Reserve System is the Board of Governors of the Federal Reserve System. State-chartered banks that are not members of the Federal Reserve System have the FDIC as their primary federal regulator. Thrifts (both state and federally chartered) had the Office of Thrift Supervision as their primary federal regulator, until the Dodd-Frank Act abolished the OTS and distributed its responsibilities among the OCC, the FDIC, and the Fed. All of these institutions, because their deposits are covered by FDIC deposit insurance, are also subject to the FDIC's regulatory authority. Credit unions–federally chartered or federally insured–are regulated by the National Credit Union Administration, which administers a deposit insurance fund separate from the FDIC's.

In general, lenders are expected to be prudent when extending loans. Each loan creates risk for the lender. The overall portfolio of loans extended or held by a lender, in relation to other assets and liabilities, affects that institution's stability. The relationship of lenders to each other, and to wider financial markets, affects the financial system's stability. The nature of these risks can vary between industry sectors, including commercial loans, farm loans, and consumer loans. Safety and soundness regulation encompasses the characteristics of (1) each loan, (2) the balance sheet of each institution, and (3) the risks in the system as a whole.

Each loan has a variety of risk characteristics of concern to lenders and their regulators. Some of these risk characteristics can be estimated at the time the loan is issued. Credit risk, for example, is the risk that the borrower will fail to repay the principal of the loan as promised. Rising interest rates create another risk because the shorter-term interest rates that the lender often pays for its funds rise (e.g., deposit or CD rates) while the longer-term interest rates that the lender will receive from fixed-rate borrowers remain unchanged. Falling interest rates are not riskless either: fixed-rate borrowers may choose to repay loans early, reducing the lender's expected future cash flow. Federal financial regulators take into account expected default rates, prepayment rates, interest-rate exposure, and other risks when examining the loans issued by covered lenders.

Each lender's balance sheet can reduce or enhance the risks of the individual loans that make it up. A lender with many loans exposed to prepayment risk when interest rates fall, for example, could compensate by acquiring some assets that rise in value when interest rates fall. One example of a compensating asset would be an interest-rate derivative contract. Lenders are required to keep capital in reserve against the possibility of a drop in value of loan portfolios or other risky assets. Federal financial regulators take into account compensating assets, risk-based capital requirements, and other prudential standards when examining the balance sheets of covered lenders.

When regulators determine that a bank is taking excessive risks, or engaging in unsafe and unsound practices, they have a number of powerful tools at their disposal to reduce risk to the institution (and ultimately to the federal deposit insurance fund). They can require banks to reduce specified lending or financing practices, dispose of certain assets, and order banks to take steps to restore sound balance sheets. Banks have no alternative but to comply, since regulators have "life-or-death" options, such as withdrawing deposit insurance or seizing the bank outright.

The federal banking agencies are briefly discussed below.

Office of the Comptroller of the Currency

The OCC was created in 1863 as part of the Department of Treasury to supervise federally chartered banks ("national" banks) and to replace the circulation of state bank notes with a single national currency (Chapter 106, 13 STAT. 99). The OCC regulates a wide variety of financial functions, but only for federally chartered banks. The head of the OCC, the Comptroller of the Currency, is also a member of the board of the FDIC and a director of the Neighborhood Reinvestment Corporation. The OCC has examination powers to enforce its responsibilities for the safety and soundness of nationally chartered banks. The OCC has strong enforcement powers, including the ability to issue cease and desist orders and revoke federal bank charters.

In addition to institution-level examinations, the OCC oversees systemic risk among nationally chartered banks. One example of OCC systemic concerns is the regular survey of credit underwriting practices. This survey compares underwriting standards over time and assesses whether OCC examiners believe the credit risk of nationally chartered bank portfolios is rising or falling. In addition, the OCC publishes regular reports on the derivatives activities of U.S. commercial banks.

Pursuant to Dodd-Frank, the OCC will be the primary regulator for federally chartered thrift institutions.

Federal Deposit Insurance Corporation

The FDIC was created in 1933 to provide assurance to small depositors that they would not lose their savings if their bank failed (P.L. 74-305, 49 Stat. 684). The FDIC is an independent agency that insures deposits, examines and supervises financial institutions, and manages receiverships, assuming and disposing of the assets of failed banks. The FDIC manages the deposit insurance fund, which consists of risk-based assessments levied on depository institutions. The fund is used for various purposes, primarily for resolving failed or failing institutions. The FDIC has broad jurisdiction because nearly all banks and thrifts, whether federally or state-chartered, carry FDIC insurance.

Deposit insurance reform was enacted in 2006 (P.L. 109-173, 119 STAT. 3601), including raising the coverage limit for retirement accounts to $250,000 and indexing both its limit and the general deposit insurance coverage ceiling to inflation. The reform act made changes to the risk-based assessment system to determine the payments of individual institutions. Within a range set by the reform act, the FDIC uses notice and comment rulemaking to set the designated reserve ratio

(DRR) that supports the Deposit Insurance Fund (DIF). The FDIC uses its power to examine individual institutions and to issue regulations for all insured depository institutions to monitor and enforce safety and soundness. The FDIC is the primary federal regulator of state banks that are not members of the Federal Reserve System and state-chartered thrift institutions.

In 2008, as the financial crisis worsened, Congress enacted a temporary increase in the deposit insurance ceiling from $100,000 to $250,000 for most accounts.[11] The increase was made permanent by Dodd-Frank.

Using emergency authority it received under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA, P.L. 102-242),[12] the FDIC made a determination of systemic risk in October 2008 and announced that it would temporarily guarantee (1) newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and (2) non-interest bearing deposit transaction accounts (e.g., business checking accounts), regardless of dollar amount.[13] Under Dodd-Frank, the FDIC's authority to guarantee bank debt is made explicit.

The Dodd-Frank Act also expanded the FDIC's role in liquidating troubled financial institutions. Under Dodd-Frank, the FSOC will designate certain financial institutions—banks and nonbanks—as systemically important. In addition to more stringent capital regulation, those firms will be required to draw up "living wills," or plans for orderly liquidation. The Federal Reserve, with the concurrence of two-thirds of the FSOC, may determine that a firm represents a "severe threat" to financial stability and may order it closed. The FDIC will administer the resolution process for nonbanks as well as banks.[14]

The Federal Reserve

The Board of Governors of the Federal Reserve System was established in 1913 to provide stability in the banking sector through the regulation of bank reserves (P.L. 63-43, 38 STAT. 251). The System consists of the Board of Governors in Washington and 12 regional reserve banks. In addition to its authority to conduct national monetary policy, the Federal Reserve has safety and soundness examination authority for a variety of lending institutions including bank holding companies; U.S. branches of foreign banks; and state-chartered banks that are members of the federal reserve system. Under the Gramm-Leach-Bliley Act (GLBA, P.L. 106-102), the Fed serves as the umbrella regulator for financial holding companies, which are defined as conglomerates that are permitted to engage in a broad array of financially related activities.

The Dodd-Frank Act made the Fed the primary regulator of all financial firms (bank or nonbank) that are designated as systemically significant by the Financial Stability Oversight Council (of which the Fed is a member). Capital requirements for such firms may be stricter than for other firms. In addition, Dodd-Frank made the Fed the principal regulator for savings and loan holding companies and securities holding companies, a new category of institution formerly defined in securities law as an investment bank holding company.

[11] Section 135 of the Emergency Economic Stabilization Act of 2008 (EESA, P.L. 110-343).

[12] FDICIA created a new section 13(c)(4) of the Federal Deposit Insurance Act,12 USC § 1823(c)(4)(G).

[13] "FDIC Announces Plan to Free Up Bank Liquidity," press release, October 14, 2008, http://www.fdic.gov/news/news/press/2008/pr08100.html.

[14] For more detail, see CRS Report R41384, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve*, by Marc Labonte.

