The Washington Report

for the week ended March 25, 2016

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Basel Committee Proposes Changes to the Internal Ratings-Based Approaches

On March 24, 2016, the Basel Committee on Banking Supervision (Basel Committee) released a consultative document entitled *Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches*. The document proposes changes to the advanced Internal Ratings-Based (IRB) approach and the foundation internal ratings-based approach of the Basel capital framework, which permit banks to use internal models as inputs for determining their regulatory capital requirements for credit risk, subject to certain constraints. The proposed changes are intended to reduce the complexity of the regulatory framework, improve comparability, and address excessive variability in the capital requirements for credit risk. More specifically, the Basel Committee proposes to:

- Remove the option to use the IRB approaches for certain exposure categories, such as loans to financial institutions;
- Adopt exposure-level, model-parameter floors to ensure a minimum level of conservatism for portfolios where the IRB approaches remain available; and
- Provide greater specification of parameter estimation practices to reduce variability in risk-weighted assets for portfolios where the IRB approaches remain available.

Comments are requested through June 24, 2016. [Press Statement] [Consultative Document]

Enterprise & Consumer Compliance

CFPB Adopts Final Rule to Broaden Special Provisions for Small Creditors Operating in Rural and Underserved Areas

The Consumer Financial Protection Bureau (CFPB or Bureau) issued an interim final rule on March 22, 2016, which amends certain provisions of Regulation Z (Truth-in-Lending) to implement provisions of the *Helping Expand Lending Practices in Rural Communities Act* that broaden the category of small creditors operating in rural or underserved areas that may be eligible for special provisions allowing balloon-payment Qualified Mortgages and balloon-payment high cost mortgages, as well as an escrow exemption for higher–priced mortgages. The amendments to Regulation Z take effect on March 31, 2016 though comments will be accepted for a period of 30 days following publication in the Federal Register. [Press Statement] [Interim Final Rule]

CFPB Office of Servicemember Affairs Issues Annual Report

On March 22, 2016, the Consumer Financial Protection Bureau's (CFPB or Bureau) Office of Servicemembers Affairs released its fourth annual report detailing the data and trends surrounding complaints submitted to the CFPB by servicemembers, veterans, and their families. The CFPB reports it received more than 19,000 complaints from members of the military community in 2015, with debt collection, mortgages, and credit reporting being the three most complained about products or services. The *Dodd-Frank Wall Street Reform and Consumer Protection Act* established the Office of Service-member Affairs to address the consumer protection concerns of the military community.
[Press Statement] [Servicemembers Annual Report]

CFPB Issues Advisory and Report on Preventing Elder Financial Exploitation

The Consumer Financial Protection Bureau (CFPB or Bureau) Office for Older Americans issued an Advisory on March 23, 2016, to outline for financial institutions, including banks and credit unions in particular, recommendations for assessing and strengthening their current practices for preventing, detecting, and responding to financial exploitation of older people. The Advisory is supplemented by a report, which contains additional background information and greater detail on the recommendations outlined in the Advisory. The CFPB states that financial exploitation, defined as the illegal or improper use of a person's funds, property, or assets, is the most common form of abuse against the elderly, costing senior citizens billions of dollars annually. The CFPB suggests that banks and credit unions are uniquely positioned to detect whether an elder account holder has been targeted or victimized, and to take action. The recommendations contained in the Advisory and report are voluntary, though are presented by the CFPB as "best practices" to assist with efforts to prevent elder financial abuse and to intervene effectively when it occurs. The recommendations include:

- Training management and staff to recognize abuse and to prevent, detect, and respond to suspicious events;
- Using fraud detection technologies to monitor for signs of elder financial exploitation;
- Reporting all cases of suspected exploitation to relevant federal, state, and local authorities;
- Filing Suspicious Activity Reports (SARs) when mandatory under the *Bank Secrecy Act* (checking the "elder financial exploitation" designation category) and voluntarily in other cases;
- Expediting documentation requests from Adult Protective Services and other law enforcement or government entities;
- Complying with the *Electronic Fund Transfer Ac*t and it implementing regulation, Regulation E;
- Enabling older account holders to consent to information sharing with trusted third parties;
- Offering age-friendly services; and
- Coordinating efforts to provide financial education to older account holders, caregivers, and the public.
  [Press Statement] [Advisory] [Report]

Insurance

House Subcommittee Conducts Hearing on Best Practices for Risk Management of Cyber Risks through Cyber Insurance

The House Committee on Homeland Security's Subcommittee on Cybersecurity, Infrastructure Protection, and Security Technologies conducted a hearing on *The Role of Cyber Insurance in Risk Management* on March 22, 2016. The purpose of the hearing was to examine potential opportunities to promote the adoption of cyber best practices and more effective management of cyber risks through cyber insurance. The Subcommittee chairman released a statement indicating that he hoped "to hear about the potential for cyber insurance to be used to drive companies of all sizes to improve their resiliency against cyber attacks and develop a more effective risk management strategy, leading to a safer Internet for all Americans." He added, "In light of these risks and their enormous significance to individuals, families, and companies, we must explore market-driven methods for improving the security of the companies that store our personal information." Representing the National Association of Insurance Commissioners, North Dakota Insurance Commissioner Adam Hamm testified on known and emerging issues impacting cybersecurity in the insurance sector. He acknowledged that the cybersecurity insurance market was a nascent market and noted that the NAIC will be able to more definitively report on the size of the market, and identify trends that will inform whether more tailored regulation is necessary, following analysis of information to be collected about insurers writing cybersecurity coverage nationwide in a new form, Cybersecurity and Identify Theft Coverage Supplement, that is due April 1. He also underscored the importance of keeping consumer data protected. [Press Statement] [Testimony]

