Financial Stability Oversight Council: A Framework to Mitigate Systemic Risk

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Summary

The Financial Stability Oversight Council (FSOC) was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA; P.L. 111-203) in 2010 as part of a comprehensive reform of banking and securities market regulators. The council is charged with monitoring systemic risk in the financial system and coordinating several federal financial regulators. The 113th Congress may wish to monitor the performance, rulemaking, and policy recommendations of the council.

This report describes the mission, membership, and scope of the FSOC. It provides an analysis of several major policy issues related to the FSOC that may come before the 113th Congress.

The DFA establishes a regulatory framework of which the FSOC is a consultative council. The new regulatory regime incorporates several policy tools to address systemic risk. The FSOC facilitates communication among financial regulators, collects and evaluates financial data to monitor systemic risk, and designates which financial institutions and financial market utilities will be subject to prudential regulation by the Federal Reserve Board (the Fed). Upon a determination of a threat to financial stability, a covered non-bank financial institution in danger of failing may under certain conditions be resolved by the Federal Deposit Insurance Corporation (FDIC), rather than through the bankruptcy process. The FSOC may under certain circumstances set aside some financial regulations for consumers if the rules create systemic risk.

The Office of Financial Research (OFR), a permanent staff of financial experts, supports the members of the FSOC. The OFR processes, monitors, and analyzes financial data gathered from member agencies and collected from reporting firms. The OFR contributes to the annual report issued by the FSOC. In the 2013 annual report, the OFR noted a number of positive trends, including increased capital levels and liquidity among financial intermediaries.

However, the 2013 report includes several areas of continuing concern. For example, several sources of wholesale funding (such as money market mutual funds and repurchase agreements) remain vulnerable to the risk of runs or fire sales. The housing finance system still relies on government support, although financial trends for the government-sponsored enterprises (GSEs) have improved. A number of operational issues, such as information technology and resilience against cyber-attacks, are ongoing concerns. Interest rates create additional concerns, including the reliability of benchmarks such as LIBOR, and the exposure of financial intermediaries to significant losses should market interest rates rise (sometimes referred to as *yield spikes*). Long-term budget issues, so-called fiscal imbalances, remain a concern although revenues have recently been rising as general economic conditions improve in the United States. Finally, the 2013 annual report discusses several factors in other countries that could negatively affect financial stability in the United States if conditions overseas deteriorate, including the resolution of European financial turmoil and Japanese macroeconomic policies.

This report is intended to be used as a reference by congressional staff working on financial issues. The macroeconomic policy rationales for various financial crisis-related issues are summarized, and a glossary is provided to assist in understanding technical terms. This report is not intended to be read from cover to cover, but instead may be more useful as issues related to the FSOC arise.

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Introduction: The Regulation of Bank and Non-Bank Financial Institutions

In 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, 124 Stat 1394), also known as the Dodd-Frank Act (DFA), established a new regulatory framework to address financial market instability. Included in that framework was the creation of the Financial Stability Oversight Council (FSOC), which is composed of the heads of the agencies that regulate financial institutions and markets. **Table 1** lists the member agencies. The FSOC has its own permanent staff in the newly created Office of Financial Research (OFR) that collects data on the financial system and provides information and technical expertise to the FSOC. OFR is housed within the Department of the Treasury, although it is funded separately.

The FSOC is expected to facilitate communication among existing financial regulators intending to identify sources of financial instability that cross agency regulatory jurisdiction, or that reside in gaps in the financial regulatory framework. Congressional staff may be interested in the organization, actions, and assessments of the FSOC, especially if a systemic financial event were to occur, a covered non-bank financial institution were to fail, and when the Secretary of the Treasury offers testimony to Congress (which is required at least once per year when the annual report is released).

Table 1. Membership of the Financial Stability Oversight Council

Voting Members (Heads of)	Non-Voting Members
Department of the Treasury	Office of Financial Research (OFR)
Federal Reserve Board (FRB or the Fed)	Federal Insurance Office
Office of the Comptroller of the Currency (OCC)	A state insurance commissioner
Consumer Financial Protection Bureau (CFPB)	A state bank supervisor
Securities and Exchange Commission (SEC)	A state securities commissioner
Federal Deposit Insurance Corporation (FDIC)	
Commodity Futures Trading Commission (CFTC)	
Federal Housing Finance Agency (FHFA)	
National Credit Union Administration (NCUA)	
Insurance expert (Appointed by the President)	

Source: P.L. 111-203 §111(b).

The FSOC was created to address some of the perceived regulatory weaknesses that may have contributed to the magnitude of the financial crisis of 2008. These perceived weaknesses included identification of risks to the financial system as a whole; lack of coordination among financial regulators; inadequate supervision of large, complex financial institutions; and instabilities that might result from the failure or bankruptcy of a non-bank financial institution. The FSOC provides a common forum for financial regulators to evaluate and address risks to the stability of the financial system, including systemic risks that might emanate from less regulated non-bank financial institutions. The FSOC has the ability to classify (or "designate" as used in the law and this report) certain non-banks as systemic, and therefore subject to prudential supervision by the

Federal Reserve (the Fed). Systemic firms with more than $50 billion in assets must also provide and maintain resolution plans (so-called living wills), which must be jointly approved by the Fed and the Federal Deposit Insurance Corporation (FDIC).

The DFA establishes a regulatory framework of which the FSOC is a consultative council. The new regulatory regime has six basic policy tools with which to pursue its mission.

1. **Coordination.** The council facilitates communication among the heads of financial regulators.
2. **Data collection and evaluation.** The FSOC has a permanent staff with the ability to gather confidential financial information and the staff of the OFR are to be experts in the financial field.
3. **Prudential regulation of certain non-banks.** The FSOC establishes the criteria and designates which firms will be subject to additional prudential regulation by the Fed, including capital requirements, asset tests, and similar safety and soundness regulations.
4. **Safety and Soundness Regulation of certain Financial Market Utilities.** The FSOC establishes the criteria and designates which financial market utilities be subjected to safety and soundness regulation. An example of a financial market utility would be an organization that provides settlement and clearing services.
5. **Resolution of non-banks.** Upon a determination of a threat to financial stability, a covered non-bank in danger of failing may under certain conditions be resolved by the FDIC rather than through the bankruptcy process.
6. **Evaluation of rules for consumer financial protection.** The FSOC may set aside some financial regulations for consumers if the rules might cause systemic risk, under certain circumstances.

