The Washington Report
for the week ended March 11, 2016

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Safety & Soundness

Basel Committee Seeks Comment on Pillar 3 Revisions

On March 11, 2016, Basel Committee on Banking Supervision (Basel Committee) released a consultation paper entitled, *Pillar 3 disclosure requirements - consolidated and enhanced framework*. This Consultative Document sets out proposals for the second phase of the Pillar 3 review and builds on the Pillar 3 revisions previously finalized in January 2015. The current proposal would include:

- The addition of a "dashboard" of key metrics;
- Disclosure of hypothetical risk-weighted assets calculated based on the Basel Committee's standardized approaches;
- Enhanced granularity in the disclosure of prudent valuation adjustments;
- Further revisions and additions to the Pillar 3 framework arising from ongoing reforms to the regulatory policy framework, including:
  - The total loss-absorbing capacity regime for global systemically important banks;
  - The proposed operational risk framework; and
  - The final standard for market risk.
- Consolidation of all existing and prospective Basel Committee disclosure requirements into the Pillar 3 framework.

Comments are requested through June 10, 2016. [Press Statement] [Consultative Document]

Working Papers

During the week ended March 11, 2016, the following working papers were released:

The Basel Committee on Banking Supervision (Basel Committee) released BCBS Working Papers 30 on March 9, 2016. The paper is aimed at providing a review of current literature assessing recent reforms on regulatory capital and liquidity instruments. The paper is comprised of three essays covering capital, liquidity and its interaction with capital, and other supervisory requirements. The authors note that there are many studies available on capital requirements, however, less information is available for liquidity requirements and other supervisory tools, such as buffers, macro prudential policies and stress tests, which were implemented following the recent financial crisis. The three essays assess the:

- Impact of higher capital requirements in terms of the costs and benefits to economic activity and welfare;
- Potential channels through which liquidity requirements can affect bank behavior, balance sheets, and profitability; and
- Whether measures other than capital and liquidity requirements adequately complement these regulations in making the banking system more resilient, and whether simpler regulatory rules may be more robust to extreme stress events than current rules and whether stress testing can enhance robustness. [Working Paper]

On March 8, 2016, the U.S. Department of the Treasury's Office of Financial Research (OFR) published a working paper entitled, *Stressed to the Core: Counterparty Concentrations and Systemic Losses in CDS Markets*, which evaluates the impact of a default of the largest counterparties on banks as well as on the financial system as a whole. Key findings from the working paper suggest:

- Banks' direct exposures in the credit default swap market are concentrated in a small number of counterparties, however their indirect exposures to those same counterparties are potentially much larger.
- Incorporating a macro-prudential perspective into stress tests would inform supervisors and regulators of the risk of systemic exposure to a counterparty.

- Bank holding companies have moved from being net sellers of protection to net buyers, which suggests a shift of risk from the banking sector to nonbanks.
- The concentration of banks' overall counterparty exposures has increased. [Working Paper]

The Bank for International Settlements released Working Papers 548 on March 7, 2016, entitled *Moving in tandem: bank provisioning in emerging market economies.* The authors summarize they studied 554 banks from 18 emerging market economies (EMEs) in an effort to identify the key determinants of loan loss provisioning and delinquency ratios, with the purposes of gaining a better understanding of the relationship between economic and credit growth, and the subsequent financial soundness of banks. Key findings from the study included:

- Provisions in EME banks responded mostly to aggregate variables, and very little to idiosyncratic factors. In particular, the bank-specific credit growth rates, which are usually thought of as a measure of individual risk-taking, did not explain the level of loan loss provisions. However, the study also noted that provisions and actual losses were negatively related to past economic growth and positively related to past aggregate credit growth.
- Earnings of the bank and the size of the intermediaries have an effect on provisioning.
- Provisions created by the banks were a function of losses reported in the past.
- Provisioning decisions among EME banks were highly correlated. [Working Paper]

