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Safety & Soundness

Federal Reserve Releases Results of 2015 Dodd-Frank Act Supervisory Stress Tests

On March 5, 2015, the Federal Reserve Board (Federal Reserve) released the results of the 2015 supervisory stress tests required by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (D-FAST) for U.S.-based bank holding companies with total consolidated assets of $50 billion or more. The results, which include information from 31 institutions representing more than 80 percent of domestic banking assets, indicate these institutions continue to build their capital levels and to strengthen their ability to lend to households and businesses during a period marked by severe recession and financial market volatility.

The Federal Reserve summarizes the most severe hypothetical scenario projects that loan losses at the participating bank holding companies would total $340 billion during the nine quarters tested. The "severely adverse" scenario features a deep recession with the unemployment rate peaking at 10 percent, a decline in home prices of 25 percent, a stock market drop of nearly 60 percent, and a "notable" rise in market volatility. Under this hypothetical scenario, the 31 firms' aggregate tier 1 common capital ratio would fall from an actual 11.9 percent in the third quarter of 2014 to a minimum level of 8.2 percent. In addition, the Federal Reserve also released results from the "adverse" hypothetical scenario, which features a more moderate recession and a rapid increase in short- and long-term interest rates. In this scenario, the aggregate tier 1 common capital ratio of the 31 firms would fall from an actual 11.9 percent in the third quarter of 2014 to the minimum level of 10.8 percent.

The quantitative results from the 2015 D-FAST are one component of the Federal Reserve's analysis during the Comprehensive Capital Analysis and Review (CCAR), an annual exercise to evaluate the capital planning processes and capital adequacy of large financial institutions. CCAR results will be released on March 11, 2015.

Office of Financial Research Working Paper: "Are the Federal Reserve's Stress Test Results Predictable?"

On March 3, 2015, the Office of Financial Research published a working paper entitled "Are the Federal Reserve's Stress Test Results Predictable?" The paper examines the results of four rounds of stress testing of the largest U.S. bank holding companies starting in 2009. The data reveal a growing correlation in results from one year to the next, highlighting whether the stress tests in their current form may be losing some of their information value over time. In particular, the paper states that projected stress losses in the 2013 and 2014 stress tests are nearly perfectly correlated for bank holding companies that participated in both rounds. The authors discuss the implications of these patterns and recommend greater diversity in the stress scenarios analyzed.

The Office of Financial Research was established by the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. It resides within the Department of the Treasury and is tasked with supporting the work of the Financial Stability Oversight Council as well as measuring and analyzing financial stability risks across the financial system, performing applied and long-term research, and collecting and standardizing financial data.

FSB and IOSCO Issue Second Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

On March 4, 2015, the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) published a second consultative document on "Assessment Methodologies for Identifying Non-Bank Non-Insurer

Global Systemically Important Financial Institutions" (NBNI G-SIFIs). As proposed, the methodologies for identifying NBNI G-SIFIs are intended to complement the methodologies for identifying G-SIFIs that currently cover banks and insurers, and take into account responses received on the first consultative document issued on January 8, 2014.

This consultative document proposes specific methodologies for the identification of NBNI G-SIFIs, but does not propose any specific entities for designation nor any policy measures applicable to NBNI G-SIFIs. In a report to the G20 Leaders published in September 2013, the FSB explained that policy measures will be developed once the assessment methodologies have been finalized.

The proposed methodologies aim to identify NBNI financial entities whose distress or disorderly failure, because of their size, complexity, and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity at the global level. These methodologies comprise a high-level framework and an operational framework for identifying G-SIFIs that would apply across NBNI financial entities, as well as detailed NBNI sector-specific methodologies.

The FSB and IOSCO will accept comments on the consultative document until May 29, 2015.