Banks and Non-Banks in Financial Turmoil

The distinction between depository banks and non-bank financial firms is important to understanding the FSOC because many of the new powers attempt to create a regulatory and resolution regime for non-banks that is similar to the way depository banks are handled.

The term *bank*, in this context, generally refers to financial institutions with bank, thrift, or credit union charters that offer loans and raise a large proportion of their funds through insured deposits. Insured depository banks have prudential regulators who monitor their assets and liabilities, including the ability to prevent concentrations in particular types of loans or reliance on particular funding sources. Prudential regulators of banks coordinate through the Federal Financial Institutions Examinations Council (FFIEC). Resolution of failing depository banks is done administratively by the FDIC (or NCUA for credit unions), not through the bankruptcy courts. Banks generally have access to liquidity facilities, such as the Federal Reserve discount window.[1]

The term *non-bank* refers to financial institutions that offer loans or other sources of capital, but do not have a bank charter and do not rely on deposits for their own funding. Prior to the financial

[1] For more information, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by (name redacted).

crisis of 2008, investment banks, such as Bear Stearns and Lehman Brothers, were examples of large, complex, non-bank financial institutions, even though in some cases they may have had relatively small subsidiaries that accepted deposits (technically "thrifts"). The insurance company American International Group (AIG) is another example of a large non-bank financial institution that had a relatively small subsidiary that accepted deposits. Authority to regulate non-bank thrifts and their holding companies had resided in the Office of Thrift Supervision (OTS). Some non-banks accepted prudential regulation by the Securities and Exchange Commission (SEC).[2] Bankruptcy courts were to handle failures among most non-banks, and non-bank subsidiaries of banks. The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, are large, complex financial institutions that did not accept deposits, but had their own prudential regulatory regime under the Office of Federal Housing Enterprise Oversight (now the Federal Housing Finance Agency, or FHFA).

As then-Federal Reserve Governor Donald Kohn evaluated lessons from the financial crisis, "We [the Fed] traditionally have provided backup liquidity to sound depository institutions. But in the crisis, to support financial markets, we had to provide liquidity to non-bank financial institutions as well."[3] In common parlance, people have sometimes referred to "too-big-to-fail" firms (TBTF), but what is typically meant are complex and interconnected financial institutions that may not rely on deposits for a large share of their funding, and whose failure may spread and magnify losses throughout the financial system—rather than absolute firm size. Governor Kohn expressed frustration for the perceived inadequacy of existing tools to deal with TBTF non-banks.[4]

Mortgage and Financial Market Turmoil and Response Overview

Dissatisfaction with existing regulation grew with the progression of the mortgage crisis that began in August 2007, especially following extraordinary government support related to the failure of several large non-banks. Some of this support was designed to prevent some creditors of failing non-banks from protracted uncertainty in the bankruptcy courts or other resolution process. Similarly, for some qualified financial contracts, support may have been designed so that some creditors would not suffer losses in the bankruptcy process.[5] For example, in March 2008, losses on mortgage-related securities caused the distress sale of investment bank Bear Stearns. The Fed provided financial support for the purchase of Bear Stearns by JPMorgan, avoiding the bankruptcy courts. In July 2008, the GSEs, Fannie Mae and Freddie Mac, had trouble raising additional capital. Policymakers tried unsuccessfully to enhance investor confidence by pledging financial support for the GSEs. Despite this pledge, in September 2008, Fannie Mae and Freddie

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[2] Prudential regulation under the SEC's Consolidated Supervised Entities program was voluntarily accepted by some U.S. non-depositories in response to proposals by European bank regulators to regulate U.S. firms that did not have comparable prudential regulation. A senior advisor to the SEC testified to the FCIC that he believed that the SEC had sufficient legal authority to regulate Bear Stearns's leverage ratio and balance sheet. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, Washington, DC, January 2011, p. 283, http://www.gpoaccess.gov/fcic/fcic.pdf.

[3] Donald L Kohn, "The Federal Reserve's Policy Actions during the Financial Crisis and Lessons for the Future," Speech, Carleton University, Ottawa, Canada, Board of Governors of the Federal Reserve System, 13 May 2010, available at http://www.federalreserve.gov/newsevents/speech/kohn20100513a.htm.

[4] Ibid.

[5] A qualified financial contract is a term of art for certain financial contracts, including derivatives, that are executed and netted immediately upon declaration of bankruptcy. Therefore, uncertainty is probably not the primary concern for these particular financial contracts.

Mac were placed in conservatorship with explicit financial support from Treasury. Lehman Brothers failed shortly thereafter, and declared bankruptcy when no firm was willing to purchase the investment bank without additional public support, which was not forthcoming. AIG, one of the world's largest insurers, would have failed the day after Lehman Brothers. However, the Fed subsequently intervened on behalf of AIG, in this case avoiding a bankruptcy process.

Following the declaration of bankruptcy by Lehman Brothers, financial panic spread to other non-bank institutions and markets, with runs on money market mutual funds and repurchase agreements (also known as "repos"). Treasury offered a temporary guarantee program for money market mutual funds. In fall of 2008, Congress provided Treasury with up to $700 billion to address troubled assets (such as mortgages) in the financial system. Despite these interventions to recapitalize and restore confidence in financial institutions, damage to the broader economy (as measured by unemployment and lost output) was severe.[6]

Congress passed the DFA to reform the financial regulatory system. For banks that accept deposits insured by the FDIC, technically "insured depositories," the general prudential regulatory approach and resolution regimes were relatively unchanged, although two regulators of depositories were combined. For large, complex non-banks, the DFA instructs the FSOC to identify which firms are systemically important, designates the Fed as the prudential regulator of these firms, and authorizes the FDIC to resolve covered non-banks outside the bankruptcy courts under certain circumstances. Under the DFA, policymakers have tried to construct resolution regimes for both banks and non-bank financial firms that will dispel investor expectations that some firms are too big to fail (i.e., that policymakers will be unwilling to let the firms fail because of potential collateral damage caused by resorting to the bankruptcy process). The following sections provide more detail on the mission, members, and recommendations of the FSOC during the 113th Congress.