In addition to institution-level examinations of covered lenders, the Federal Reserve oversees systemic risk. This role came about not entirely through deliberate policy choices, but partly by default, as a result of the Fed's position as lender of last resort and its consequent ability to inject capital or liquidity into troubled institutions. The Federal Reserve's standard response to a financial crisis has been to announce that it stood ready to provide liquidity to the system. Until 2007, this announcement was sufficient: a number of crises—the Penn Central bankruptcy, the stock market crash of 1987, the junk bond collapse, sovereign debt crises, the Asian crises of 1997-1998, the dot.com crash, and the 9/11 attacks—were quickly brought under control, in most cases without doing harm to the U.S. economy. In 2007, however, the Fed's statements and its actual provision of liquidity failed to restore stability. As a result, the Fed's role as the primary systemic risk regulator was closely scrutinized and the Financial Stability Oversight Council was created.

Finally, Title VIII of Dodd-Frank gave the Fed new safety and soundness authority over payment, clearing, and settlement systems that the FSOC determines to be systemically important. The utilities and institutions that make up the U.S. financial infrastructure process millions of transactions daily, including bill payments, loans, securities purchases, and derivatives trades, representing trillions of dollars. The Federal Reserve is authorized to write risk management standards (except for clearing entities subject to appropriate rules of the CFTC or SEC) and to participate in supervisory examination and enforcement activities in coordination with prudential regulators.

Office of Thrift Supervision (Abolished by Dodd-Frank)

The OTS, created in 1989 during the savings and loan crisis (P.L. 101-73, 103 STAT. 183), is the successor institution to the Federal Savings and Loan Insurance Corporation (FSLIC), created in 1934 and administered by the old Federal Home Loan Bank Board. The OTS has the responsibility of monitoring the safety and soundness of federal savings associations and their holding companies. The OTS also supervises federally insured state savings associations. The OTS is part of the Treasury Department but is primarily funded by assessments on covered institutions. The primary business model of most thrifts is accepting deposits and offering home loans, but thrifts offer many other financial services.

There are three main advantages for firms to choose a federal thrift charter. First, a federal thrift charter shields the institution from some state regulations, because federal banking law can preempt state law.[15] Second, a federal thrift charter permits the institution to open branches nationwide under a single regulator, while state-chartered thrifts must comply with multiple state regulators. Third, a federal thrift charter and its holding company are regulated by the same regulator, but a federal bank charter may split regulation of the institution (OCC) from regulation of its holding company (FRB). Thus, a number of diversified financial institutions that are not primarily savings and loans have come under the supervision of OTS as "thrift holding companies," including Lehman Brothers, AIG, and Morgan Stanley.

OTS was created in response to the savings and loan crisis of the late 1980s. That crisis was characterized by an increase in the number of bad loans coincident with inflation, rising costs of deposits, and significantly declining collateral values, primarily in commercial real estate. The

[15] The scope of federal preemption has been the subject of recent court decisions. See CRS Report RS22485, *Watters v. Wachovia Bank, N.A.*, by M. Maureen Murphy.

magnitude of the losses threatened to overwhelm the deposit insurance funds in the FSLIC. In 1989 Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA; P.L. 101-73), which reorganized thrift regulation and created OTS. FIRREA also created the Resolution Trust Corporation (RTC), charged with sorting out which thrifts could be successfully reorganized or merged with others and which were beyond help. The RTC paid deposit insurance claims and liquidated the assets of failed thrifts.

The Dodd-Frank Act abolished the OTS and distributed its regulatory functions among the Fed, the FDIC, and the OCC. It will cease to exist after a transition period that ends in the second half of 2011.

National Credit Union Administration

The NCUA, originally part of the Farm Credit Administration, became an independent agency in 1970 (P.L. 91-206, 84 STAT. 49). The NCUA regulates all federal credit unions and those state credit unions that elect to be federally insured. It administers a Central Liquidity Facility, which is the credit union lender of last resort, and the National Credit Union Share Insurance Fund, which insures credit union deposits. Credit unions are member-owned financial cooperatives, and must be not-for-profit institutions. As such, they receive preferential tax treatment compared to mid-sized banks.

Non-Bank Financial Regulators

Securities and Exchange Commission

The SEC was created as an independent agency in 1934 to enforce newly-written federal securities laws (P.L. 73-291, 48 Stat. 881). The SEC is not primarily concerned with ensuring the safety and soundness of the firms it regulates, but rather with maintaining fair and orderly markets and protecting investors from fraud. This distinction largely arises from the absence of government guarantees for securities investors comparable to deposit insurance. The SEC generally[16] does not have the authority to limit risks taken by non-bank financial institutions, nor the ability to prop up a failing firm. Two types of firms come under the SEC's jurisdiction: (1) all corporations that sell securities to the public, and (2) securities broker/dealers and other securities markets intermediaries.

Firms that sell securities—stocks and bonds—to the public are required to register with the SEC. Registration entails the publication of detailed information about the firm, its management, the intended uses for the funds raised through the sale of securities, and the risks to investors. The initial registration disclosures must be kept current through the filing of periodic financial statements: annual and quarterly reports (as well as special reports when there is a material change in the firm's financial condition or prospects).

Beyond these disclosure requirements, and certain other rules that apply to corporate governance, the SEC does not have any direct regulatory control over publicly traded firms. Bank regulators are expected to identify unsafe and unsound banking practices in the institutions they supervise,

[16] Dodd-Frank created two exceptions to this rule, discussed below.

and have power to intervene and prevent banks from taking excessive risks. The SEC has no comparable authority; the securities laws simply require that risks be disclosed to investors. Registration with the SEC, in other words, is in no sense a guarantee that a security is a good or safe investment.

To enable investors to make informed investment choices, the SEC has statutory authority over financial accounting standards. All publicly traded firms are required to use generally accepted accounting principles (GAAP), which are formulated by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the SEC itself.

Besides publicly traded corporations, a number of securities market participants are also required to register with the SEC (or with one of the industry self-regulatory organizations that the SEC oversees). These include stock exchanges, securities brokerages (and numerous classes of their personnel), mutual funds, auditors, investment advisers, and others. To maintain their registered status, all these entities must comply with rules meant to protect public investors, prevent fraud, and promote fair and orderly markets. The area of SEC supervision most analogous to banking regulation is broker/dealer regulation. Several provisions of law and regulation protect brokerage customers from losses arising from brokerage firm failure. The Securities Investor Protection Corporation (SIPC), created by Congress in 1970, operates an insurance scheme funded by assessments on broker/dealers (and with a backup line of credit with the U.S. Treasury). SIPC guarantees customer accounts up to $500,000 for losses arising from brokerage failure or fraud (but not market losses). Unlike the FDIC, however, SIPC does not examine broker/dealers and has no regulatory powers.

Since 1975, the SEC has enforced a net capital rule applicable to all registered broker/dealers. The rule requires broker/dealers to maintain an excess of capital above mere solvency, to ensure that a failing firm stops trading while it still has assets to meet customer claims. Net capital levels are calculated in a manner similar to the risk-based capital requirements under the Basel Accords, but the SEC has its own set of risk weightings, which it calls haircuts. The riskier the asset, the greater the haircut.

Although the net capital rule appears to be very close in its effects to the banking agencies' risk-based capital requirements, there are significant differences. The SEC has no authority to intervene in a broker/dealer's business if it takes excessive risks that might cause net capital to drop below the required level. Rather, the net capital rule is often described as a liquidation rule—not meant to prevent failures but to minimize the impact on customers. Moreover, the SEC has no authority comparable to the banking regulators' prompt corrective action powers: it cannot preemptively seize a troubled broker/dealer or compel it to merge with a sound firm.

The differences between bank and securities regulation with respect to safety and soundness came into sharp focus with the collapse of Bear Stearns, one of the five largest investment banks, in March 2008.[17] The SEC monitored Bear Stearns' financial condition until shortly before the collapse (which was precipitated by the refusal of other market participants to extend short-term credit), and believed that the firm had sufficient levels of capital and liquidity. When bankruptcy

[17] See CRS Report RL34420, *Bear Stearns: Crisis and "Rescue" for a Major Provider of Mortgage-Related Products,* by Gary Shorter.

suddenly loomed, it was the Federal Reserve that stepped in to broker the sale of Bear Stearns to JP Morgan Chase by agreeing to purchase $30 billion of "toxic" Bear Stearns assets.

