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In This Issue

Bank & Thrift

Agencies Propose Revised Qualified Residential Mortgage Definition for Risk Retention Rules under the Dodd-Frank Act

Six Federal agencies (the Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development - collectively, Agencies) released a joint proposed rule on August 28, 2013 that would revise those Agencies' previously published proposed rule (April 2011) to implement the credit risk retention requirements of Section 941 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act).

Section 941 generally requires the securitizer of asset-backed securities to retain not less than 5 percent of the credit risk of the assets collateralizing the asset-backed securities. A variety of exemptions are provided, including an exemption for asset-backed securities that are collateralized exclusively by residential mortgages that qualify as "qualified residential mortgages" (QRMs) as such term is defined by the Agencies by rule.

The current proposal makes changes to the 2011 proposal, including:

- Provisions that a securitizer's 5 percent minimum risk retention obligation could be met through "any combination of an 'eligible vertical interest' and an 'eligible horizontal residual interest'." Also, the horizontal risk retention would be based on fair value measurements (rather than "par") without a premium capture provision.
- A new definition of QRM that equates the QRM to the definition of a Qualified Mortgage (QM), as defined by the Bureau of Consumer Financial Protection (CFPB - note: this definition has no down payment requirement); and
- An alternate definition of QRM, the "QM-plus approach," which incorporates certain credit underwriting standards not included in the CFPB's definition of QM. In particular, this alternative uses the core QM criteria to define QRM but requires three more aspects of the loan's underwriting to be considered:
  - QRM status would be available only for first-lien loans secured by one-to-four family real properties that constitute the principal dwelling of the borrower, and would not be available if any other recorded or perfected liens on the property exist at closing;
  - QRM status would only be available if the loan-to-value ratio (LTV) at closing did not exceed 70 percent (effectively a 30 percent down payment requirement); and
  - The borrower's credit history would need to indicate an ability to manage debt.

Similar to the original proposal, securitizations of commercial loans, commercial mortgages, or automobile loans of low credit risk would not be subject to risk retention. Further, the new proposed rule would recognize the full guarantee of payments of principal and interest provided by Fannie Mae and Freddie Mac for their residential mortgage-backed securities as meeting the risk retention requirements while Fannie Mae and Freddie Mac are in conservatorship or receivership and have capital support from the U.S. government.

Comments are requested no later than October 30, 2013.

Federal Reserve Releases Paper on Expectations for Internal Capital Planning at Large Bank Holding Companies

On August 19, 2013, the Federal Reserve Board released a paper, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice*, that details the agency's expectations for internal capital planning at large bank holding companies (BHCs) and describes the range of practices it has observed at these companies during the past three Comprehensive Capital Analysis and Review (CCAR) exercises. The Federal Reserve states the paper is intended to promote better capital planning at BHCs generally, and to provide greater clarity on the standards against which those practices are evaluated as part of the CCAR exercise.

Based on its observations during the 2013 CCAR, the Federal Reserve notes that large BHCs have improved their capital planning processes in recent years, but have more work to do to enhance their practices for assessing the capital they need to withstand stressful economic and financial conditions. Areas where some BHCs continue to fall short of leading practice include

- Showing how all risks were accounted for in the capital planning processes.
- Developing stress scenarios and modeling techniques that address specific business activities,
- Implementing capital policies that clearly articulate capital goals and targets, provide analytical support for how these goals and targets were determined to be appropriate, and provide clear guidance about how the BHC would respond as its capital position changed in different economic circumstances.
- Ensuring governance or controls around the capital planning process are robust, including around fundamental elements such as risk-identification, risk-measurement, and risk-management practices.

The 2014 CCAR will begin in the fourth quarter of 2013. Thirty firms with more than $50 billion in total assets are expected to participate.

OCC Updates Commercial Real Estate Lending Guidance

The Office of the Comptroller of the Currency (OCC) released Bulletin 2013-19 on August 20, 2013 to announce issuance of the *Commercial Real Estate Lending* booklet of the *Comptroller's Handbook* to replace the OCC's *Commercial Real Estate and Construction Lending* booklet previously issued in 1995. The *Commercial Real Estate Lending* booklet also replaces sections 210, *Income Property Lending*, and 213, *Construction Lending*, of the former Office of Thrift Supervision's (OTS) *Examination Handbook* issued in 2009 and 1994, respectively. Other documents that are rescinded include: OCC Bulletin 2012-27, *Investor-Owned One- to Four-Family Residential Properties: Supervisory Guidance on Risk Management and Reporting Requirements* (September 17, 2012); and OCC Advisory Letter 2003-7, *Guidelines for Real Estate Lending Policies* (August 8, 2003).