This report will discuss the FSOC's mission and issues it is intended to address in Section I, and the members and their roles in Section II. Section III will analyze the perceived threats to financial stability as identified in law and by the FSOC in its 2013 annual report.

I. Financial Stability Oversight Council Mission

Section 112 of DFA lists three purposes of the FSOC: (1) *identify risks* to the financial system that may arise from large, complex financial institutions; (2) *promote market discipline* by reducing expectations of federal financial support for failing institutions; and (3*) respond to emerging threats* to the stability of the U.S. financial system. Items (1) and (2) are arguably directed at minimizing the chances that particular firms will be viewed as too big to fail, or too connected to fail, or otherwise pose risks to the financial system. Item (3) is arguably a more general catch-all for any factors that might destabilize the financial system.

In instructing the FSOC to promote financial stability, the DFA uses the terms *financial stability* and *systemic risk* in several places. For example, Section 112 directs member agencies of the FSOC to state in writing whether the agency believes that all reasonable steps are being taken "to

[6] Unemployment statistics are available through the Bureau of Labor Statistics at http://www.bls.gov. Information on the value of total output is available through the Bureau of Economic Analysis, at http://www.bea.gov.

ensure financial stability and to mitigate systemic risk that would negatively affect the economy." However, the DFA does not define the terms *financial stability* or *systemic risk*.

Financial Stability

Although the DFA does not define financial stability, the first FSOC annual report (2011) described some essential features of stable financial systems. "A stable financial system should not be the source of, nor amplify the impact of, shocks."[7] According to its annual report, the FSOC believes that there are three main risks that a financial system might transmit shocks: (1) failure of a financial institution or a market participant to honor a contractual obligation, (2) deterioration in market functioning, and (3) disruptions in financial infrastructure.[8] Applying the FSOC's interpretation of financial stability as used in Title I of the DFA, the mission of the FSOC is to help avoid financial activities, practices, and regulations that might spread or magnify shocks to the financial system.

Systemic Risk

There is no single, commonly accepted definition of the term systemic risk among financial professionals. The FSOC annual reports address the definition of systemic risk as follows: "Although there is no one way to define systemic risk, all definitions attempt to capture risks to the stability of the financial system as a whole, as opposed to the risk facing individual financial institutions or market participants."[9] Possible features of systemic risks include externalities and the fallacy of composition. With externalities, there are costs or benefits of actions by financial market participants that are not borne by those participants. With fallacies of composition, what is true for each individual firm in isolation may not be true when all firms follow similar strategies—just as while one person standing in a crowded stadium sees better, that strategy will fail if everyone stands at the same time.

Channels of Risk Proliferation

To better analyze whether the FSOC's approach addresses commonly understood channels of risk proliferation, one might examine central bankers' views of ways that failing firms can damage financial stability. Federal Reserve Governor Daniel Tarullo identified four such ways that in his view are most common.[10] They are as follows:

- **Domino effects** occur when the failure of one firm causes its creditors to fail, which causes the creditors' creditors to fail, and so on.
- **Fire sales** may become reinforcing when a product serves as the collateral to finance itself or in markets in which participants must post risk-based margin.

[7] Financial Stability Oversight Council, *Annual Report*, Washington, DC, July 26, 2011, p. 3, available at http://www.treasury.gov/initiatives/fsoc/Pages/annual-report.aspx.

[8] Ibid., p.131.

[9] Ibid., p.132.

[10] Governor Daniel K. Tarullo, "Regulating Systemic Risk," Speech, 2011 Credit Markets Symposium, North Carolina, Charlotte, March 31, 2011, Board of Governors of the Federal Reserve System, available at http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm.

Fire sales may become self-reinforcing if failure to pay causes lenders to seize the collateral (the good itself), sell it at distressed prices, and thereby cause further losses on other holders of the asset. These holders may then default on their loans or fail to post margin.

- **Contagion** can occur if the failure of one firm is a signal to investors that firms in the same industry or with similar assets are likely to be in financial trouble. Contagion can result in the restriction of liquidity to other firms as possible counterparties shy away.
- **The failure of critical functions** can cause systemic risk if a firm provides a unique financial service with no close substitutes. For example, if a clearinghouse has a monopoly on settlement services for a market, and the clearinghouse fails, then other market participants may not be able to process their own transactions.

Three of the sources of systemic risk identified by Tarullo, domino effects, fire sales, and critical functions, depend upon a firm's connections to other firms. These three forms of interconnectedness will typically be correlated with the size and scope of the firm, at least in relation to its market or service. If potential creditors to large firms judge that governments are likely to intervene to prevent an eventual bankruptcy, then this lower perceived risk of default may result in creditors being willing to offer the firms loans on easier terms than their less interconnected competitors. Big firms may thus gain funding advantages over smaller competitors, reinforcing the tendency of these firms to grow relative to their markets. Systemic risk regulators may attempt to construct and estimate a firm-specific index of systemic risk arising from these three sources of instability.

The remaining source of systemic risk identified by Tarullo, contagion, is relatively independent of firm size and complexity. Like the death of a canary in a coal mine,[11] the failure of even the smallest firm may signal that large firms, if they are exposed to similar risks, may be in danger. Contagion is thus based on the information that a firm's failure provides to investors, rather than a specific transactions or interconnections of the failed firm. Tarullo interprets the run on money market mutual funds that occurred in September 2008 as contagion that had little to do with the size, complexity, or transparency of Lehman Brothers. Rather, in Tarullo's view, the failure of Lehman Brothers was a signal to investors that money market mutual funds exposed to holders of mortgage-related assets could be in financial trouble. If correct, it would be difficult to construct or estimate a firm-specific index of systemic risk arising from this type of contagion.

The next section discusses the membership of the FSOC, and the special roles that some members have with respect to these six policy tools.

II. FSOC Membership and Roles

The FSOC has 10 voting members and 5 nonvoting members. (See **Table 1** above for a complete listing.) The council is chaired by the Secretary of the Treasury. Voting members include prudential bank regulators (e.g., the Office of the Comptroller and the Currency [OCC] and the

[11] Historically, canaries were used as sentinels to test air quality in poorly ventilated underground mines because they are more sensitive to certain odorless, toxic, or explosive gases.