The Bear Stearns situation highlighted several apparent anomalies in the U.S. regulatory structure. The SEC lacked safety and soundness powers over the institutions it supervised, while the Fed was forced to commit funds to an investment bank over which it had no regulatory jurisdiction. The anomaly became even more pronounced when the Fed subsequently established a lending facility to provide short-term credit to other investment banks.[18]

The Bear Stearns collapse showed the inability of the SEC to respond to a brokerage failure with systemic risk implications. There is more to the story, however, than the differences between bank regulation and the SEC's net capital rule. In 2004, the SEC devised a voluntary supervisory scheme for the largest investment banks, called the Consolidated Supervised Entities (CSE) program.[19] The CSE firms were all registered broker/dealers, but were also large holding companies with extensive operations carried on outside the broker/dealer unit. Thus, the SEC had no capital requirement that applied to the entire investment bank. Under CSE, this was to change: as a substitute for the net capital rule, the firms agreed to abide by the Basel risk-based standard, and maintain that level of capital *at the holding company level*. On a voluntary basis, the firms agreed to grant the SEC the authority to examine and monitor their compliance, above and beyond the SEC's explicit statutory authority.[20]

Whatever the intent of the CSE program, it did not succeed in preventing excessive risk-taking by the participants.[21] By the end of September 2008, all five CSE investment banks had either failed (Lehman Brothers), merged to prevent failure (Merrill Lynch and Bear Stearns), or applied for bank holding company status (Morgan Stanley and Goldman Sachs).[22] On September 26, 2008, SEC Chairman Cox announced the end of the CSE program, declaring that "[t]he last six months have made it abundantly clear that voluntary regulation does not work. When Congress passed the Gramm-Leach-Bliley Act, it created a significant regulatory gap by failing to give to the SEC or any agency the authority to regulate large investment bank holding companies."[23]

With Dodd-Frank, Congress eliminated the investment bank holding company framework in section 17 of the Securities Exchange Act of 1934. Section 618 of Dodd-Frank permits a securities holding company that wishes to be subject to supervision on a consolidated basis to submit to regulation by the Federal Reserve. Under Title I of Dodd-Frank, any securities firm that

---

[18] See CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses,* by Marc Labonte

[19] SEC, "Holding Company Supervision Program Description: Consolidated Supervised Entities ("CSEs")," http://www.sec.gov/divisions/marketreg/hcsupervision.htm.

[20] The Market Reform Act of 1990 permits the SEC to collect certain financial information from unregulated affiliates of broker/dealers, under the Broker-Dealer Risk Assessment Program. The impetus for the CSE program was a European Union requirement that investment banks operating in Europe be subject to consolidated financial supervision.

[21] Some argue that CSE allowed the investment banks to hold less capital and increase their leverage. For two views on this issue, see Stephen Labaton, "Agency's '04 Rule Let Banks Pile Up New Debt, and Risk," *New York Times*, October 3, 2008, p. A1, and: Testimony of SEC Chairman Christopher Cox, House Oversight and Government Reform Committee, October 23, 2008. (Response to question from Rep. Christopher Shays.)

[22] By becoming bank holding companies, Morgan Stanley and Goldman Sachs placed themselves under Federal Reserve regulation, presumably to signal to the markets that their financial condition was being monitored.

[23] SEC, "Chairman Cox Announces End of Consolidated Supervised Entities Program," press release 2008-230.

is deemed to be systemically significant by the FSOC will automatically come under the consolidated supervision of the Federal Reserve.

Other provisions of Dodd-Frank, however, gave the SEC new responsibilities that have aspects of safety and soundness regulation. Under Section 731, the SEC will set capital requirements for major security-based swap participants and security-based swap dealers. Section 956 gives the SEC new authority to prohibit compensation structures in broker-dealers and investment advisory firms that create inappropriate risks.

Commodity Futures Trading Commission

The CFTC was created in 1974 to regulate commodities futures and options markets, which at the time were poised to expand beyond their traditional base in agricultural commodities to encompass contracts based on financial variables such as interest rates and stock indexes. The CFTC's mission is to prevent excessive speculation, manipulation of commodity prices, and fraud. Like the SEC, the CFTC oversees industry self-regulatory organizations (SROs)—the futures exchanges and the National Futures Association—and requires the registration of a range of industry firms and personnel, including futures commission merchants (brokers), floor traders, commodity pool operators, and commodity trading advisers.

The Dodd-Frank Act greatly expanded the CFTC's jurisdiction by eliminating exemptions for certain over-the-counter derivatives. As a result, swap dealers, major swap participants, swap clearing organizations, swap execution facilities, and swap data repositories will be required to register with the CFTC. These entities will be subject to business conduct standards contained in statute or promulgated as CFTC rules.

Like the SEC, the CFTC does not directly regulate the safety and soundness of individual firms, with the exception of newly-regulated swap dealers and major swap participants, for whom it will set capital standards pursuant to Dodd-Frank.

Federal Housing Finance Agency

The FHFA was created in 2008 by the Housing and Economic Recovery Act of 2008 (P.L. 110-289) to consolidate and strengthen regulation of a group of housing finance-related government-sponsored enterprises (GSEs): Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.[24] The FHFA succeeded the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (FHFB).

The impetus to create the FHFA came from concerns about risk—including systemic risk—arising from the rapid growth of the GSEs, particularly Fannie and Freddie. These two GSEs were profit-seeking, shareholder-owned corporations that took advantage of their government-sponsored status to accumulate undiversified investment portfolios of over $1.5 trillion, consisting almost exclusively of home mortgages (and securities and derivatives based on those mortgages).

[24] For more on GSEs and their regulation, see CRS Reports CRS Report RS21724, *GSE Regulatory Reform: Frequently Asked Questions*, by N. Eric Weiss, and CRS Report RS21663, *Government-Sponsored Enterprises (GSEs): An Institutional Overview*, by Kevin R. Kosar.

The FHFA was given enhanced safety and soundness powers resembling those of the federal bank regulators. These powers included the ability to set capital standards, to order the enterprises to cease any activity or divest any asset that posed a threat to financial soundness, and to replace management and assume control of the firms if they became seriously undercapitalized.

The FHFA's first action was to place both Fannie and Freddie in conservatorship.[25] Fannie and Freddie continue to operate, under an agreement with the U.S. Treasury. The Treasury will provide capital to the two firms, by means of preferred stock purchases, to ensure that each remains solvent. In return, the government received warrants equivalent to a 79.9% equity ownership position in the firms.

Bureau of Consumer Financial Protection

Title X of Dodd-Frank created a Bureau of Consumer Financial Protection, to bring the consumer protection regulation of depository and non-depository financial institutions into closer alignment.[26] The bureau is an independent entity within the Federal Reserve with authority over an array of consumer financial products and services (including deposit taking, mortgages, credit cards and other extensions of credit, loan servicing, check guaranteeing, collection of consumer report data, debt collection, real estate settlement, money transmitting, and financial data processing). It will also serve as the primary federal consumer financial protection supervisor and enforcer of federal consumer protection laws over many of the institutions that offer these products and services.

However, the bureau's regulatory authority varies based on institution size and type. Regulatory authority differs for (1) depository institutions with more than $10 billion in assets, (2) depository institutions with $10 billion or less in assets, and (3) non-depositories. The Dodd-Frank Act also explicitly exempts a number of different entities and consumer financial activities from the bureau's supervisory and enforcement authority. Among the exempt entities are

- merchants, retailers, or sellers of nonfinancial goods or services, to the extent that they extend credit directly to consumers exclusively for the purpose of enabling consumers to purchase such nonfinancial goods or services;
- automobile dealers;
- real estate brokers and agents;
- financial intermediaries registered with the SEC or CFTC;
- insurance companies; and
- depository institutions with $10 billion or less in assets.