Federal Reserve Chair Yellen Discusses Results of Improved Supervision

In a speech before the Citizens Budget Commission in New York on March 3, 2015, Janet L. Yellen, Chair of the Federal Reserve Board (Federal Reserve), stated that recent regulatory changes have "significantly improved the strength and stability of large financial institutions and the financial system." In her presentation entitled "Improving the Oversight of Large Financial Institutions," Chair Yellen stated that the results of improved supervision include:

- The amount and quality of capital and the strength of liquidity positions at large firms are greatly improved since the crisis.
- Risk management, internal controls, and governance at large firms is improved, although large firms still have room for improvement.
- Both the Federal Reserve and the large firms it oversees have become more forward looking in evaluating large firms' capacity to withstand significant financial stress, which she also said has enhanced financial stability.
- There is a more consistent and industry-wide perspective on risks and vulnerabilities than existed prior to the crisis.
- The problem of "too big to fail" has been reduced by the resolution authority enacted by the Congress and Federal Reserve's work with the Federal Deposit Insurance Corporation on the orderly resolution of large institutions. Chair Yellen said that the plans developed by the largest firms to date still have a number shortcomings, but she expects those institutions to make substantial progress in the coming months, putting both firms and the government in a better position to manage the failure of a large institution in an orderly way.

FDIC Vice Chairman Hoenig Discusses "Basic Principles" of Financial Supervision

In a March 2, 2015, address at the Institute of International Bankers Annual Washington Conference, Thomas M. Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation (FDIC) discussed what he called "basic principles" for financial supervision. In particular, he stated that:

- All commercial banking firms, not just small and mid-sized ones, should be subject to full-scope examinations.
- The largest banks should be subject to greater disclosure requirements related to their financial condition because they are subsidized and can significantly impact the economy.
- Proprietary trading should be conducted outside the safety net and subject to market forces.
- All banks, including the largest banking firms, should fund and capitalize themselves at levels the market would demand if there was no public safety net.

Vice Chair Hoenig said that evidence indicates simple but well-tested principles best serve the industry, supervisors, and the public. "Underwriting standards and asset quality should be systematically reviewed and tested, first by the firms and then checked by the supervisor. Better disclosure of results will improve performance; it almost always does. Separating

commercial banking and its inherent safety net from broker-dealer and proprietary trading activities will diminish conflicts of interest and abuse of the safety net. Finally, better capitalized is not the same as well capitalized, and it's important to acknowledge the difference. Insisting that bank ownership provide funding -- capital -- commensurate with the bank's risk appetite is the most fundamental step for assuring that the banking system is a contributor to economic growth."

Basel Committee Publishes Basel III Monitoring Results

On March 3, 2015, the Bank for International Settlements' Basel Committee on Banking Supervision (Basel Committee) published the results of its latest Basel III monitoring exercise. A total of 224 banks participated in the current study, including 98 large internationally active banks. The results of the monitoring exercise assume that the final Basel III package is fully in force, based on data as of June 30, 2014. The results do not take account of the transitional arrangements set out in the Basel III framework, such as the gradual phase-in of deductions from regulatory capital. The results indicate that, based on the data as of June 30, 2014, all large internationally active banks now meet the Basel III risk-based capital minimum requirements. Moreover, capital shortfalls relative to the higher target levels have been further reduced.

The study, the seventh in a series, is based on the reporting process set up by the Basel Committee to periodically review the implications of the Basel III standards for banks. The results of most recent previous exercise were published in September 2014.

The exercise also addressed the Basel III Liquidity Coverage Ratio (LCR), which came into effect on January 1, 2015 with an initial minimum ratio requirement of 60 percent and increasing annually to 100 percent in 2019. For banks in the sample, 80 percent reported an LCR that met or exceeded 100 percent while 96 percent reported an LCR at or above 60 percent. The Net Stable Funding Ratio (NSFR), finalized by the Basel Committee in October 2014, also was addressed in the exercise. As of June 2014, 80 percent of the 212 banks in the NSFR sample reported a ratio that met or exceeded 100 percent, while 92 percent of the banks reported an NSFR at or above 90 percent.