FDIC), securities market regulators (e.g., the Commodity Futures Trading Commission [CFTC] and the SEC), and an independent insurance expert appointed by the President, with Senate confirmation. The nonvoting members include state level representatives from bank, securities, and insurance regulators, as well as the directors from the OFR and the Federal Insurance Office (FIO).

Several agencies have special roles in addressing the kinds of systemic risks that the FSOC was designed to monitor. The DFA grants specific authority under certain circumstances for the Secretary of the Treasury, the Fed, and the FDIC to act without further approval from the FSOC as a whole. However, with regard to actions taken for particular firms, these three agencies will often be relying on shared FSOC resources, such as the information provided by the OFR, or will coordinate actions with the firm's primary regulator, which will typically be another agency represented on the FSOC. The following describes the Treasury Secretary's role as chair of the FSOC, the Fed's role as prudential regulator of firms designated systemic by the FSOC, and the FDIC's role in resolving non-banks if the firm's failure is perceived as a threat to financial instability (not necessarily just firms designated as systemic). Whether the heads of these three agencies would be acting as members of FSOC, or in their agency's independent capacity, is beyond the scope of this report.

Secretary of the Treasury, Chair of the FSOC

The Secretary of the Treasury has a number of important functions on the FSOC that differ from the other members of the council. Foremost, the Secretary serves as the chair of the council. The chair has a number of powers and responsibilities related to FSOC meetings, congressional reports and testimony, and certain rulemakings and recommendations of the council. As chair, the Secretary may call a meeting of the FSOC.[12] Otherwise, meetings may be called by a majority of the members, but shall be held at least quarterly. The Secretary must testify before the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs in conjunction with the release of the annual FSOC report. If any member agencies have notified Congress of deficiencies in systemic risk efforts, the Secretary is to address those concerns at the hearing.

The Secretary has special powers regarding the designation of systemic non-bank firms. Under Section 113(a)(1), a two-thirds vote of the FSOC is required to designate a non-bank as posing systemic risk and therefore subject to supervision by the Federal Reserve. However, one of the affirmative votes must be that of the Secretary of the Treasury. In other words, the chair of the FSOC has an effective veto over the designation of individual firms as systemically important; this applies to domestic and foreign firms, and for anti-evasion.[13] Similarly, the chair's vote is required to rescind or reevaluate the systemic designation of a firm. In emergencies, the chair's affirmative vote is required as part of the determination that a non-bank will not be granted the usual hearing before its designation as systemic. As part of those anti-evasion provisions, if certain large recipients of Troubled Asset Relief Program (TARP) funds (specifically, if they hold over $50 billion and were part of the Capital Purchase Program) cease to be bank holding

[12] P.L. 111-203 §111(e).

[13] P.L. 111-203 §113(c) authorizes the FSOC to designate as systemically important a firm that has organized itself in such a way as to avoid such designation.

companies, then they are automatically considered a systemically significant firm as if they had been designated as such by the FSOC and are placed under Fed supervision.[14]

As chair of the FSOC, the Secretary also has the responsibility to conduct or coordinate and report on periodic studies of the economic impact of systemic risk regulations.[15] These reports must be completed at least every five years. The Secretary of the Treasury has a consultative role with the OFR, which is responsible for certain research functions related to those reports and in other areas.

The Secretary, along with the Fed, negotiates with foreign regulators and multilateral organizations to coordinate prudential supervision and regulation for all highly leveraged and interconnected financial companies.

The Secretary plays a role in recommending receivership procedures for failing firms that have been designated as systemic. Although the Fed and the FDIC can make their own request for a receivership of a systemic firm based on evaluations described in Section 203a(2)(A-H), the Secretary may request a determination that a financial firm will default or is likely to default, with a systemic impact, and then appoint the FDIC as receiver. Note that the determination requires two-thirds vote of both the Fed and the FDIC board. In cases in which the firm is a broker-dealer, or its largest subsidiary is a broker-dealer, it is the Fed and the SEC by two-thirds vote that make the determination, in consultation with the FDIC. The Fed and the director of the Federal Insurance Office make the recommendation for insurance companies. The Secretary petitions the courts if the covered firm objects to the determination. The FDIC must consult with the Secretary to obtain a second extension of the time limit for the receivership.

Once a recommendation for receivership has been made, the Secretary is to make the determination and findings that trigger the resolution regime under the FDIC. The Secretary's determination must address (1) the likelihood that the firm will default or is in default; (2) the likely effect of the firm's failure on financial stability; (3) the viability of private sector alternatives available to prevent the default; (4) the impact on the firm's creditors and other counterparties; (5) the likelihood of FSOC resolution avoiding or mitigating systemic risks, its likely cost to the general fund of the Treasury, and the potential of receivership resulting in excessive risk taking by the firm or its creditors and other counterparties (i.e., moral hazard); (6) a federal regulatory agency has ordered the firm to convert all of its convertible debt instruments that are subject to the regulatory order; and (7) the company satisfies the definition of a financial company.[16]

The Secretary has a number of duties pertaining to the determination and procedures for the FDIC to act as receiver. First, the Secretary must notify certain majority and ranking members of Congress within 24 hours of the appointment of the FDIC as receiver. In addition, the rules and regulations that the FDIC issues for the use of funds pursuant to receivership must be acceptable to the Secretary.[17] The FDIC is to provide to the Secretary and the comptroller general an annual

[14] P.L. 111-203 §117.

[15] P.L. 111-203 §123.

[16] P.L. 111-203 §203(b).

[17] P.L. 111-203 §203(D).

accounting report of receiverships. The Secretary's approval is required for the FDIC to provide additional payments[18] under some circumstances.[19]

The Secretary has a number of roles regarding orderly liquidation plans of covered institutions. Amounts from the resolution fund to support orderly liquidation under a liquidation plan must be acceptable to the Secretary. Amendments to an orderly liquidation plan must be acceptable to the Secretary.[20] Furthermore, the FDIC is to assure the Secretary of a repayment plan for the orderly liquidation plan, and the Secretary and the FDIC must report to Congress on the terms of the repayment plan. To date, no firms have been subject to an orderly liquidation.