[25] See CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling.

[26] See CRS Report R41338, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau*, by David H. Carpenter.

Regulatory Umbrella Groups

The need for coordination and data sharing among regulators has led to the formation of innumerable interagency task forces to study particular market episodes and make recommendations to Congress. Three interagency organizations have permanent status.

Financial Stability Oversight Council

Title I of the Dodd-Frank Act creates the FSOC on the date of enactment.[27] The council is chaired by the Secretary of the Treasury, and the other voting members consist of the heads of the Federal Reserve, FDIC, OCC, NCUA, SEC, CFTC, FHFA, the Bureau of Consumer Financial Protection, and a member appointed by the President with insurance expertise. Nonvoting members, serving in an advisory capacity, include the director of the Office of Financial Research (which is created by Title I to support the FSOC), the head of the Federal Insurance Office (created by Title V of Dodd-Frank), a state banking supervisor, a state insurance commissioner, and a state securities commissioner.

The FSOC is tasked with identifying risks to financial stability and responding to emerging systemic risks, while minimizing moral hazard arising from expectations that firms or their counterparties will be rescued from failure. The FSOC's duties include

- collecting information on financial firms from regulators and through the Office of Financial Research;
- monitoring the financial system to identify potential systemic risks;
- proposing regulatory changes to Congress to promote stability, competitiveness, and efficiency;
- facilitating information sharing and coordination among financial regulators;
- making regulatory recommendations to financial regulators, including "new or heightened standards and safeguards";
- identifying gaps in regulation that could pose systemic risk;
- reviewing and commenting on new or existing accounting standards issued by any standard-setting body; and
- providing a forum for the resolution of jurisdictional disputes among council members. The FSOC may not impose any resolution on disagreeing members, however.

The council is required to provide an annual report and testimony to Congress.

In contrast to some proposals to create a systemic risk regulator, the Dodd-Frank Act does not give the Council authority (beyond the existing authority of its individual members) to eliminate emerging threats or close regulatory gaps it identifies. In many cases, the council can only make regulatory recommendations—it cannot impose change.

---

[27] See CRS Report R41384, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve*, by Marc Labonte.

Although the FSOC does not have direct supervisory authority over any financial institution, it plays an important role in regulation, because firms that it designates as systemically important come under a consolidated supervisory regime that may be considerably more stringent than the standards that apply to non-systemic firms. The FSOC is also required to approve (by a two-thirds vote) decisions by the Federal Reserve to shut down systemically significant financial firms that pose a severe threat to financial stability.

Federal Financial Institution Examinations Council

The Federal Financial Institutions Examination Council (FFIEC) was created by legislation[28] in 1979 as a formal interagency body to coordinate federal regulation of lending institutions. Through the FFIEC, the federal banking regulators issue a single set of reporting forms for covered institutions. The FFIEC also attempts to harmonize auditing principles and supervisory decisions. The FFIEC is made up of the Federal Reserve, OCC, FDIC, OTS, and NCUA, each of which employs examiners to enforce safety and soundness regulations for lending institutions.

Federal financial institution examiners evaluate the risks of covered institutions. The specific safety and soundness concerns common to the FFIEC agencies can be found in the handbooks employed by examiners to monitor lenders. Each subject area of the handbook can be updated separately. Examples of safety and soundness subject areas include important indicators of risk, such as capital adequacy, asset quality, liquidity, and sensitivity to market risk.

President's Working Group on Financial Markets

The President's Working Group on Financial Markets (PWG) was created by President Reagan through executive order in 1988.[29] The PWG includes the Secretary of the Treasury and the Chairmen of the Federal Reserve, the SEC, and the CFTC. It is not a formal agency subject to congressional oversight, although each member is subject to Senate confirmation at the time of appointment.

The impetus for the creation of the PWG was the stock market crash of October 1987, and specifically the role that the stock index futures markets (under CFTC jurisdiction) had played in creating panic in the stock market (regulated by SEC). Studies conducted by the SEC, the CFTC, a blue-ribbon panel appointed by the President (the Presidential Task Force on Market Mechanisms, or Brady Commission), and the stock and futures exchanges reached strikingly different conclusions; the task of the PWG was to review the studies and issue a further report.

The PWG was not dissolved, but continued to provide interagency coordination and information sharing, and to study entities and products that raised intermarket regulatory issues, such as hedge funds and OTC derivatives. In March 2008, at the direction of President Bush, the PWG issued a policy statement on the ongoing financial crisis.[30]

---

[28] P.L. 95-630, 92 STAT. 3641.

[29] Executive Order 12631, March 18, 1988, 53 FR 9421.

[30] President's Working Group on Financial Markets, "Policy Statement on Financial Market Developments," March 2008, http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

Unregulated Markets and Institutions

Although federal financial statutes and regulations fill many volumes, not all participants in the financial system are regulated. In some cases, unregulated (or self-regulated) markets appear to work very well, but disruptions or major frauds in these markets are likely to bring calls for increased government supervision. The dynamic nature of financial markets is a perennial challenge to regulatory structure design, because a market that appears insignificant at the time a law is written may grow into a potential threat to systemic stability in a few years. The following are some of the major unregulated markets and institutions.

Foreign Exchange Markets

Buying and selling currencies is essential to foreign trade, and the exchange rate determined by traders has major implications for a country's macroeconomic policy. The market is one of the largest in the world, with average daily turnover in excess of $3 trillion.[31] Nevertheless, no U.S. agency has regulatory authority over the foreign exchange market.

Trading in currencies takes place between large global banks, central banks, hedge funds and other currency speculators, commercial firms involved in imports and exports, fund managers, and retail brokers. There is no centralized marketplace, but rather a number of proprietary electronic platforms that have largely supplanted the traditional telephone broker market.

Despite the fact that extreme volatility in exchange rates for a number of European and Asian currencies in the 1990s was often blamed on currency speculators, neither U.S. nor foreign regulators have moved towards regulating the market.

U.S. Treasury Securities

The secondary, or resale, market for Treasury securities is largely unregulated. Like the foreign exchange market, there is no central exchange, but there are a number of proprietary, computer-based transaction systems. Treasury securities were exempted from SEC regulation by the original securities laws of the 1930s. In 1993, following a successful corner of a Treasury bond auction by Salomon Brothers, Congress passed the Government Securities Act Amendments (P.L. 103-202), which required brokers and dealers that were not already registered with the SEC to register as government securities dealers. (Existing broker/dealer registrants were simply required to notify the SEC that they were in the government securities business.) Nevertheless, the government securities market remains much more lightly regulated than the corporate securities markets.

The primary market in Treasury securities, where new debt instruments are sold to fund government operations, is also relatively unregulated. A principal channel for the distribution of new Treasuries is a group of firms called primary dealers, who purchase securities at auction for their own accounts and for their customers. The primary dealers are 19 commercial and investment banks, both foreign and domestic. The primary dealer list is maintained by the Federal

[31] Bank for International Settlements, *Triennial Central Bank Survey: Foreign exchange and derivatives market activity,* December 2007, p. 1, http://www.bis.org/publ/rpfxf07t.pdf.

Reserve Bank of New York, which conducts auctions for the Treasury, but its relationship to the dealers is commercial, rather than regulatory.[32] The New York Fed does, however, collect certain data about primary dealers' transactions in government securities.

In March 2008, as part of its multifaceted attempt to supply liquidity to the financial system, the Federal Reserve established a Primary Dealer Credit Facility, to make short-term loans against a variety of collateral (including asset-backed and mortgage-backed securities) to the primary dealers.[33] This step attracted attention in part because the primary dealer group included investment banking firms over which the Fed had no regulatory authority.

Private Securities Markets

The securities laws mandate registration of and extensive disclosures by public securities issuers, but also provide for private sales of securities, which are not subject to disclosure requirements. Private placements of securities may only be offered to limited numbers of "accredited investors" who meet certain asset tests. (Most purchasers are life insurers and other institutional investors.) There are also restrictions on the resale of private securities.