Enterprise & Consumer Compliance

FTC to Study Credit Card Industry Data Security Auditing

On March 7, 2016, the Federal Trade Commission (FTC) announced that, as part of its initiative to review the credit card industry's auditing standards on data security, it intends to study the policies practices, and procedures of companies that audit the compliance of others with the Payment Card Industry Data Security Standards (PCI DSS). To do so, it issued orders to nine companies that require them to provide the FTC with information on how they conduct assessments to measure a company's compliance with the PCI DSS, examples of such assessments, and information on additional services they provide, including forensic audits. PCI DSS audits are required by the major payment card issuers for retailers and other businesses that process more than 1 million card transactions in a year. This practice is intended to ensure that companies are provide adequate protection to consumers' sensitive personal information.
[Press Statement] [Order]

CFPB Begins Accepting Consumer Complaints Related to Marketplace Lenders

The Consumer Financial Protection Bureau (CFPB or Bureau) announced that, beginning March 7, 2016, it has begun to accept consumer complaints on loans from online marketplace lenders, also referred to as "peer-to-peer" or "platform" lenders. The Bureau states that marketplace lenders use an online interface to connect consumers or businesses seeking to borrow money with investors willing to buy or invest in the loan. Generally, the marketplace lending platform handles all underwriting and customer service interactions with a borrower and once a loan is originated, the company generally makes arrangements to transfer ownership to the investors but continues to service the loan. Marketplace lenders may offer different types of financial products such as installment loans, mortgages, student loans, or auto loans so that consumers submitting a complaint should select among the different complaint categories for the products and services that best apply to their situation.

Coincident with the announcement, the Bureau released a consumer bulletin that provides an overview of marketplace lending and outlines guidelines for consumers to consider when seeking a loan, including loans from marketplace lenders. [Press Statement] [Consumer Bulletin]

Enforcement Actions

The Federal Trade Commission (FTC) announced that it had obtained a federal court order banning a financial services company, its related entities, and seven individuals from collecting or disclosing consumer information. The FTC charged the defendants with buying sensitive personal information from data brokers and using it to charge millions of dollars to consumers' bank and credit card accounts for services they did not perform and for which they did not receive consumer authorization. The FTC separately sued the data brokers who sold consumers' private information. The court imposed a judgment of more than $79 million against the defendants as well as bans against them marketing and selling credit-related products or services.

Capital Markets and Investment Management

Enforcement Actions

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

- The SEC charged a state government agency and its bond underwriter with defrauding investors in the process of making a municipal bond offering to finance a startup company in the state. The SEC charged the lead banker on the deal and two former agency executives with aiding and abetting the fraud. The agency's executives agreed to settle the charges by paying a penalty of $25,000 each, without admitting or denying the allegations. They are prohibited from participating in any future municipal securities offerings. The SEC's litigation against the investment bank, its lead banker, and government agency continues.
- The SEC announced fraud charges against an unregistered fund manager and his firm for providing false and misleading data to investors and an independent research firm, distributing false and misleading investment marketing materials, misappropriating investor funds, and using false identities while communicating with investors. The case will be scheduled for a public hearing.
- The SEC charged an Oregon-based investment group and three of its top executives with fraud for hiding the deteriorating financial condition of their enterprise while raising more than $350 million from investors. More than 1,500 investors were allegedly misled into believing that they were making health care, education, and transportation-related investments though their funds were actually being used to pay the firm's expenses. Some of the money raised was also allegedly used to pay earlier investors. The SEC's complaint charged the group with violating federal securities laws and seeks permanent injunctions, disgorgement with prejudgment interest, and monetary penalties from all defendants, as well as bars prohibiting the group's executives from serving as officers or directors of any public company.
- The SEC settled charges against a Texas-based company and several individuals for failure to maintain internal controls with respect to financial reporting. SEC rules require companies' management to evaluate and report annually on the effectiveness of Internal Control over Financial Reporting (ICFR). The company and its executives failed to properly evaluate and apply applicable ICFR standards and improperly concluded that the company had no material weaknesses. The company agreed to pay a penalty of $250,000 and one of its executives and its consultant agreed to pay penalties of $25,000 and $15,000 respectively, without admitting to or denying the findings in the cease-and-desist orders covering various reporting and internal control provisions of the federal securities laws. The

individuals also agreed to be suspended from practicing as accountants, which includes not participating in the financial reporting or audits of public companies for a period of one year, after which they could apply for a reinstatement.