Senate Committee on Banking, Housing, and Urban Affairs Holds Hearing on Federal Reserve Accountability and Reform

On March 3, 2015, the U.S. Senate Committee on Banking, Housing, and Urban Affairs held a hearing entitled, "Federal Reserve Accountability and Reform." Testimony was presented by four academic scholars, three from universities and one from a not-for-profit public policy research institute. They recommended that Congress:

- Exercise closer oversight of the Federal Reserve Board's (Federal Reserve's) ongoing interactions with international standard-setting bodies, such as the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision.
- Instruct the Government Accountability Office (GAO) to assess the costs, benefits, and processes associated with the Federal Reserve stress tests.
- Assess potential conflicts that may be developing between the Federal Reserve's expanded powers over the domestic insurance industry and state insurance regulations.
- Require the Federal Reserve to describe its strategy for monetary policy because there should be a close connection between a strategy and a rules-based process.
- Maintain the buffer that separates the Federal Reserve from politics without eliminating its public accountability. Focus should be placed on the Federal Reserve's governance structure rather than micromanaging its policies.

Enterprise & Consumer Compliance

CFPB Director Testifies Before U.S. House Committee on Financial Services

In his semi-annual appearance before the U.S. House Committee on Financial Services (Committee) on March 3, 2015, Richard Cordray, Director of the Consumer Financial Protection Bureau (CFPB or Bureau) discussed the Bureau's sixth Semi-Annual Report, which covered the Bureau's activities between April 2014 and September 2014. The report was submitted to Congress and the President on December 4, 2014.

Following his testimony, Committee members questioned Director Cordray about a variety of topics, including the effect of the Qualified Mortgage (QM) rule, also known as the Ability to Pay rule, on mortgages backed by the Government Sponsored Enterprises (GSEs). Because Congress is considering GSE reforms, some members of the Committee asked how the housing markets might be impacted if loans backed by the GSEs were not eligible for QM status. Director Cordray told the Committee that the Bureau is scheduled to review the QM rule in advance of the expiration of the GSEs' temporary exemption from the QM provisions.

The Committee members also questioned Director Cordray regarding payday lending, reverse mortgage lending, and community banking, among other things.

OCC Releases "Deposit-Related Credit" Booklet of the *Comptroller's Handbook*

On March 6, 2015, the Office of the Comptroller of the Currency (OCC) issued Bulletin 2015-17 to announce publication of the "Deposit-Related Credit" booklet of the *Comptroller's Handbook*. This booklet replaces and clarifies the "Deposit-Related Consumer Credit" booklet previously issued earlier in 2015 (February 11, 2015). The new "Deposit-Related Credit" booklet references relevant supervisory guidance and includes examination procedures that OCC examiners use to assess a bank's deposit-related credit products and services. In particular, the booklet addresses:

- Check credit products and services;
- Overdraft protection services;
- Deposit advance products; and
- Risk management of third-party relationships involving these products and services.

Capital Markets and Investment Management

MSRB Receives SEC Approval to Create Baseline Standards of Professional Qualification for Municipal Advisors

On March 2, 2015, the Municipal Securities Rulemaking Board (MSRB) issued Regulatory Notice 15-04 to announce that it has received approval from the Securities and Exchange Commission (SEC) to create baseline standards of professional

qualification for municipal advisors. The new standards will be incorporated through amendments to the MSRB's existing Rules G-2 and G-3 on professional qualifications and take effect April 27, 2015.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* charged the MSRB with developing professional standards as part of a comprehensive regulatory framework for municipal advisors. Revised MSRB Rule G-3 establishes two classifications of municipal advisor professionals, representative and principal, with firms required to designate at least one principal to oversee the municipal advisory activities of the firm.

The MSRB last month approved the content outline for the Municipal Advisor Representative Qualification examination (the Series 50 examination), which will be filed with the SEC and made publicly available as a study aid. The MSRB plans to administer a pilot exam later in 2015 that will precede the final exam, which is expected to be available in 2016. To facilitate the transition to the new exam requirement, the MSRB's rule provides for a one-year grace period during which individuals will be able to take the municipal advisor representative exam while still engaging in municipal advisory activities.

Amended Rule G-3 also eliminates the requirement of apprenticeship. Previously, municipal securities representatives were required to apprentice for 90 days before conducting business with the public. Omitting the apprenticeship requirement for dealers — and not establishing it for municipal advisors — allows both types of firms to identify appropriate training and supervision for new employees.