The size of the private placement market is subject to considerable variation from year to year, but at times the value of securities sold privately exceeds what is sold into the public market. In recent decades, venture capitalists and private equity firms have come to play important roles in corporate finance. The former typically purchase interests in private firms, which may be sold later to the public, while the latter often purchase all the stock of publicly traded companies and take them private.

Comprehensive Reform Legislation in the 111th Congress

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) included provisions to bring a number of previously unregulated markets under federal supervision. Notable examples include the following:

- **Hedge Funds and Private Equity Funds**.[34] Title IV of Dodd-Frank repealed an exemption in the Investment Advisers Act of 1940 for advisers with fewer than 15 clients. Many hedge funds and private equity funds relied on this exemption to avoid SEC registration. Now, funds with more than $100 million in assets must register with the SEC as investment advisers, which will make them subject to disclosure and business conduct rules. (Smaller advisers will register with the states.) Funds with more than $150 million in assets that meet the statutory definition of "private fund" may be subject to extensive and frequent disclosure requirements, involving information regarding their portfolios and strategies which the SEC will share with the FSOC.

---

[32] See http://www.newyorkfed.org/aboutthefed/fedpoint/fed02.html.

[33] Federal Reserve Bank of New York, "Federal Reserve Announces Establishment of Primary Dealer Credit Facility," Press Release, March 16, 2008. http://www.newyorkfed.org/newsevents/news/markets/2008/rp080316.html.

[34] See CRS Report R40783, *Hedge Funds: Legal History and the Dodd-Frank Act*, by Kathleen Ann Ruane and Michael V. Seitzinger.

- **Over-the-Counter Derivatives.**[35] OTC derivatives, a $600 trillion market, were generally not subject to the Commodity Exchange Act before Dodd-Frank. Title VII of Dodd-Frank establishes a comprehensive regime for the regulation of swap contracts by the CFTC, and security-based swap contracts by the SEC.
- **Nonbank Lenders**. During the housing boom of the early 2000s, substantial volumes of mortgages were written not by chartered depository institutions, but by nonbank lenders with access to credit from Wall Street firms involved in the securitization of mortgages. These lenders were not subject to safety and soundness regulation, although they were required to comply with the Federal Reserve's Truth in Lending Act consumer protection regulations. Hundreds of these nonbank mortgage lenders failed in 2007 and 2008, as delinquency rates on their subprime and other non-traditional mortgages soared. The Bureau of Consumer Financial protection, created by Title X of Dodd-Frank, will have authority (subject to certain exemptions) over nonbank mortgage lending, payday lending, and other extensions of credit by non-depository institutions. While the Bureau is not granted a full array of safety and soundness powers, it may require covered non-depositories to register with the Bureau, submit to background checks, and adhere to other measures "to ensure that such persons are legitimate entities and are able to perform their obligations to consumers."[36]

[35] See CRS Report R41398, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title VII, Derivatives,* by Mark Jickling and Kathleen Ann Ruane.

[36] Dodd-Frank Section 1024. See CRS Report R41338, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau,* by David H. Carpenter.

Appendix A. Forms of Banking Organizations

The structure of banks can be complex. Currently, the regulator of a particular activity of a bank or its subsidiary depends in part on the activity of the subsidiary or its charter, as described above. The following flow charts provide simplified representations of various bank structures. In some cases, the umbrella bank and its subsidiaries may have different regulators.

Figure A-1. National Bank

Figure A-2. National Bank and Subsidiaries

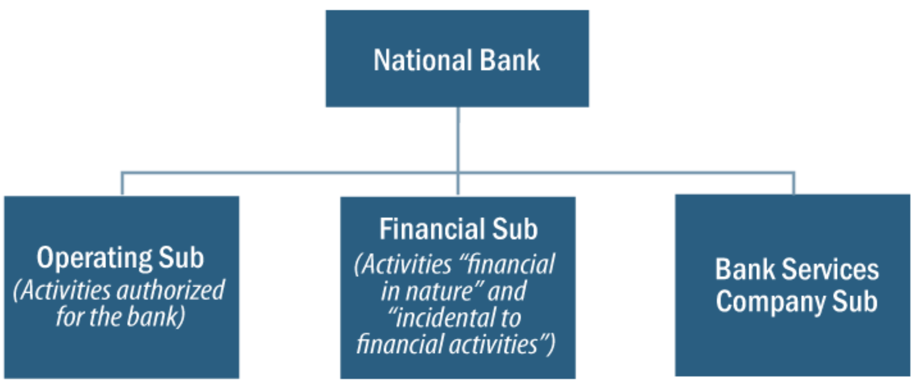


Figure A-3. Bank Holding Company

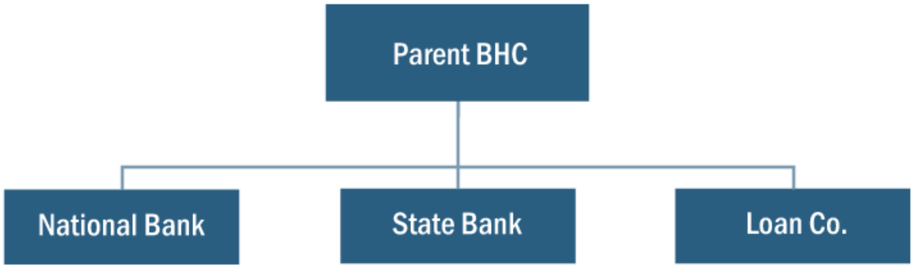
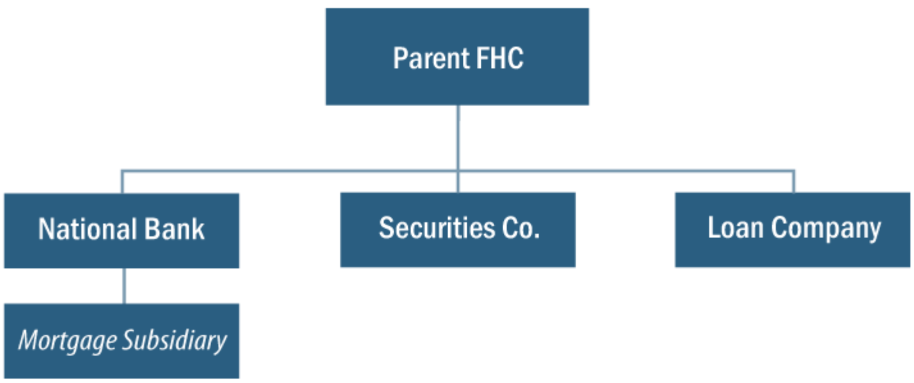


Figure A-4. Financial Holding Company



Appendix B. Bank Ratings: UFIRS and CAMELS

Federal bank regulators conduct confidential assessments of covered banks. The Federal Financial Institutions Examination Council (FFIEC) helps coordinate the ratings system used by bank examiners so that there is some consistency to the examinations, although the ratings do take into account differences in bank size, sophistication, complexity of activities, and risk profile. The FFIEC adopted the Uniform Financial Institutions Rating System (UFIRS) in 1979. The system was revised in 1996 and is often referred to as the CAMELS rating system. CAMELS stands for **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk. A description of the CAMELS system is found in the Comptrollers Handbook: Bank Supervision Process, provided by the OCC.[37] Market factors can affect more than one category in the CAMELS ratings.

Capital Adequacy

This component assesses the level of capital held by the institution in relation to the risks that it takes. Capital adequacy can be affected by a number of factors, including changes in credit risk, market risk, and the institution's financial condition. Increases in problem assets would require increased capital. Capital adequacy is also supposed to reflect risks even if they are technically off of the bank's balance sheet.

Asset Quality

Asset quality refers to existing and potential credit risk associated with a the bank's portfolio. Like capital adequacy, this component is supposed to reflect risk even if it is not technically on the bank's balance sheet. Asset quality can include changes in loan default rates, investment performance, exposure to counterparty risk, and all other risks that may affect the value or marketability of an institution's assets.