Federal Reserve—Prudential Regulator for Large Non-Banks

Since its creation in 1913, the Federal Reserve (the Fed) has had the authority to address financial market instability. Congress created the Fed as a lender of last resort following the recommendations of a commission established to investigate the causes of a financial panic that had occurred in 1907. Relative financial stability after WWII, and congressional directives to focus on price stability and maximum employment, may have redirected the Fed's focus to macroeconomic variables, but addressing financial market instability has always been a core mission of the Fed.[21] Under the FSOC, the Fed will not only be a lender of last resort, and conduct monetary policy, but the Fed will also have additional supervision and examination authority for individual non-banks designated by the FSOC.[22]

The Dodd-Frank Act directs the Fed to supervise certain large non-bank financial companies, but the FSOC recommends the standards. Section 115 of Dodd-Frank states that the regulatory standards for non-bank financial firms under Fed supervision must be more stringent than the standard for non-bank financial firms which are not under Fed supervision and do not present systemic risks. Section 115(b)(3) lists characteristics of non-bank firms that the Fed may supervise, including (1) risk-based capital requirements, (2) leverage limits, (3) liquidity requirements, (4) resolution plan and credit exposure report requirements; (5) concentration limits; (6) a contingent capital requirement, (7) enhanced public disclosures, (8) short-term debt limits, and (9) overall risk management requirements. Standards for foreign firms are to acknowledge equality of competitive opportunity and take into account the extent to which the foreign non-bank is subject to comparable standards in its home country.

The Fed has several powers and duties over covered bank holding companies and non-banks, upon a two-thirds vote of the FSOC.[23] For example, the Fed can limit the ability of the company

[18] Further, the Secretary may invest unused portions of the fund for receivership in obligations of the United States, and the Secretary may purchase obligations for the FDIC to proceed in its receivership powers. The Secretary determines the interest based upon yields on U.S. debt plus a surcharge based upon the spread between U.S. securities and corporate bonds of comparable maturity. These transactions may be considered U.S. public debt, and proceeds from sales reduce the public debt. The Secretary jointly consults with the FDIC in determining the rules and regulations for the maximum obligations that can be used in relation to the assets of a failing firm subject to FDIC resolution.

[19] P.L. 111-203 §203-4.

[20] P.L. 111-203 §210(n)(9)(A).

[21] "FRB: Mission," Board of Governors of the Federal Reserve System, available at http://www.federalreserve.gov/aboutthefed/mission.htm.

[22] For an in depth review in this area, see CRS Report R41384, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve*, by (name redacted).

[23] P.L. 111-203 §121.

to merge with other companies. It can restrict the products the firm offers, or impose conditions on the manner that the firm conducts activities. Under some circumstances, the Fed can require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities.

The Fed also has information collection authority, including through examinations, for covered firms, although the Fed is to rely on existing data sources to the extent possible.[24] In cases in which the covered firm has another primary regulator (such as the OCC), the Fed is to give the primary regulator reasonable notice of the proposed examination.

The DFA permits the Fed to establish standards for systemic firms in a number of additional areas.[25] These areas include a contingent capital requirement, enhanced public disclosures, short-term debt limits, and such other prudential standards as the Board of Governors, on its own or pursuant to a recommendation made by the FSOC, determines are appropriate.

FDIC Resolution Process for Certain Non-Banks

Since its inception, the FDIC has had the authority to administratively resolve insured depositories (banks and thrifts) that fail, rather than proceed through the bankruptcy courts. The DFA extends this authority to certain large and complex non-bank financial companies, under some circumstances.[26]

In addition to the Treasury Secretary's authority, the FDIC, with the concurrence of the Fed, may also recommend a determination of systemic risk from failing non-banks.[27] The FDIC's determination must include the votes of two-thirds of the FDIC's Board. Among the eight factors that the determination must address are

- the likelihood that the non-bank will default;
- a description of likely financial instability that could result from default;
- the recommended actions under liquidation authority; and
- an explanation of perceived deficiency of the bankruptcy process for this firm.[28]

Furthermore, Section 206 states that FDIC actions must be for the purpose of addressing systemic risk, and not be for the purpose of preserving the non-bank.

The powers and duties of the FDIC with respect to resolving systemic firms are set out in Section 210 of DFA. Essentially, the FDIC is the successor to the failing firm. The FDIC has the firms' rights, titles, and privileges. The FDIC takes over its assets, with rights of collection. The FDIC takes over the functions of the firm's officers, directors, and shareholders. The FDIC has powers over any of the firms' subsidiaries that pose systemic risk. The FDIC can form bridge companies

[24] P.L. 111-203 §161.

[25] P.L. 111-203 §165.

[26] For an in-depth review in this area, see CRS Report R40530, *Insolvency of Systemically Significant Financial Companies (SSFCs): Bankruptcy vs. Conservatorship/Receivership*, by (name redacted).

[27] As noted above however, the SEC evaluates the likelihood of default for broker-dealers, and the Director of the Federal Insurance Office evaluates insurance firms.

[28] P.L. 111-203 §203(a)(2).

for the purpose of orderly liquidation. The FDIC is to pay valid obligations, subject to its systemic risk determinations. The FDIC's resolution is intended to ensure that shareholders and unsecured creditors bear losses. The FDIC may pay resolution costs as described in Section 204(d) of the DFA.

Once a resolution has been undertaken, the FDIC has reporting requirements to the FSOC and to Congress. After 60 days, the FDIC must deliver a written report to the appropriate congressional committees, providing additional details of the receivership. These additional details include but are not limited to (1) describing the financial condition of the failing firm at the time of receivership, (2) describing the FDIC's plan to resolve the failing firm, (3) describing the reasons for the provision of any funding to the receivership out of the Fund, and (4) explaining the expected costs of resolving the firm.

III. Analysis of Perceived Threats to Financial Stability

The FSOC's annual report to Congress is to include an analysis of perceived threats to the financial system. The following sections analyze specific threats mentioned in the 2013 FSOC annual report.[29] For each topic, the reader is provided a brief description of the issue, how it might contribute to a systemic event, and an analysis of the FSOC's report.

Vulnerabilities in Wholesale Funding Markets[30]

Issue Area

Although commercial banks raise significant funds through insured deposits, banks and other financial institutions also use a variety of other funding sources. Many of these alternative funding sources, often blending securities contracts and traditional loans, are categorized as *wholesale funding*. Examples of wholesale funding sources include money market mutual funds and repurchase agreements (repos). Wholesale funding sources are not eligible for certain government initiatives that assist financial stability, such as deposit insurance. Non-banks that use wholesale sources to fund capital market activity may be subject to runs similar to a depository bank, but would not typically have access to certain emergency lending facilities such as the Fed's discount window.