CFTC Chairman Discusses Key Agenda Items for the Coming Months

In a March 2, 2015, address before the Institute of International Bankers, Timothy G. Massad, Chairman of the Commodity Futures Trading Commission (CFTC) discussed "key agenda" items for the CFTC in the months ahead:

- *Margin Rule for Uncleared Swaps.* Margin will continue to be a significant tool to mitigate the risk of default from uncleared swaps transactions and the potential risk to the financial system as a whole. The margin rule is also important in cross-border harmonization. Chairman Massad expects the CFTC to finalize a rule by the summer that will incorporate a slight delay in the implementation timetable for the rule.
- *Addressing Cross-Border Issues*. "One of the greatest challenges of implementing the new regulatory framework for swaps is the simple fact that this is a global and mobile market…there will inevitably be differences in specific rules and requirements because the new framework can only be implemented through the actions of individual jurisdictions, each of which has its own legal traditions, regulatory philosophy, political process, and market concerns." Although progress in harmonization has been made, Chairman Massad said it is challenging and will take time.
- *Clearinghouse Strength and Stability*. The CFTC is "looking hard" at the exposure of clearing members to defaults, and recovery plans and resolution generally. It requires that clearinghouses follow core principles that cover everything from financial resources and treatment of funds, to settlement and default procedures. The CFTC engages in "constant surveillance of risk and frequent examinations."
- *Cybersecurity*. Trading platforms and clearinghouses are required to develop and maintain risk management programs and recovery procedures that meet certain standards. Cybersecurity issues are a focus in examinations.
- *Benchmarks*. The CFTC has focused on this issue in its enforcement efforts. The CFTC believes that general international standards for administration of benchmarks should be developed.

SEC Suspends Trading in 128 Dormant Shell Companies

On March 2, 2015, the Securities and Exchange Commission (SEC) suspended trading in 128 inactive penny stock companies to prevent them from becoming a source for pump-and-dump schemes. The companies are based in 24 states and Canada. The SEC stated in its Order of Suspension of Trading that there is a lack of current and accurate information concerning these securities and that the OTC Markets Group, Inc. has been unable to contact the issuers for more than a year. The suspensions are part of the SEC's *Operation Shell-Expel*, which uses technology to scour the over-the-counter (OTC) marketplace and identify dormant companies that could be targets for abuse.

SEC Makes First Whistleblower Award to a Company Officer

On March 2, 2015, the Securities and Exchange Commission SEC) announced that it awarded a whistleblower between $475,000 and $575,000. The recipient is a former company officer who reported original, high-quality information about a securities fraud that resulted in an SEC enforcement action with sanctions exceeding $1 million.

Officers, directors, trustees, or partners who learn about a fraud through another employee reporting the misconduct generally are not eligible for an award under the SEC's whistleblower program. However, there is an exception to this exclusion that makes an officer eligible if he or she reports the information to the SEC more than 120 days after other responsible compliance personnel possessed the information and failed to adequately address the issue. This is the first SEC whistleblower award to an officer under these circumstances.

Enforcement Actions

The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) recently announced the following enforcement actions:

- The SEC charged a Texas-based brokerage firm with violating key customer protection rules after failing to adequately supervise registered representatives who misappropriated customer funds. Without admitting or denying the SEC's findings, the firm agreed to settle the charges by paying a $225,000 penalty and retaining an independent compliance consultant to improve its supervisory controls.
- The CFTC announced that U.S. District Court entered a Supplemental Consent Order requiring a New Jersey-based individual and his firm to jointly pay a $26 million civil monetary penalty for operating a fraudulent commodity pool and misappropriating customer funds. In a parallel criminal proceeding, the individual pleaded guilty to the charges and is currently awaiting sentencing. The plea agreement in the criminal case requires the individual to pay restitution.
- The CFTC charged a Michigan-based individual with illegally operating a commodity pool and fraudulently soliciting at least $968,000 to trade foreign exchange (forex) in a commodity pool, by among other things, guaranteeing pool participants a monthly return on their investment based on profits purportedly earned from forex trading. The CFTC seeks restitution, disgorgement, monetary penalties, permanent registration and trading bans, and a permanent injunction.

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