Capital Markets and Investment Management

Financial Stability Oversight Council Convenes to Discuss Potential Risks to U.S. Financial Stability from Asset Management Products

The Financial Stability Oversight Council (Council) announced that it conducted a meeting on March 21, 2016, to discuss its ongoing assessment of potential risks to the financial stability of the United States from asset management products and activities, including a discussion of potential financial stability risks related to liquidity and redemption risks and risks associated with the use of leverage by asset management vehicles. A public update on the Council's analysis is expected to be released later in the spring. [Press Statement]

Office of Financial Research Analyzes Hedge Fund Risk Reporting on Form PF

On March 23, 2016, the U.S. Department of Treasury's Office of Financial Research published a working paper entitled *Form PF and Hedge Funds: Risk-Measurement Precision for Option Portfolios*. Form PF was introduced by the Securities and Exchange Commission (SEC) to implement a mandate of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* requiring hedge funds to report their risk exposures in order to help protect investors and monitor systemic risk. The author of the paper attempts to assess how precisely the statistics reported on the form reflect the actual risks in fund portfolios as well as how adding derivatives to a hedge fund's portfolio affects Form PF's effectiveness in measuring risk. The authors report the analysis reveals that funds with identical Form PF filings could have vastly different risk exposures, adding that the form allows significant tolerance for risk exposures to differ among funds and that it does not adequately reflect these differences. This tolerance is much larger among funds with derivatives. The authors state the analysis also confirms that requiring funds to report specific risk statistics, such as value-at-risk, has a beneficial side effect in that they significantly decrease the measurement tolerances in other risk dimensions. Such a finding, the authors suggest, is a way to improve the risk reporting on Form PF. [Press Statement] [Working Paper]

Enforcement Actions

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

- The SEC charged a fund manager and two of his firms with fraud for allegedly misappropriating approximately $5.7 million from investors and using the funds to pay off earlier investors, support other funds, and pay personal expenses. The SEC's complaint seeks permanent injunctions, disgorgement with prejudgment interest, and monetary penalties from the individual and his firms. The SEC also announced that it has obtained a court order freezing the defendants' assets, ordering the appointment of an independent monitor to oversee the operations of the firms and their affiliates, and preliminarily enjoining the defendants from violating antifraud provisions of federal securities laws and raising funds from investors.
- The CFTC announced that a Federal Court ordered a former Alabama resident and his companies to pay more than $4.7 million in restitution and civil monetary penalties, in addition to imposing permanent trading and registration bans against them. The court's order stems from a CFTC complaint charging the defendants with fraud and misappropriation in conjunction with operating two commodity pools.
- The CFTC charged a foreign investment bank with violating speculative position limits for wheat futures. The bank is required to pay a civil monetary penalty of $525,000, and cease and desist from further violations of the *Commodity Exchange Act* (CEA) and CFTC Regulations. In addition, it was found that the U.S. based brokerage arm of the same parent banking group submitted to the CFTC's Division of Enforcement, false or misleading information reflecting

certain inflated swap positions. The brokerage firm is required to pay a $140,000 civil monetary penalty and to cease and desist from further violations of the CEA to settle these charges.

- The CFTC issued an order charging and simultaneously settling with two affiliated companies, a commodity trading and risk-management company and a bank, for failing to submit accurate Large Trader Reports (LTRs) for physical commodity swap positions, thereby violating provisions of the *Commodity Exchange Act* (CEA) and CFTC Regulations. The CFTC Order requires the defendants to pay a civil monetary penalty of $225,000, and to cease and desist from committing further violations of the CEA and CFTC Regulations.
- The CFTC filed a civil enforcement action against an individual and his investment advisory firm, for fraudulently soliciting more than $1.2 million from customers by misrepresenting that their funds would be invested in Treasury Bills when they were actually used to trade commodity futures. In ongoing litigation, the CFTC is seeking restitution, disgorgement of ill-gotten gains, civil monetary penalties, permanent trading and registration bans, and a permanent injunction against further violations of federal commodities laws.
- FINRA and the Nasdaq Stock Market LLC announced that they jointly censured a private investment banking and brokerage firm for supervisory violations in connection with its handling of a client's redemption activity and trading of leveraged exchange-traded funds (ETFs) that led to "chronic fails to deliver." Without admitting or denying the changes, the firm agreed to pay a $675,000 fine to settle charges.

Financial Crimes

Agencies Release Joint Guidance to Issuing Banks on Applying Customer Identification Program to Holders of Prepaid Cards

The Financial Crimes Enforcement Network (FinCEN) and the federal banking agencies (Federal Reserve Board, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation, and National Credit Union Administration) issued joint guidance on March 21, 2016, which is intended to provide clarification on the applicability of the Customer Identification Program (CIP) rule to prepaid cards issued by banks. Prepaid cards include those cards that are sold and distributed by third-party program managers, as well as cards that are used to provide employee wages, healthcare, and government benefits, as well as certain prepaid access products offered through mobile phones or Internet sites that are used to access funds. The guidance clarifies that a bank should apply its CIP to the cardholders of certain prepaid cards issued by the bank. The guidance highlights that:

- The applicable CIP requirements are derived by determining whether an Account (as defined) is created and then identifying the Customer (as defined).
- An Account is created when a Customer exercises the ability to reload funds onto the prepaid card, or accesses the prepaid card's credit or overdraft features.
- Depending on the nature of the prepaid card program, the Customer could be either the cardholder or the third-party card provider.
- Issuing banks should enter into well-constructed, enforceable contracts with third-party program managers that clearly define the expectations, duties, rights, and obligations of each party in a manner consistent with the guidance.
  [Joint Press Release] [Interagency Guidance]

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