Updated guidance includes "prudent" loan workouts, management of concentrations, stress testing, updated interagency appraisal guidelines, and statutory and regulatory developments in environmental risk management. Discussions of statutes and regulations governing Federal savings associations have also been incorporated.

FDIC Releases Quarterly Banking Profile for Second Quarter

The Federal Deposit Insurance Corporation (FDIC) released the *Quarterly Banking Profile* for the second quarter of 2013 on August 29. Results highlighted by the FDIC indicate:

- Insured commercial banks and savings institutions reported aggregate net income of $42.2 billion in the second quarter of 2013, a 22.6 percent increase from the profits the industry reported a year earlier. Also, it is the 16th consecutive quarter that earnings have registered a year-over-year increase.
- Year-over-year earnings increased at more than half (53.8 percent) of the 6,940 insured institutions reporting financial results. The proportion of banks that were unprofitable fell to 8.2 percent, from 11.3 percent a year earlier.
- The average return on assets (ROA) rose to 1.17 percent from 0.99 percent a year ago. It is the highest quarterly ROA for the industry since the 1.22 percent posted in the second quarter of 2007.
- Net operating revenue (net interest income plus total noninterest income) totaled $170.6 billion, a 3 percent increase from a year earlier. The average net interest margin — the difference between the average yield banks earn on loans and other investments and the average cost of funding those investments — fell to 3.26 percent, its lowest level since the 3.20 percent reported in the fourth quarter of 2006. Total noninterest expenses were $1.4 billion (1.4 percent) below the level of the second quarter of 2012. Banks set aside $8.6 billion in provisions for loan losses, a reduction of $5.6 billion (39.6 percent) compared to a year earlier.
- Charge-offs of uncollectable loans were down 30.7 percent from a year earlier. The amount of noncurrent loans and leases fell by 8.3 percent, and the percentage of loans and leases that were noncurrent declined to 3.09 percent, the lowest level since the 2.97 percent posted at the end of 2008.
- Loan balances increased 1.8 percent in the three months ending June 30 and 2.9 percent for the 12 months ended June 30.
- Insured institutions reported an 89.1 percent decline in unrealized gains in their holdings of available-for-sale securities during the quarter, which was due primarily to rising medium- and long-term interest rates.
- The number of problem banks declined from 612 to 553 during the quarter.
- The Deposit Insurance Fund balance rose from 0.59 percent as of March 31 to 0.63 percent as of June 30. It must achieve a minimum reserve ratio of 1.35 percent by 2020.

Enterprise & Consumer Compliance

CFPB Releases Supervisory Highlights

On August 21, 2013, the Bureau of Consumer Financial Protection (CFPB or Bureau) released its second *Supervisory Highlights* report. The issue, which covers supervisory activities between November 2012 and June 2013, reviews the development of the Bureau's supervision program and shares certain key findings gained through those supervisory activities with the intent of helping the industry "limit risks to consumers and comply with Federal consumer financial laws."

The CFPB's current *Supervisory Highlights* include *Supervisory Observations* in the areas of compliance management systems, mortgage servicing, and fair lending. In particular, the CFPB notes that:

- Nonbanks are more likely to lack a robust compliance management system (CMS) and most CMS deficiencies noted in nonbanks are generally related to the supervised entity's lacking a CMS structure altogether. Issues identified include the lack of formal policies and procedures, the lack of a consumer compliance program, and the lack of a consumer compliance audit.
  - In contrast to nonbanks, the most common weakness identified for banks was a deficient system of periodic monitoring and independent compliance audits.
- Mortgage servicing reviews have highlighted issues related to:
  - Servicing transfers, including noncompliance with disclosure requirements under the *Real Estate Settlement Procedures Act*, and lack of controls related to key documentation.
  - Payments processing related to loan payments as well as escrows for taxes and insurance, including providing adequate notice before making changes (such as address changes or due date changes), paying required tax and insurance payments in a timely manner, and delayed processing of consumer requests.
  - Loss mitigation processing, including inconsistencies related to underwriting, communications with consumers, waivers, missing documentation, incomplete policies and procedures, and lack of quality assurance on underwriting decisions, among others.
- Some lenders are not complying with various aspects of the adverse action notification requirements under the *Equal Credit Opportunity Act* (ECOA) and its implementing regulation, Regulation B. In such instances, the CFPB has directed the entities to develop and implement plans to ensure that the appropriate monitoring and internal controls are in place to detect and prevent future violations.