- The SEC announced that a Florida-based individual traded on inside information ahead of a pharmaceutical company merger. Both the individual and his accomplice who tipped him with the information agreed to settle enforcement actions against them. The individual agreed to return more than $700,000 in illegal profits plus more than $60,000 in interest earned after allegedly purchasing stock options and call options in the company. The accomplice agreed to pay back the cash kickbacks he received and to be barred from the securities industry and penny stock offerings.
- The SEC charged a company for misleading investors about the production status, sales agreements and potential revenues for a key product. These misrepresentations caused the company's stock price to more than double, enabling the then-CEO and CFO to make more than $2 million in personal profits from selling their shares in company's stock. Without admitting or denying the SEC's charges, the company agreed to pay $750,000 to settle charges that it violated sections of the *Securities Act of 1933* and the *Securities and Exchange Act of 1934*. The former chairman of the board has agreed to cooperate with the SEC and to be barred from serving as an officer and director for five years. The SEC has separately filed charges against the two former executives.
- The SEC charged a municipal agency with misleading investors about its financial condition during the issuance of a $77 million bond offering in 2012. The agency had agreed in prior bond offerings to maintain a debt service coverage ratio of 1.25. Although the agency learned as early as 2010 that it would be unable to maintain this ratio due to certain external business conditions, it proceeded with the bond issue and used extraordinary accounting transactions to maintain the required ratio. The agency agreed to pay $125,000 to settle the SEC's charges without admitting or denying to its findings and agreed to cease and desist from future violations. Additionally, the SEC charged the agency's general manager and former assistant general manager who agreed to pay penalties of $50,000 and $20,000 respectively to settle charges. The agency is the second municipal issuer to pay a financial penalty in an SEC enforcement action.
- The CFTC charged an agricultural cooperative company and its commodity brokerage subsidiary for failing to comply with requirements to submit accurate monthly CFTC Form 204 Reports. CFTC Regulations requires all persons holding or controlling reportable futures and options positions in certain agricultural commodities to file CFTC Form 204 reports showing the composition of their fixed price cash position in each such commodity hedged. Form 204 report serves to check compliance with speculative position limits by ensuring that filers that classify their futures positions as hedging actually own or control offsetting cash positions. The CFTC Order requires the company and its commodity brokerage subsidiary to jointly pay a $1 million civil monetary penalty and to cease and desist from committing further violations of CFTC Regulation 19.01.
- The CFTC issued a Consent Order requiring the owner of a trading firm and other related companies to pay $7.1 million in restitution to U.S. customers for engaging in the illegal trade of off-exchange binary options. The defendants were also ordered to pay a $2 million civil monetary penalty. The Order imposed a permanent ban on offering or trading any further off-exchange binary options with U.S. customers.

Financial Crimes

Comptroller Curry Indicates OCC Studying Risk Re-Evaluations and the Need for Guidance

Thomas J. Curry, Comptroller of the Currency, spoke before the annual conference of the Institute of International Bankers on March 7, 2016. In general, his remarks addressed global financial regulation and highlighted the importance of international cooperation, what he called "comprehensive, cross-border, cross-agency response," to improve cybersecurity and the fight against money laundering. He also provided insight into the Office of the Comptroller of the

Currency's (OCC) efforts to evaluate how banks conduct risk re-evaluation, or "de-risking." This process refers to the way banks evaluate the Bank Secrecy Act/anti-money laundering (BSA/AML) risk posed by their customer relationships, including risks posed by the activities of foreign correspondent banks. Comptroller Curry said these re-evaluations have led banks to terminate some relationships where there are concerns about the host country's ability to supervise AML risk and doubts that the potential financial benefits of the relationship would offset the cost of managing the BSA compliance risk associated with the relationship. He added that many such relationships have been terminated, particularly those with foreign correspondent banks. The OCC is currently gathering data and other information through the supervision process to determine current risk re-evaluation practices and whether it would be appropriate to issue related guidance. In particular, the OCC is looking at whether banks have explicit policies on risk re-evaluation, who is involved in the decision to terminate a relationship, whether oversight committee review such decisions, whether the decisions are reported to the Board of Directors or senior management, and whether correspondents have an opportunity to address concerns before the relationship is terminated. [Press Statement] [Speech]

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