How it Might Go Wrong

Some wholesale funding markets can be subject to runs and fire sales. Banks and other financial intermediaries typically raise money in one market (such as deposits, repurchase agreements, and commercial paper) to fund activity in another (offer bank loans, capitalize securities investments, etc.). During periods of uncertainty and financial instability, financial intermediaries may lose trust in each other, and refuse to extend or roll over their loans to each other. The resulting

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[29] 2013 Annual Report, Financial Stability Oversight Council, available at http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.

[30] Ibid., p. 64.

reduction in wholesale funding can have many of the characteristics of a bank run by depositors if providers of wholesale funding fear that wholesale borrowers will not repay their obligations; but unlike deposits, sources of wholesale funding typically do not have any government guarantee.

A fire sale occurs when someone holding an asset must sell it in a distressed market even though a better price could likely be had if the seller had more time. Some wholesale sources of funding, such as repos and asset-backed commercial paper may be subject to fire sales. Collateralized lending can be subject to fire sales because borrower defaults are likely to occur at the same time that the market for the collateral is also distressed. As a result, when the lender seizes the collateral, the value of the collateral may be falling—the addition of the distress sales by lenders can magnify a downward spiral in prices. Both asset-backed commercial paper and repos use forms of collateral and may be subject to fire sales.

FSOC's Perspective

The 2013 annual report notes some positive and negative developments (from the FSOC perspective) in wholesale funding. On the positive side, the annual report notes that intra-day credit exposure of the two clearing banks (JPMorgan and BNY Mellon) in the tri-party repo market has declined significantly. Similarly, the reliance of broker-dealers on overnight repos as a source of funding has also declined. However, the potential for runs on broker-dealers, or fire sales should there be a default by a major market participant, has not been completely eliminated. Furthermore, efforts to address potential instability in money market mutual funds have not as yet been finalized by the SEC (as regulator of MMFs as issuers of securities).

Housing Finance Reliance on Government Support[31]

Issue Area

Reliance on government assisted sources of funding increased markedly as a share of all mortgage funding in 2008. At the origination level, the mortgage market share of Federal Housing Administration (FHA) loans increased even for borrowers who could offer significant down payments with their house purchase. At the wholesale level, private mortgage securitization almost completely evaporated, making the government sponsored enterprises (GSEs) the dominant providers of wholesale mortgage funding. GSE funding has a variety of government support, including preferred stock purchases by the U.S. Treasury (through a conservatorship announced in September 2008), Federal Reserve purchases of corporate debt issued by the GSEs, and Federal Reserve purchases of mortgage-backed securities issued by the GSEs.

How it Might Go Wrong

The lack of significant private capital in mortgage funding is a sign that financial instability in mortgage markets has not yet completely healed (things already went wrong). It has been an announced goal of the FSOC to restore private capital as the primary source of long-term mortgage funding, along with improvements in consumer protection and financial stability. However, there are a number of signs that mortgage markets are improving. House prices have begun rising in a number of areas, default rates and foreclosures are no longer rising sharply, and

[31] Ibid., p. 3.

the flow business (current mortgage revenues and guarantee fees compared with current payments) of the GSEs has been positive in recent quarters. One possible contributing factor for a delay in the return of private capital to mortgage markets (in addition to general pessimism about the speed of economic recovery in general and housing in particular) may be regulatory uncertainty as federal agencies implement changes to regulations related to the mortgage market.

FSOC's Perspective

The 2013 annual report says that there has been significant improvement in mortgage markets, but additional progress is needed. On the positive side (from the FSOC's perspective), the conservatorship agreements (Treasury Preferred Stock Purchase Agreements, PSPAs) have been modified to expedite the wind-down of the retained portfolios of Fannie Mae and Freddie Mac. Regulatory uncertainty in mortgage markets may be reduced by the publication of final rules for the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), and the Dodd-Frank Act's ability-to-pay standard. Additional work may need to be done to raise GSE guarantee fees to make room for private competitors to the GSEs.

Technology, Security, and Operational Risks[32]

Issue Area

The financial infrastructure can also be a source of systemic risk. This is essentially the "plumbing" of the financial system. It includes the environment in which financial trading occurs, communications of the interbank payment system, clearing and settlement of retail payments (including mobile payments), the security of confidential financial information, and the resilience of information storage systems. The "plumbing" of the financial system evolves with changes in communication technology and the organization of firms—historically, telegraphs, stock tickers, telephones, and computers have allowed for improved financial communications across long distances—but the stability of such systems can be threatened by the potential disruptions to the operational network.

How it Might Go Wrong

The financial infrastructure is vulnerable to natural disasters and human activity. For example, Hurricane Sandy temporarily halted trading on the New York Stock Exchange in October 2012. Malfunctions have disrupted the issuance of securities (such as the initial public offering of Facebook). Reportedly, major financial institutions have been subjected to attempts to access confidential information or disrupt their telecommunications (cyberattacks).

FSOC's Perspective

The 2013 annual report noted several initiatives to address operational issues. For example as discussed in the wholesale funding section above, the tri-party repo task force has recommended improvements to the settlement and clearing processes in among the two central clearing banks to reduce their intra-day credit exposure. In the section of the 2013 report devoted to operational issues, the FSOC notes that the SEC recently proposed Regulation Systems Compliance and Integrity (Regulation SCI) to try to address malfunctions in capital markets.

[32] Ibid., p. 135.

Interest Rate Risks: Especially Rising Rates and Benchmarks[33]

Issue Area

Future interest rate changes may be a source of financial instability. A combination of a global savings glut, deficient aggregate demand, and central bank interest-rate policies have contributed to an extended period of low interest rates (by historical standards). At some point, interest rates are likely to rise, either because the demand for loanable funds rises as the economy improves driving up the rates or because a negative shock causes a spike in interest rates. Financial intermediaries, including but not limited to banks, can be damaged by rising interest rates if they have not adequately addressed the mismatch between the interest rates on their cost of funds and their revenues from longer-term lending. Furthermore, revelations of manipulation of the London Interbank Offer Rate (LIBOR) has cast doubt on the accuracy of key reference rates used to benchmark interest rates in many private contracts.