Management Capability

The governance of the bank, including management and board of directors, is assessed in relation to the nature and scope of the bank's activities. This rating is affected by the level and quality of management oversight. It also includes legal compliance, responsiveness to auditor recommendations, and similar issues.

Earnings Quantity and Quality

The rating of a bank's earnings takes into account current earnings and the sustainability of future earnings. Earnings that rely on favorable tax effects and nonrecurring events receive lower ratings. Similarly, inadequate controls for expenses can reduce the rating for earnings. Difficulties in forecasting and managing risks can also reduce the earnings rating.

[37] The Comptrollers handbooks are occasionally updated. The most recent handbook for the Bank Supervision Process is dated September 2007 and can be found at http://www.occ.gov/handbook/banksup.pdf.

Liquidity

Liquidity includes the ability of a bank to meet its expected funding needs. For a given institution size and complexity, this factor assesses the ability of the firm to fulfill its financial obligations in a timely manner. Liquidity refers to the ability to meet short-term funding needs without incurring excessive losses, which might occur if assets had to be sold at a steep discount in a time-pressure situation (or “fire sale”). Liquidity also includes assessments of specific financial categories, such as the trend and stability of deposits, and the expected ability to securitize and sell pools of assets.

Sensitivity to Market Risk

Market risk includes potential changes in the prices of financial assets, such as movements in interest rates, foreign exchange rates, commodity prices, and stock prices. The nature and scope of a bank’s activities can affect the markets that it is exposed to; therefore, market risk is closely related to the other CAMELS factors. This rating takes into account management’s ability to identify and manage the risks that can arise from the bank’s trading activities in financial markets. It also takes into account interest rate risk from nontrading positions, such as any duration mismatch in loans held to maturity.

Appendix C. Acronyms

AICPA	American Institute of Certified Public Accountants
BIS	Bank for International Settlements
CAMELS	Capital Adequacy, Asset Quality, Management, Liquidity, Sensitivity to Market Risk
CFTC	Commodity Futures Trading Commission
CSE	Consolidated Supervised Entities
DIF	Deposit Insurance Fund
EESA	Emergency Economic Stabilization Act
FASB	Financial Accounting Standards Board
FCM	Futures Commission Merchant
FDIC	Federal Deposit Insurance Corporation
FDICIA	The FDIC Improvement Act of 1991
FFIEC	Federal Financial Institution Examination Council
FHFA	Federal Housing Finance Agency
FHFB	Federal Housing Finance Board
FINRA	Financial Industry Regulatory Authority
FIRREA	The Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Federal Reserve Board
FSOC	Financial Stability Oversight Council
FSLIC	Federal Savings and Loan Insurance Corporation
FX	Foreign Exchange
GLBA	Gramm-Leach-Bliley Act
GAAP	Generally Accepted Accounting Principles
GSE	Government-Sponsored Enterprise
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OFR	Office of Financial Research
OTS	Office of Thrift Supervision
PCS	Payment, Clearing, and Settlement Systems
PWG	President's Working Group on Capital Markets
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
SRO	Self Regulatory Organization
UFIRS	Uniform Financial Institutions Rating System

Appendix D. Regulatory Structure Before the Dodd-Frank Act

Regulatory Agency	Institutions Regulated	Emergency/Systemic Risk Powers	Other Notable Authority
Federal Reserve	Bank holding companies,[a] financial holding companies, state banks that are members of the Federal Reserve System, U.S. branches of foreign banks, foreign branches of U.S. banks	Lender of last resort to member banks (through discount window lending). In "unusual and exigent circumstances" the Fed may lend to *"any individual, partnership, or corporation ... "*	*The Fed issues consumer protection regulations under various federal laws, including the Truth-in-Lending Act*
Office of the Comptroller of the Currency (OCC)	National banks, U.S. federal branches of foreign banks		
Federal Deposit Insurance Corporation (FDIC)	Federally-insured depository institutions, including state banks that are not members of the Federal Reserve System	After making a determination of systemic risk, the FDIC may invoke broad authority to use the deposit insurance funds to provide an array of assistance to depository institutions	
Office of Thrift Supervision (OTS)	*Federally chartered and insured thrift institutions, savings and loan holding companies*		
National Credit Union Administration (NCUA)	Federally-chartered or insured credit unions	Serves as a liquidity lender to credit unions experiencing liquidity shortfalls through the Central Liquidity Facility	Operates a deposit insurance fund for credit unions, the National Credit Union Share Insurance Fund (NCUSIF)
Securities and Exchange Commission (SEC)	Securities exchanges, brokers, and dealers; mutual funds; investment advisers. Registers corporate securities sold to the public	May unilaterally close markets or suspend trading strategies for limited periods	Authorized to set financial accounting standards which all publicly traded firms must use
Commodity Futures Trading Commission (CFTC)	Futures exchanges, brokers, pool operators, advisers	May suspend trading, order liquidation of positions, or raise margins *in emergencies.*	
Federal Housing Finance Agency (FHFA)	Fannie Mae, Freddie Mac, and the Federal Home Loan Banks	Acting as conservator (since Sept. 2008) for Fannie and Freddie	

Source: CRS.

Note: Provisions in italics were repealed by Dodd-Frank.

c. See **Appendix A**.

Appendix E. Glossary of Terms

This glossary has been compiled from several earlier CRS reports, from the CFTC and SIFMA websites, and from other sources.

Affiliate—A corporate relationship of control. Two companies are affiliated when one owns all or a large part of another, or when both are controlled by a third (holding) company (see subsidiary). All subsidiaries are affiliates, but affiliates that are less than 50% controlled are usually not treated as subsidiaries.

Agency relationship—A business relationship of two parties in which one represents the other in transactions with third parties. The agent negotiates on behalf of the party actually at risk, who is known as the "principal." A commission goes to the agent who does not take on the risk of the transaction; the profit or loss goes to the principal.

Asset-backed security—A bond that represents a share in a pool of debt obligations or other assets. The holder is entitled to some part of the repayment flows from the underlying debt. (See "securitization.")

Bank holding company—A business incorporated under state law, which controls through equity ownership ("holds") one or more banks and, often, other affiliates in financial services as allowed by its regulator, the Federal Reserve. On the federal level, these businesses are regulated through the Bank Holding Company Act.

Bank Holding Company Act—The federal statute under which the Federal Reserve regulates bank holding companies and financial holding companies (FHC). Besides the permissible financial activities enumerated in the Gramm-Leach-Bliley Act (P.L. 106-102), the law provides a mechanism between the Federal Reserve and the Department of the Treasury to decide what is an appropriate new financial activity for FHCs.

Blue sky laws—State statutes that govern the offering and selling of securities.

Broker/dealer—An individual or firm that buys and sells securities for itself as well as for customers. Broker/dealers are registered with the Securities and Exchange Commission.

Bubble—Self-reinforcing process in which the price of an asset exceeds its fundamental value for a sustained period, often followed by a rapid price decline. Speculative bubbles are usually associated with a "bandwagon" effect in which speculators rush to buy the commodity (in the case of futures, "to take positions") before the price trend ends, and an even greater rush to sell the commodity (unwind positions) when prices reverse.

Capital requirements—Capital is the owners' stake in an enterprise. It is a critical line of defense when losses occur, both in banking and nonbanking enterprises. Capital requirements help assure that losses that might occur will accrue to the institution incurring them. In the case of banking institutions experiencing problems, capital also serves as a buffer against losses to the federal deposit insurance funds.

Charter conversion - Banking institutions may, with the approval of their regulators, switch their corporate form between: commercial bank or savings institution, National or State charter, and to stockholder ownership from depositor ownership. Various regulatory conditions may encourage switching.

Clearing Organization—An entity through which futures and other derivative transactions are cleared and settled. A clearing organization may be a division or affiliate of a particular exchange, or a freestanding entity. Also called a clearing house, multilateral clearing organization, or clearing association.

Collateralized debt obligation (CDO)—A bond created by the securitization of a pool of asset-backed securities.

Collateralized mortgage obligation (CMO)—A multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans.

