



## **Memorandum**

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**SUBJECT: Regulators and Terms Related to the Financial Crisis**

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This memorandum responds to requests for information on financial regulators, financial terms, and CRS products related to the disruption in financial markets. Financial regulators and their responsibilities are presented first. A glossary of terms is then presented. There is also a list of related CRS products. For additional questions or concerns, my direct number is 7-6201.

### **Regulators with Responsibilities Related to Financial Markets, Institutions, and Assets**

#### *Securities and Exchange Commission (SEC)*

- Enforces disclosure and anti-fraud provisions of the securities laws.
- Oversees the Financial Accounting Standards Board (FASB).
- Oversees ratings agencies and securities exchanges.

#### *Commodity Futures Trading Commission (CFTC)*

- Regulates commodity futures and option markets.
- Oversees financial futures exchanges.

#### *Federal Reserve Board (FRB)*

- Determines monetary policy to balance economic growth, employment, and inflation.
- Regulates safety and soundness of bank holding companies.
- Enforces the Truth in Lending Act to provide consumer protection for mortgages.

#### *Federal Financial Institutions Examinations Council (FFIEC)*

- Coordinates federal bank regulators with examination powers.
- Appraisal subcommittee oversees establishment of standards for property appraisers.

*Federal Deposit Insurance Corporation (FDIC)*

- Administers Deposit Insurance Fund (DIF) to insure deposits in covered banks.
- Regulates safety and soundness of state banks with insured deposits.

*Office of the Comptroller of the Currency (OCC)*

- Regulates safety and soundness of banks with a federal charter.

*Office of Thrift Supervision (OTS)*

- Regulates safety and soundness of thrifts with a federal charter.
- Note: some large institutions choose a federal thrift charter.

*National Credit Union Administration (NCUA)*

- Regulates safety and soundness of credit unions with a federal charter.
- Administers the fund to insure deposits of federal credit unions.

*Federal Housing Finance Agency (FHFA)*

- Formerly the Office of Federal Housing Enterprise Oversight (OFHEO).
- Safety and soundness regulator for the government sponsored enterprises (GSEs), Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs).

## **Glossary of Terms Related to Disruption of Financial Markets**

*Adverse Selection* — When a party having greater information about the quality of a pool of assets offers to sell the inferior ones to the less knowledgeable party.

*Alt-A Borrowers* — Borrowers with relatively high credit scores, but who either cannot or choose not to document their income.

*Asset-Backed Commercial Paper* — Short term commercial loans backed by various forms of collateral, including mortgages and mortgage-backed securities.

*Bank holding companies* — Companies that own one or more banks.

*Basel Accords* — International agreements to standardize regulation of bank capital.

*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.

*Call Option* — A contract that allows, but does not mandate, the purchase of a security at a specified price.

*Certainty equivalent* — An amount spent or received with certainty. Insurance provides a certainty equivalent because it removes the chance that an expense will be unexpected.

*Conforming Loan Limit* — The largest size loan that a GSE may purchase, adjusted each year based on changes in U.S. house prices. It is adjusted for high cost areas.

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

*CDO, Collateralized Debt Obligation* — Securities deriving their income from other fixed income assets, including but not limited to, mortgage-related assets.

*Credit Event* — In a credit default swap, an event specified in the contract that triggers the payment between the parties. Is often a bankruptcy or credit downgrade.

*Credit Risk* — The risk that a borrower will fail to repay a loan in full.

*Credit Default Swap* — A tradeable contract in which one party agrees to pay another if a third party experiences a credit event, such as bankruptcy or credit downgrade.

*Currency Swap* — A swap that exchanges payments in another currency.

*Debt-deflation* — A decline in the price level increases the real cost of debts.

*Duration* — The (weighted) average lifetime of a stream of payments from debt securities. It is affected by prepayment rates.

*Excess Spread* — The difference between total payments from the underlying assets (mortgages) and the total payout to investors holding securities. Often used to provide credit enhancement.

*Efficient Market Hypothesis* — Theory that securities prices fully reflect all information that is available to the public.

*Fannie Mae* — The Federal National Mortgage Association (FNMA), a GSE that securitizes residential mortgages.

*FAS 140* — An accounting standard issued by FASB that covers the definition of a true sale of assets. Determines if securitized assets are removed from the balance sheet.

*FAS 157* — An accounting standard issued by FASB that covers the reporting of the fair value of financial assets. Determines if financial assets must be marked-to-market.

*FICO Score* — An index of a borrower's creditworthiness based on credit history.

*Financial Derivatives* — Investment products that derive their payments from previously issued securities.

*Glass-Steagall Act* — Prohibited commercial banks to underwrite securities for sale to the public, created the FDIC, and prohibited interstate branch banking, among other things.

*Gramm-Leach-Bliley Act* — Law that repealed portions of Glass-Steagall.

*GSE, Government Sponsored Enterprise* — A private corporation with a special purpose charter that may give it unique benefits and public duties.

*Hedge Funds* — Unregulated mutual funds that buy and sell investment assets.

*Insolvent* — When a firm's liabilities are greater than assets.

*Jumbo Loan* — A loan larger than the conforming loan limit and ineligible for the GSEs.

*Leverage Ratio* — Ratio of a firm's capital to its assets.

*LIBOR, London Interbank Offer Rate* — An interest rate large international banks charge each other for short term loans.

*Liquidity* — The ability to trade an asset quickly without significantly reducing its price, or the ability of a person or firm to access credit markets.

*Low-Doc Loan* — A loan in which the borrower does not fully document credit indicators. Sometimes referred to as liar loans.

*LTV* — Loan to Value Ratio. An important factor in loan qualification. A high LTV implies a low down payment and higher risk of default.

*Macro Hedge* — A hedge of interest rate risk, or other risk, of a firm's entire portfolio.