How it Might Go Wrong

There are several examples of rising interest rates contributing to stress in the financial system. Rising rates in the 1970s and 1980s created a great deal of stress for banks (especially savings and loans) that had funded long-term mortgages with short-term deposits. Rising rates in 1994 caused a significant sell-off in the bond market. Rising rates during 2004-2006 contributed to the end of the housing bubble (which would have ended eventually, but perhaps not at that time). Under-reporting of LIBOR rates in 2008 may have given financial regulators an overoptimistic view of the lending ability of major financial institutions during the liquidity crunch at that time.

There are several ways in which the current interest rate environment could contribute to financial instability. Low interest rates make it difficult for savers to earn significant returns with relative safety. For example, money market mutual funds are at greater risk because their income stream (from relatively safe bonds) is close to zero, which means that they are more likely to "break the buck" (return less than a dollar for each dollar invested) if any of their investments experience losses. Certain pension systems may find it difficult to earn adequate returns safely, especially if they have committed to defined benefits (a preset fixed payment) and have limited eligible investments. Other investors may have a greater temptation to "reach for yield" by investing in more risky categories of investments, increasing the likelihood of asset bubbles in other markets.

FSOC's Perspective

In its 2013 report, the FSOC attributes current interest rates (low yields) to three factors. First, capital market participants forecast continued low interest rate policies by major central banks globally. The second is the pricing of short-term risk, which is partially caused by the increase in Treasury market purchases by institutions with low-risk sensitivity (including but not limited to central banks). The third factor cited by the FSOC is the willingness of bond market buyers to accept credit risk (i.e., the risk that borrowers will not pay back fully and on time). Provisions for credit losses and loan losses have declined recently.

The FSOC notes a number of initiatives to mitigate the risks when interest rates do rise. First, investigations and prosecutions related to LIBOR (and similar reference rates) may reduce the

[33] Ibid., p. 137.

incentive to misreport, and combined with regulatory reform of reporting banks, may lead to more accurate interest rate benchmarks. The FSOC did express concern at potential reaches for yield, noting that the issuance of high yield bonds (riskier classes of bonds) had increased markedly, and that underwriting standards for collateralized loan obligations (CLOs) had reportedly loosened. Furthermore, threats to financial stability posed by rising rates are mitigated in part by one of the potential causes of rising rates—improved financial conditions. Even if rates rise for the "wrong" reason, a second credit crunch, the FSOC notes that the measurable financial resilience of major banks (such as capital levels and measures of liquidity) have improved.

Long-Term Fiscal Imbalances[34]

Issue Area

Fiscal policy refers to the relationship of government revenues and spending. Typically, recessions cause government revenues to decline and government spending to rise (fiscal policy expands). Economic booms can cause fiscal policy to contract if government revenues expand faster than government spending. Although recessions and booms cause fluctuations in short-term fiscal policy, long-term fiscal policy refers to the balance between expected government spending and revenues over an extended time horizon. CBO and other projections of long-term fiscal policy project an imbalance between expected federal revenues and expected federal spending for an extended period of time (spending commitments are greater than expected revenue streams). Thus far, the United States has not experienced any backlash in bond markets for running extended fiscal deficits. Not only has the yield on U.S. Treasury bonds remained low, but obligations of the United States have been viewed as a safe haven for some foreign investors and central banks.

How it Might Go Wrong

Fiscal imbalances can cause short-term problems and long-term problems. In the short run, governments with large fiscal imbalances run the risk that investors may suddenly demand higher yields to roll-over existing debt. Unlike Cyprus or Greece, short-term fiscal problems of the United States could be cushioned by purchases of Treasury securities by the Fed (which would be likely because a short-run fiscal crisis is often accompanied by the same kinds of poor economic conditions that cause the Fed to expand its monetary policies—although the early 1980s are a counter-example). In the longer term, the combination of higher interest rates and higher outstanding debt can cause interest payments to crowd out other government programs (depending on the relative growth of interest payments to GDP).

FSOC's Perspective

The FSOC does not see a gradual normalization of long-term Treasury yields and volatilities as a significant threat to fiscal imbalances or the wider economy. However, the long-run imbalances could threaten financial instability if there is a sudden spike in yields. The FSOC notes that the financial impact of potentially disruptive short-run fiscal events has had "minimal impact"[35] thus far. For example, U.S. debt is still seen as a safe harbor despite the automatic tax increases and

[34] Ibid., p. 30.

[35] Ibid., p. 8.

spending cuts at the start of 2013 (the fiscal cliff) and the February 2013 debt ceiling debates. Similarly, the downgrade of U.S. Treasury securities by Standard & Poor's did not cause a significant spike in Treasury yields.

Exposures to Risks from Other Countries[36]

Issue Area

Financial markets are global; therefore, financial instability overseas can threaten financial stability in the United States. There are many channels through which financial instability can cross borders. For example, the failure of a global bank could cause cross-border resolution issues, monetary policies of other countries can lead to competitive currency devaluations, capital flights away from some countries can cause global investment money (i.e., hot money) to flood other countries—and in some cases cause asset bubbles in the recipient country, and sovereign debt problems or banking policies in one country can cast doubt on the reliability of government debts or guarantees in other countries.

In introductory finance classes, sovereign debt of the governments of developed economies is often characterized as a risk-free asset. Recent events in Europe have cast serious doubt on this simplifying assumption. Changes in the perceived risk of the debt of sovereigns, such as Greece, Cyprus, Italy, Portugal, Ireland, are potential threats to financial stability in part because many financial regulators and financial institutions treat those debts as if they were risk-free. As a result, financial institutions and financial systems do not typically retain capital buffers against the possibility of sovereign debt restructuring, or in the extreme a sovereign default. The mere change in the perceived risk of sovereign debt can cause people to try to avoid institutions and markets with large exposure to that country's debt. At a minimum, exposed institutions may find it difficult to find counterparties for new transactions and may suffer withdrawals, or refusals to renew loans, from existing counterparties. The resulting financial instability can cause credit to dry up, interest rates to rise, and may magnify the financial difficulties of the sovereign experiencing the financial stress.