Commercial bank—A deposit-taking institution that can make commercial loans, accept checking accounts, and whose deposits are insured by the Federal Deposit Insurance Corporation. National banks are chartered by the Office of the Comptroller of the Currency; state banks, by the individual states.

Commodity Futures Modernization Act of 2000 (CFMA, P.L. 106-554, 114 Stat. 2763)—Overhauled the Commodity Exchange Act to create a flexible structure for the regulation of futures and options trading, and established a broad statutory exemption from regulation for OTC derivatives. Largely repealed by the Dodd-Frank Act.

Community financial institution—As provided for in the Gramm-Leach-Bliley Act, a member of the Federal Home Loan Bank System whose deposits are insured under the Federal Deposit Insurance Act and which has assets of less than $500 million (calculated according to provisions in the law, and in succeeding years to be adjusted for inflation). Such institutions may become members without meeting requirements with regard to the percentage of total assets that must be in residential mortgage loans and may borrow from the Federal Home Loan Banks for small business and agriculture.

Conservatorship—When an insolvent financial institution is reorganized by a regulator with the intent to restoring it to an ongoing business.

Counterparty—The opposite party in a bilateral agreement, contract, or transaction, such as a swap.

Credit Default Swap (CDS)—A tradeable contract in which one party agrees to pay another if a third party experiences a credit event, such as default on a debt obligation, bankruptcy, or credit rating downgrade.

Credit Risk—The risk that a borrower will fail to repay a loan in full, or that a derivatives counterparty will default.

Credit union—A nonprofit financial cooperative of individuals with one or more common bonds (such as employment, labor union membership, or residence in the same neighborhood). May be state or nationally chartered. Credit unions accept deposits of members' savings and transaction balances in the form of share accounts, pay dividends (interest) on them out of earnings, and primarily provide consumer credit to members. The federal regulator for credit unions is the National Credit Union Administration.

Dealer—An individual or financial firm engaged in the purchase and sale of securities and commodities such as metals, foreign exchange, etc., for its own account and at its own risk as principal (see broker). Commercial banks are typically limited to acting as dealers in specified high-quality debt obligations, such as those of the federal government.

Depository institution—Customarily refers to commercial banks, savings institutions, and credit unions, since traditionally the greater part of their funding has been in the form of deposits. Deposits are a customer's funds placed with an institution according to agreed on terms and conditions and represent a credit to the depositor.

Derivatives—Financial contracts whose value is linked to the price of an underlying commodity or financial variable (such as an interest rate, currency price, or stock index). Ownership of a derivative does not require the holder to actually buy or sell the underlying interest. Derivatives are used by hedgers, who seek to shift risk to others, and speculators, who can profit if they can successfully forecast price trends. Examples include futures contracts, options, and swaps.

Discount window—Figurative term for the Federal Reserve facility for extending credit directly to eligible depository institutions. It may be used to relieve temporary cash shortages at banks and other depository institutions. Borrowers are expected to have tried to borrow elsewhere first and must provide collateral as security for loans. The term derives from the practice whereby bankers would come to a Reserve Bank teller window to obtain credit in the early days of the Federal Reserve System.

Dual banking system—The phrase refers to the fact that banks may be either federally or state-chartered. In the case of state-chartered banks, the state is the primary regulator; for national banks, the Office of the Comptroller of the Currency is the primary regulator.

Electronic fund transfer (EFT) systems—A variety of systems and technologies for transferring funds electronically rather than by paper check.

Exchange—A central marketplace with established rules and regulations where buyers and sellers meet to trade futures and options contracts or securities.

Federal Home Loan Banks—Twelve regional member-owned federally sponsored organizations that extend credit to their member banking institutions, largely to finance mortgages made to homeowners. The 12 FHLBs make up a single government-sponsored enterprise.

Federal safety net—A broad term referring to protection of banking institutions through deposit insurance, discount window credit, other lender of last resort support, and certain forms of regulations to reduce risk. Commercial and industrial companies generally lack any of these cushions against loss.

Financial businesses—In discussions about financial services modernization, usually refers to commercial banks and savings institutions, securities firms, and insurance companies and agents, as contrasted with commercial and industrial firms.

Financial holding company—A holding company form authorized by the Gramm-Leach-Bliley Act that goes beyond the limits a of bank holding company. It can control one or more banks, securities firms, and insurance companies as permitted by law and/or regulation.

Financial institution—An enterprise that uses its funds chiefly to purchase financial assets such as loans and debt securities, as opposed to tangible property. Financial institutions are differentiated by the manner in which they invest their funds: in loans, bonds, stocks, or some combination; as well as by their sources of funds. Depository financial institutions are differentiated in that they may accept deposits which are federally insured against loss to the depositor. Nondepository financial institutions such as life and property/casualty insurance companies, pension funds, and mutual funds obtain funds through other types of receipts, whose values may fluctuate with market conditions.

Financial subsidiary—Under the Gramm-Leach-Bliley Act, both national and state-chartered banks are authorized to form financial subsidiaries to engage in activities that would not otherwise be permitted within the bank itself, subject to certain limits. Besides the permissible financial activities enumerated in P.L. 106-102, the law provides a mechanism between the U.S. Department of the Treasury and the Federal Reserve to decide what is an appropriate new financial activity for a financial subsidiary.

Firewalls—Barriers to the flow of capital, information, management, and other resources among business units owned by a common entity. In case of financial distress of one operation ("fire"), the "walls" are intended to prevent the spread of loss to the other units—especially to banking units. Example: losses in a securities subsidiary of a holding company could not be covered by any of the holding company's bank subsidiaries.

Foreign bank—Banks and their holding companies headquartered in other countries may have a variety of financial operations in the United States: U.S.-chartered subsidiary banks, agencies, branches, and representative offices. Their primary federal regulator is the Federal Reserve, under the International Banking Act of 1978 as amended. States and the Office of the Comptroller of the Currency may also regulate them.

Functional regulation—Regulatory arrangements based on activity ("function") rather than organizational structure. The Gramm-Leach-Bliley Act called for more functional regulation than in the past.

Glass-Steagall Act—Part of the Banking Act of 1933; divided the commercial and investment banking industries. The Gramm-Leach-Bliley Act repealed two sections of the act dealing with the relationship between banks and securities firms.

Government-sponsored enterprise (GSE)—GSEs are private companies with government charters. Government sponsorship typically gives them a funding advantage over purely private competitors, while their charters restrict the kinds of businesses they may conduct.

Gramm-Leach-Bliley Act of 1999—P.L. 106-102, also known as the Financial Services Modernization Act, authorized increased affiliations between banks, securities firms, and insurers. Permitted the establishment of financial holding companies, under the regulation of the Federal Reserve. Also addressed privacy protection for consumers' financial data.

Haircut—In computing the value of assets for purposes of capital, segregation, or margin requirements, a percentage reduction from the stated value (e.g., book value or market value) to account for possible declines in value that may occur before assets can be liquidated.

Hedge funds—Hedge funds are essentially unregulated mutual funds. They are pools of invested money that buy and sell stocks and bonds and many other assets, including precious metals, commodities, foreign currencies, and derivatives (contracts whose prices are derived from those of other financial instruments). Hedge funds are limited to qualified investors with high net worth.

Hedging—Investing with the intention of reducing the impact of adverse movements in interest rates, commodities, or securities prices. Typically, the hedging instrument gains value as the hedged item loses value, and vice versa.

Insolvent—A firm whose liabilities exceed its assets.

Institutional regulation—Regulation that is institution-specific as contrasted with activity-specific (see functional regulation).

Investment bank—A financial intermediary, active in the securities business. Investment banking functions include underwriting (marketing newly registered securities to individual or institutional investors), counseling regarding merger and acquisition proposals, brokerage services, advice on corporate financing, and proprietary trading.

Investment bank holding company—A holding company for securities firms authorized under the Gramm-Leach-Bliley Act. Such holding companies are subject to regulation by the Securities and Exchange Commission.