*Market Makers* — Dealers who can buy or sell securities from their own holdings to ensure that there is always a market for investors.

*Mark-to-Market* — The accounting requirement to report assets held for sale at current market prices. Related to FAS 157.

*MBS, Mortgage Backed Security* — A security which derives its payments from a pool of mortgage obligations.

*Micro Hedge* — A hedge for a specific asset.

*Moral Hazard* — The tendency of people to take more risks once another party has agreed to provide protection.

*Naked Short Sale* — A short sale in which the security is not borrowed for the transaction.

*NRSRO, Nationally Recognized Statistical Rating Organization* — An SEC designation for ratings agencies. Sometimes used in regulations that require an asset to be rated.

*Negative Amortization* — A loan that allows the balance to rise if the borrower pays less than the current interest due.

*Notional Principal* — In a swap contract, the amount on which the interest is being paid (for interest rate swaps) or the protection payment is calculated (for credit default swaps).

*OTC, Over-the-Counter Market* — Unregulated market in which dealers at different locations stand ready to trade securities with anyone willing to accept the prices.

*Pass-Through Trust* — An institution that passively transfers the principal and interest of a

debt to securities holders and is not taxed as a corporate entity.

*Prepayment Risk*— The risk that a borrower will pay the balance of a loan prior to the period during which it is expected.

*Preferred Stock* — Receives a fixed dividend and must be paid before common stock but typically does not have voting rights.

*Primary Dealers* — Dealers in government securities who trade directly with the Federal Reserve's open market desk.

*Prime Borrowers* — Borrowers with high credit scores, sufficient down payments, documented income, and other indicators of low credit risk.

*Protection Buyer* — In a credit default swap, the party that receives payment if a credit event occurs.

*Protection Seller* — In a credit default swap, the party that makes payment if a credit event occurs.

*Put Option* — Contract that allows, but does not mandate, the sale of a security at a specified price.

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

*Regulation Z* — The name of the Federal Reserve's regulations to implement the Truth in Lending Act, which provides consumer protection for mortgage loans.

*REMIC, Real Estate Mortgage Investment Conduit*— A special pass-through institution created as part of the 1986 tax reform that allows the creation of multi-class mortgage backed securities.

*Risk-Based Capital* — An amount of capital a lending institution must keep in reserve based on the riskiness of its assets.

*Securitization* — The process of transforming a flow of funds, typically from a debt, into a new marketable security.

*Shelf Registration* — An arrangement with the SEC that allows a single registration that permits multiple securities issues.

*Short Sale* — An arrangement with a broker to borrow and sell securities, to be replaced with securities that are purchased later. Short sales make money if prices fall.

*Spreads* — The difference between two rates, typically bond yields or interest rates of the same maturity. Wide spreads often indicate lack of market confidence.

*Strike Price* — Also called an exercise price. The price at which the holder of an option has the right to exercise the option.

*Subprime Borrowers* — Borrowers with low credit scores and/or other indicators of higher credit risk.

*TED Spread* — The difference between the yield on 3-month Treasuries and 3-month LIBOR. Formerly was the comparison of Treasury and EuroDollar (TED).

*Toxic Waste* — An extremely risky junior tranche of an MBS.

*Tranche* — Any one of the classes of security emanating from a REMIC. For example, tranches can be divided between interest and principal payments.

*Waterfall* — The order of payments from senior tranche to junior tranche in a complex mortgage-backed security structure.

## Related CRS Products

*Averting Financial Crisis*, RL34412, by Mark Jickling

*Banking and Securities Regulation and Agency Enforcement Authorities*, RL33235, by Mark Jickling, Gary Shorter, M. Maureen Murphy, Michael V. Seitzinger

*Bear Stearns: Crisis and 'Rescue' for a Major Provider of Mortgage-Related Products*, RL34420, by Gary Shorter

*Bond Insurers: Issues for the 110th Congress*, RL34364, by Baird Webel, Darryl E. Getter

*The Cost of Government Financial Interventions, Past and Present*, RS22956, by Baird Webel, N. Eric Weiss, Marc Labonte

*Credit Default Swaps: Frequently Asked Questions*, RS22932, by Edward V. Murphy

*Economic Slowdown: Issues and Policies*, RL34349, by Jane G. Gravelle, Thomas L. Hungerford, Marc Labonte, Edward V. Murphy, N. Eric Weiss, Julie M. Whittaker

*Fannie Mae and Freddie Mac in Conservatorship*, RS22950, by Mark Jickling

*Financial Turmoil: Federal Reserve Policy Responses*, RL34427, by Marc Labonte

*Financial Crisis? The Liquidity Crunch of August 2007*, RL34182, by Darryl E. Getter, Edward V. Murphy, Marc Labonte, Mark Jickling

*Financial Market Intervention*, RS22963, by Edward V. Murphy

*Hedge Fund Failures*, RL33746, by Mark Jickling

*Hedge Funds: Should They Be Regulated?* 94-511, by Mark Jickling

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*Proposal to Allow Treasury to Buy Mortgage-Related Assets to Address Financial Instability*, RS22957, by Edward V. Murphy, Baird Webel

*The Resolution Trust Corporation: Historical Analysis*, RS22, by Gary Shorter

*Securitization and Federal Regulation of Mortgages for Safety and Soundness*, RS22722, by Edward V. Murphy

*The Uptick Rule: The SEC Removes a Limit on Short Selling*, RL34519, by Gary Shorter

*The U.S. Financial Crisis: Lessons From Sweden*, RS22962, by James K. Jackson

*The U.S. Financial Crisis: Lessons From Chile*, RS22961, by J. F. Hornbeck

*The U.S. Financial Crisis: Lessons From Japan*, RS22960, by Dick K. Nanto