How it Might Go Wrong

Although financial regulators and Treasury officials in many countries have generally tried to coordinate their responses to the global financial crisis, there are a number of channels through which financial instability could be spread. First, there is no formal way to address a sovereign default (no international bankruptcy law applies to sovereigns), and thus European sovereign debt crises have been a series of evolving government funding and banking crises. Second, even if central banks target their domestic economies rather than their exchange rate, expansionary monetary policies can cause exchange rates to depreciate, and thus exports to rise and imports to fall. But one country's declining imports is another country's declining exports; therefore, expansionary monetary policies run the risk of competitive devaluation if policymakers fail to coordinate across countries.

FSOC's Perspective

[36] Ibid., p. 144.

The 2013 FSOC report addressed several issues related to global financial stability. The FSOC noted a number of positive developments in Europe, including the potential for the European Central Bank (ECB) to purchase sovereign debt of member states under some circumstances. However, the report also noted that banking disruptions and policy responses in Cyprus (which briefly cast doubt on the status of insured bank deposits) create downside risk. The FSOC report also noted that austerity programs in Europe have "contributed to a contraction in euro-area economies," although euro area deficits may also have declined. The report also discussed expansionary monetary policies in Japan, which have contributed to a depreciation of the Yen. The FSOC took the view that "the U.S. has a strong financial stability interest in Japan finally escaping from deflation and securing more robust growth."[37]

[37] Ibid., p. 8.

Appendix A. Glossary of Terms

This glossary has been compiled from several earlier CRS reports, the FCIC report, 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.

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 Fed. On the federal level, these businesses are regulated through the Bank Holding Company Act.

Bank Holding Company Act—The federal statute under which the Fed 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—Assets minus liabilities; what a firm owns minus what it owes. Regulators often require financial firms to hold minimum levels of capital.

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.

Capital Purchase Program—Initiative under the Troubled Asset Relief Program providing financial assistance to U.S. financial institutions through the purchase of senior preferred shares in the corporations on standardized terms.

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. (See CLO and CMO.)

Collateralized loan obligation (CLO)—A bond created by the securitization of a pool of loans, bonds, or asset backed securities. (See CDO and CMO.)

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.

Commercial Paper Funding Facility Emergency Program—Created by the Fed in 2008, this program purchased three-month unsecured and asset-backed commercial paper from eligible companies.

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 Reinvestment Act 1977—A federal law which encouraged depository institutions to make loans and provide services in the local communities in which they take deposits.

Consolidated Supervised Entities program—A Securities and Exchange Commission program created in 2004 and terminated in 2008 that provided voluntary supervision for the five largest investment bank conglomerates.

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 Rating Agency—Private company that evaluates the credit quality of securities and provides ratings on those securities; the largest are Fitch Ratings, Moody's Investors Service, and Standard & Poor's.

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/dealer"). 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.

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

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.

Federal Open Market Committee—Its members are the Board of Governors of the Federal Reserve System and certain of the presidents of the Federal Reserve Banks; oversees market conditions and implements monetary policy through such means as setting interest rates.

Financial holding company—A holding company form authorized by the Gramm-Leach-Bliley Act (P.L. 106-102) 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. Non-depository 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 (P.L. 106-102), 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.

Financial Stability Oversight Council—A council created by the Dodd-Frank Act (P.L. 111-203) with identifying and monitoring systemic risks to the U.S. financial system, reducing expectations of extraordinary government intervention, and to respond to emerging threats to U.S. financial stability.

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 (P.L. 106-102) called for more functional regulation than in the past.

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.

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.

Illiquid Assets—Assets that cannot be easily or quickly sold.

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 Fed 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.

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.

Mark-to-Market—The process by which the reported amount of an asset is adjusted to reflect true the market value instead of the purchase price, or expected future sale price.

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

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.

Net Asset Value (or NAV)—Value of an asset minus any associated costs; for financial assets, typically changes each trading day.

Office of Financial Research (OFR)—An office created by the Dodd-Frank Act (P.L. 111-203) to support the Financial Stability Oversight Council and member agencies by collecting and standardizing financial data, performing applied and long-term research, developing tools for risk measurement and monitoring.

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.

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

Repurchase Agreement (Repos)—A method of secured lending where the borrower sells securities to the lender as collateral and agrees to repurchase them at a higher price within a short period, often within one day.

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.

Shadow Banking—Financial institutions and activities that in some respects parallel banking activities but are subject to less regulation than commercial banks. Institutions include mutual funds, investment banks, and hedge funds.

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 debt holders 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.")

Tri-Party Repo Market—A repurchase agreement in which a third party agrees to clear and settle the transaction and to monitor and assure the treatment of collateral.

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

Undercapitalized—A condition in which a business does not have enough capital to meet its needs, or to meet its capital requirements if it is a regulated entity.

Variable Rate Demand Obligation—A security which pays a variable interest rate, and can be redeemed upon the demand of the holder.

Write-Downs—Reducing the value of an asset as it is carried on a firm's balance sheet because the market value has fallen.

Appendix B. Acronyms

Acronym	Name
AIG	American International Group, Inc.
ASC	Accounting Standards Codification released by the FASB
BAB	Build America Bonds
BHC	Bank Holding Company
BIS	Bank for International Settlements
CDS	Credit Default Swap
CFTC	Commodity Futures Trading Commission
CPP	Capital Purchase Program
DFA	The Dodd-Frank Act: P.L. 111-203
ETF	Exchange Traded Fund
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institution Examination Council
FHA	Federal Housing Administration
FHC	Financial Holding Company
FHFA	Federal Housing Finance Agency
FRB or the Fed	Federal Reserve Board of Governors
FRBNY	Federal Reserve Bank of New York
FSOC	Financial Stability Oversight Council
FTE	Full-Time Employee Equivalent
GDP	Gross Domestic Product
GSE	Government-Sponsored Enterprise
HUD	Department of Housing and Urban Development
LCBO	Large, Complex Banking Organization
MMF	Money Market Fund
NAV	Net Asset Value
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OFR	Office of Financial Research
OTS	Office of Thrift Supervision
QM	Qualified Mortgage
QRM	Qualified Residential Mortgage
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
TBTF	Too Big To Fail
VRDO	Variable Rate Demand Obligations

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