Issuer—A person or entity (including a company or bank) that offers securities for sale. The issuing of securities, where the proceeds accrue to the issuer, is distinct from the secondary, or resale, market, where securities are traded among investors.

Lender of last resort—Governmental lender that acts as the ultimate source of credit in the financial system. In the United States, the Federal Reserve has this role.

Leverage—The ability to control large dollar amounts of a commodity or security with a comparatively small amount of capital. Leverage can be obtained through borrowing or the use of derivatives.

Limited-purpose bank—Although generally commercial firms may not conduct a banking business, some exceptions exist. Examples: Nonbank banks are banks that either accept deposits or make commercial loans but cannot do both. Such banks grew up through a loophole in law which was closed by the Competitive Equality Banking Act of 1987 (CEBA). Credit card banks conduct credit card operations. Industrial loan companies in a few states may offer restricted banking services.

Liquidity—The ability to trade an asset quickly without significantly affecting its price, or the condition of a market with many buyers and sellers present. Also, the ability of a person or firm to access credit markets.

Liquidity risk—The possibility that the market for normally-liquid assets will suddenly dry up, leaving firms unable to convert assets into cash. Also, the risk that other firms will refuse to extend credit on any terms to a firm that is perceived as distressed.

Market risk—The risk that the price of a tradeable security or asset will decline, resulting in a loss to the holder.

Merchant banker—A European style investment banker concentrating on corporate deals, in which it may invest its own funds.

Money market mutual fund (MMF)—A form of mutual fund that pools funds of individuals and other investors for investment in high-grade, short-term debt and bank deposits paying market rates of return. Examples of these money market instruments include U.S. Treasury bills, certificates of deposit, and commercial paper. In addition to the investment features, most MMFs offer check-writing redemption features.

Moral hazard—The tendency of people to take more risks once another party has agreed to provide protection. Regulatory interventions to bail out failing firms are often said to create moral hazard, on the assumption that others will expect to be saved from their mistakes, too.

Mortgage-backed security (MBS)—A bond backed by a pool of mortgage loans. The bondholders receive a share of the interest and principal payments on the underlying mortgages. The cash flows may be divided among different classes of bonds, called tranches.

Mutual fund—An investing company that pools the funds of individuals and other investors, and uses them to purchase large amounts of debt or equity obligations of businesses and sometimes debt obligations of governments. The owners of the mutual fund hold proportional shares in the entire pool of securities in which a fund invests. Owners pay taxes on their distributions from a fund; the mutual fund itself is not normally subject to federal or state income taxation.

Naked option—The sale of a call or put option without holding an equal and opposite position in the underlying instrument.

Operational risk—The possibility that a financial institution will suffer losses from a failure to process transactions properly, from accounting mistakes, from rogue traders or other forms of insider fraud, or from other causes arising inside the institution.

Over-the-counter (OTC)—Trading that does not occur on a centralized exchange or trading facility. OTC transactions can occur electronically or over the telephone.

Ponzi Scheme—Named after Charles Ponzi, a man with a remarkable criminal career in the early 20th century, the term has been used to describe pyramid arrangements whereby an enterprise makes payments to investors from the proceeds of a later investment rather than from profits of the underlying business venture, as the investors expected, and gives investors the impression that a legitimate profit-making business or investment opportunity exists, where in fact it is a mere fiction.

Receivership—When an insolvent financial institution is taken over with the intent to liquidate its assets.

Resolution Trust Corporation (RTC) - The agency set up to resolve savings and loans declared failed beginning in 1989. Between 1989 and mid-1995, the Resolution Trust Corporation closed or otherwise resolved 747 thrifts with total assets of $394 billion.

Savings association—A savings and loan association, mutual savings bank, or federal savings bank, whose primary function has traditionally been to encourage personal saving (thrift) and home buying through mortgage lending. In recent years, such institutions' charters have been expanded to allow them to provide commercial loans and a broader range of consumer financial services. The federal regulator for most savings associations is the Office of Thrift Supervision. Also known as savings and loans, thrifts, and mutual savings banks.

Securities Investor Protection Corporation (SIPC)—A private nonprofit membership corporation set up under federal law to provide financial protection for the customers of failed brokers and/or dealers. SIPC is a liquidator; it has no supervisory or regulatory responsibilities for its members, nor is it authorized to bail out or in other ways assist a failing firm.

Securitization—The process of transforming a cash flow, typically from debt repayments, into a new marketable security. Holders of the securitized instrument receive interest and principal payments as the underlying loans are repaid. Types of loans that are frequently securitized are home mortgages, credit card receivables, student loans, small business loans, and car loans.

Self-regulatory organizations (SROs)—National securities or futures exchanges, national securities or futures associations, clearing agencies and the Municipal Securities Rulemaking Board are all authorized to make and enforce rules governing market participants. The respective federal regulatory agency has authority in connection with SROs and may require them to adopt or modify their rules. Examples of SROs in the securities industry include the Financial Industry Regulatory Authority (FINRA), and the New York Stock Exchange.

Special-purpose entities (SPEs)—Also referred to as off–balance-sheet arrangements, SPEs are legal entities created to perform a specific financial function or transaction. They isolate financial risk from the sponsoring institution and provide less-expensive financing. The assets, liabilities, and cash flows of an SPE do not appear on the sponsoring institution's books.

Speculation—A venture or undertaking of an enterprising nature, especially one involving considerable financial risk on the chance of unusual profit.

State regulation—Under the dual system of bank regulation, states as well as the federal government may charter, regulate, and supervise depository institutions. States are the primary regulators in the insurance field. States also have authority over securities companies, mortgage lending companies, personal finance companies, and other types of companies offering financial services.

Structured debt—Debt that has been customized for the buyer, often by incorporating complex derivatives.

Subordinated debt—Debt over which senior debt takes priority. In the event of bankruptcy, subordinated debtholders receive payment only after senior debt claims are paid in full.

Subsidiary—A company whose controlling shares are owned 50% or more by another ("parent") corporation. Like companies with less than 50% ownership, it is an affiliate of the controlling company. A subsidiary is usually consolidated for regulatory and reporting purposes with its parent.

Systemic Risk—The term "systemic risk" does not have a single, agreed-upon definition. Some define systemic risk as the risk an institution faces that it cannot diversify against. In other circumstances, systemic risk is defined as the risk that the linkages between institutions may affect the financial system as a whole, through a dynamic sometimes referred to as contagion.

Thrift holding company—Also known as a savings and loan holding company, a business that controls one or more savings associations. These holding companies are regulated under the Home Owners' Loan Act by the Office of Thrift Supervision.

Too-big-to-fail doctrine—an implicit regulatory policy holding that very large financial institutions must be rescued by the government, because their failure would destabilize the entire financial system. (See "moral hazard.")

Umbrella supervision—The term applied to comprehensive regulation of a holding company and its parts by one or more holding company regulator(s).

Underwriter—For securities markets, see investment bankers. For insurance, underwriters are the life, health and property-casualty companies that receive premiums and pay off losses and other risks as they occur. The underwriters bear the risks of losses and expenses exceeding receipts.

Unitary thrift holding company (UTHC)—A holding company that owns a single thrift institution. A distinction between UTHCs and other thrift holding companies has been that a UTHC could be involved in any lines of business, whereas the others have been restricted to certain activities primarily financial in nature. The Gramm-Leach-Bliley Act limits the commercial activities and affiliations of new UTHCs.

Universal bank—An organizational model typical of some foreign countries whereby a bank can exist as an operating enterprise and own directly a variety of other businesses (See Subsidiary). It contrasts with the banking model typical in the United States where the parent holding company owns several different businesses, all structurally separate (See "affiliate."). In practice, the two approaches are not exclusive.

Author Contact Information

Mark Jickling
Specialist in Financial Economics
mjickling@crs.loc.gov, 7-7784

Edward V. Murphy
Specialist in Financial Economics
tmurphy@crs.loc.gov, 7-6201

Acknowledgments

The authors gratefully acknowledge helpful comments from our colleagues Walter Eubanks, Marc Labonte, and Maureen Murphy.