CFPB Asks Public Service Employers to Pledge to Tell Employees about Student Debt Repayment Options

The Bureau of Consumer Financial Protection (CFPB or Bureau) released a "toolkit" on August 28, 2013, entitled the *Employer's Guide to Assisting Employees with Student Loan Repayment*. It is directed to school districts, non-profit organizations, and other public service employers to assist them with providing information about loan forgiveness programs that are specifically available to public service employees. The toolkit is comprised of:

- An action guide for employers detailing when to provide information to employees and how to help employees maintain certification to participate in certain programs;
- An action guide for borrowers explaining how to qualify for benefits, available options, and other considerations;
- A sample letter from public service employers to employees conveying the employer is a "qualified employer" under the Federal Public Service Loan Forgiveness program; and
- A set of frequently asked questions.

The CFPB concurrently launched a new public service pledge that asks employers to make a commitment to talk to their employees about student debt, help them understand the available options for student loan forgiveness, and assist them in enrolling in student loan repayment programs.

The CFPB's toolkit and pledge respond to the findings in its *Public Service and Student Debt Repor*t, also released by the CFPB on August 28, which estimates that more than 25 percent of the U.S. labor force is in public service and notes that many public service fields face major workforce shortages in the coming years. The report also notes that these professions frequently have low starting salaries and low wage growth making student debt repayment "a daunting obstacle."

FDIC Schedules Webinar on Financial Education Programs

The Federal Deposit Insurance Corporation's (FDIC) Division of Depositor and Consumer Protection announced that it will conduct a webinar on September 10, 2013 entitled, *How to Effectively Utilize and Implement Financial Education Programs*. The FDIC states the webinar will focus on exploring opportunities and best practices for banks to implement financial education programs intended to strengthen the ability of consumers to effectively use banking products and services. It will also include an overview of approaches to providing financial education that may potentially qualify for consideration under the *Community Reinvestment Act* (CRA).

The webinar is the fourth in a series of six webinars offered during 2013 that are designed to highlight "strategies institutions can use to promote community development and expand access to the banking system." Registration information is available on the FDIC Web site.

Capital Markets & Investment Management

SEC Releases Risk Alert on Business Continuity and Disaster Recovery Planning Directed at Investment Advisers

The Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert on business continuity and disaster recovery planning for investment advisers on August 27, 2013. The Alert was prompted by a review of responses to Hurricane Sandy, which caused widespread damage to Northeastern states and closed U.S. equity and options markets for two days in October 2012. It follows a joint advisory issued on August 16 by the OCIE, the Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight, and the Financial Industry Regulatory Authority that covered business continuity and disaster recovery planning for a broad array of firms. Both documents encourage firms to review their business continuity plans so as to improve responses to, and reduce recovery time after, significant large-scale events.

The SEC states that firms can strengthen their business continuity and disaster recovery plans by considering the observations in the Risk Alert and implementing or strengthening practices as appropriate. The August 27 Alert makes observations specific to investment advisers in the following areas:

- Preparation for widespread disruption;
- Planning for alternative locations;

- Preparedness of key vendors;
- Telecommunications services and technology;
- Communication plans; and
- Reviewing and testing.

Enforcement Actions

The Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Financial Industry Regulatory Authority (FINRA) recently announced the following enforcement actions:

- The SEC charged an investment advisory firm and its president for allegedly steering winning trades to favored clients and misappropriating soft dollar funds for undisclosed purposes.
- The SEC sanctioned a former portfolio manager of an investment advisory firm for forging documents and misleading the firm's chief compliance officer to conceal failure to report personal trades. To settle the SEC's charges, the former portfolio manager agreed to pay more than $350,000 and to be barred from the securities industry for at least five years.
- The SEC charged an individual and his company with fraud in connection with a Ponzi scheme targeted at retirement savings.
- The SEC issued an order to stop a company's initial public offering (IPO) before its shares were sold to the public after the SEC determined the company's registration statement contains false and misleading information. The company agreed to the issuance of the order and also agreed not to engage or participate in any unregistered offering of securities conducted in reliance on Rule 506 of the SEC's Regulation D for a period of five years.
- The SEC charged an investment adviser and its former owner for misleading an investment fund's board of directors about the adviser's ability to conduct algorithmic currency trading in order to gain approval for a contract to manage the fund.
- The CFTC obtained a Federal court consent Order of permanent injunction requiring an individual and his company to jointly and severally to pay $254,236 in restitution and a $350,000 civil monetary penalty in connection with an off-exchange leveraged foreign currency Ponzi scheme. The Order further finds that the company and the individual failed to register as a Commodity Pool Operator (CPO) and Associated Person of a CPO, respectively, as required by the *Commodity Exchange Act* (CEA) and CFTC Regulations.
- The CFTC issued an Order filing and simultaneously settling charges against a registered Futures Commission Merchant (FCM) for failing to comply with the minimum financial requirements for FCMs. The Order imposes a $300,000 civil monetary penalty and a cease and desist order on the company for these violations.
- The CFTC announced that it obtained a Federal court default judgment Order against a company and its principal for running a fraudulent precious metals scheme and misappropriating customers' funds. The Order requires the defendants to pay a $1.26 million civil monetary penalty, $736,979 in restitution and to disgorge $186,860 in ill-gotten gains, and also imposes permanent trading and registration bans against the defendants.
- FINRA announced that it fined a company $1 million and ordered a payment of $188,000 in restitution plus interest for failing to provide best execution in certain customer transactions involving corporate and agency bonds, and failing to provide a fair and reasonable price in certain customer transactions involving municipal bonds. In concluding the settlement, the company neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

Recent Supervisory Actions against Financial Institutions

Last Updated: September 3, 2013

Agency	Institution Type	Action	Date	Synopsis of Action
Consumer Financial Protection Bureau	Debt Relief Services	Complaint for Permanent Injunction	08/20	The Bureau of Consumer Financial Protection filed a complaint in Federal district court seeking an injunction for permanent relief from a debt-relief services company for deceptive marketing practices in violation of the Telemarketing Sales Rule and deceptive acts or practices under the Dodd-Frank Wall Street From and Consumer Protection Act. t
Federal Reserve Board	Banking Holding Company	Written Agreement	08/08	The Federal Reserve Board entered into a Written Agreement with a Texas-based bank holding company to address dividends, debt and stock redemptions, and books and records to ensure that it serves as a source of strength for its state nonmember bank subsidiary.
Federal Reserve Board	State Member Bank	Civil Money Penalty	08/01	The Federal Reserve Board imposed an Order of Assessment of Civil Money Penalty against an Iowa-based state member bank to address violations of the National Flood Insurance Act.
Federal Reserve Board	State Member Bank	Civil Money Penalty	07/18	The Federal Reserve Board imposed an Order of Assessment of Civil Money Penalty against an Ohio-based state member bank to address violations of the National Flood Insurance Act.
Federal Reserve Board	Bank Holding Company; State Member Bank	Written Agreement	06/11	The Federal Reserve Board entered into a Written Agreement with a bank holding company to address deficiencies related to Bank Secrecy Act and anti-money laundering compliance, customer due diligence, suspicious activity monitoring and reporting, and transaction review.
Federal Reserve Board	Savings and Loan Holding Company	Written Agreement	06/11	The Federal Reserve Board entered into a Written Agreement with a savings and loan holding company to address deficiencies related to board oversight, risk management, internal controls, regulatory reporting, dividends and distributions, debt and stock redemptions, and affiliate transactions to ensure that it serves as a source of strength for its state chartered savings banks and various other nonbank subsidiaries.
Federal Reserve Board	Foreign Bank; Federal Branch	Written Agreement	05/17	The Federal Reserve Board entered into a Written Agreement with a foreign bank and one of its U.S. federal branches to address deficiencies related to board oversight, Bank Secrecy Act/Anti-Money Laundering Compliance, suspicious activity reporting, and customer due diligence.
Federal Reserve Board	Banking Holding Company	Written Agreement	05/02	The Federal Reserve Board entered into a Written Agreement with a Wisconsin-based bank holding company to address dividends, debt and stock redemptions, and capital to ensure that it serves as a source of strength for its national bank subsidiary.

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