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Safety & Soundness

OFR Publishes Working Paper on Incentives to Centrally Clear OTC Derivatives

The U.S. Department of the Treasury's Office of Financial Research (OFR) has published a working paper assessing whether recent regulatory reforms create a cost incentive for banks to use central clearing with respect to over-the-counter (OTC) derivatives. Those reforms required standardized OTC derivatives to be cleared through central counterparties (CCPs). They also set higher capital and margin requirements for derivatives that have not been cleared centrally. (See OFR Working Paper 16-07, *Does OTC Derivatives Reform Incentivize Central Clearing*?) The authors find that various cost structures do not necessarily favor central clearing. In addition, when cost structures do favor central clearing for OTC derivatives, the incentives may be driven by differences in CCPs' default waterfall resources. The model used to generate this analysis compared total capital and collateral costs when banks transact fully bilaterally against the capital and collateral costs when banks clear fully through CCPs. The authors find that the main factors driving the cost comparison are i) the netting benefits achieved through bilateral and central clearing; ii) the margin period of risk used to set initial margin and capital requirements; and iii) the level of CCP guarantee fund requirements.
[Press Statement] [Working Paper]

FDIC Proposes Guidance for Third-Party Lending

The Federal Deposit Insurance Corporation (FDIC) is seeking comment on proposed Guidance for Third-Party Lending regarding the agency's expectations for the safety and soundness and consumer compliance measures FDIC-supervised institutions should follow when lending through a business relationship with a third party. The proposed guidance seeks to supplement the FDIC's existing Guidance for Managing Third-Party Risk, which applies to any institution's third-party arrangements, including lending.

Highlights of the proposed guidance include:

- "Third-party lending" is defined as an arrangement that relies on a third party to perform a significant aspect of the lending process. Categories include (but are not limited to): institutions originating loans for third parties; institutions originating loans through third parties or jointly with third parties; and institutions originating loans using platforms developed by third parties.
- An institution's board of directors and senior management are ultimately responsible for managing third-party lending arrangements as if the activity were handled within the institution.
- Institutions should establish a third-party lending risk management program and compliance management system (CMS) that is commensurate with the significance, complexity, risk profile, transaction volume, and number of third-party lending relationships. The risk management program and CMS should address risk assessment, due diligence and oversight, and contract structuring and apply when selecting and managing individual third-party lending relationships.
- Institutions that engage in significant lending activities through third parties would be subject to increased supervisory attention, including a 12-month examination cycle, concurrent risk management and consumer protection examinations, offsite monitoring, and possible review of third parties.

Comments on the proposed guidance will be accepted through September 12, 2016. [FIL-50-2016]

Agencies Issue Results of Shared National Credit Program Review

The Federal Reserve Board, the Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency jointly released the results of their most recent Shared National Credit (SNC) Program Review on July 29, 2016, showing that credit risk remains elevated, but underwriting and risk management practices have improved from prior assessments. The review also finds that the level of adversely rated assets remains higher than in previous periods of economic expansion, raising concern that future losses and problem loans could rise considerably in the next credit cycle. The agencies attribute the elevated level of risk observed to the high inherent risk in the leveraged loan portfolio and growing credit risk in the oil and gas portfolio. Examiners noted continued progress toward full compliance with the underwriting and risk management expectations for leveraged loans, which were published by the agencies in December 2013.

In 2016, the agencies initiated a semi-annual SNC examination schedule and reviews are now planned for the first and third calendar quarters each year, with some banks receiving two examinations and others continuing to participate in a single review. Results from prior semi-annual examinations will be combined in order to present a complete review of the entire SNC portfolio that will be comparable to prior years. [Joint Press Statement] [SNC Review]

OFR Issues Assessment that U.S. Financial Stability Threats Increased Due to Brexit Vote

On July 25, 2016, the Office of Financial Research (OFR) reported that risks to the U.S. financial stability remain in the medium range. However, risks have increased since the last assessment in December 2015 due to UK's decision to leave the European Union. The OFR highlighted in particular the risks associated with prolonged uncertainty about the rules governing the UK's investment, financing, and trade relations. In addition, the OFR notes that adverse outcomes in the UK financial system could ultimately pose a risk to the financial stability of the U.S. Ongoing vulnerabilities for U.S. financial stability beyond the Brexit issues include:

- Elevated levels of credit risks in U.S. nonfinancial businesses and in some major foreign markets.
- "Ultra-low" levels of long-term U.S. interest rates and negative interest rates in many foreign jurisdictions.
- Uneven resilience in the U.S. financial system. [Press Release] [OFR Report]

Enterprise & Consumer Compliance

CFPB Publishes Outline of Debt Collection Proposals

On July 28, 2016, the Consumer Financial Protection Bureau (CFPB) released an outline of possible regulatory proposals to address debt collection practices by third-party debt collectors and others covered by the *Fair Debt Collection Practices Act* (FDCPA). The CFPB published the outline in preparation for an impact assessment review to be conducted with a group of small debt collection businesses, as required by the *Small Business Regulatory Enforcement Fairness Act* (SBREFA). The review is expected to be convened in August 2016, and the findings will be used to inform the CFPB's forthcoming notice of proposed rulemaking (NPR) on the FDCPA.

The outline includes, among others:

- Requirements for debt collectors to substantiate a debt before initiating collections activity;
- Requirements for debt collectors to provide consumers with a written verification of the debt when the consumer disputes the debt collector's claim in a timely manner;
- Limitations on the number of contact attempts that can be made weekly, and the location of those attempts;
- Disclosures regarding a debt collector's right to sue;

- Prohibitions against a subsequent debt collector initiating collections activity if the previous debt collector did not resolve a dispute; and
- A list of information that debt collectors would be required to transfer to subsequent debt collectors.

The CFPB indicates that it will address consumer protection issues involving first-party debt collectors and creditors on a separate track and will convene a separate SBREFA in the next several months. [Press Statement] [Cordray Remarks] [Outline]

CFPB Monthly Complaint Report Highlights Credit Cards

The Consumer Financial Protection Bureau (CFPB or Bureau) released a monthly complaint report on July 26, 2016, spotlighting consumer complaints about credit cards. Through July 1, 2016, the CFPB has handled more than 97,000 credit card complaints. The most common of these complaints concern consumers' difficulties in understanding:

- Credit decisions made by credit card issuers, including changes made to the interest rates.
- The application of payments to accounts with multiple balances.
- Fees and other charges imposed on their accounts.
- The terms and conditions of special rewards programs. [Press Statement] [CPFB Monthly Complaint Report]

CFPB Proposes Amendments to Mortgage Disclosure Rule

The Consumer Financial Protection Bureau (CFPB or Bureau) is proposing amendments to federal mortgage disclosure requirements under the *Real Estate Settlement Procedures Act* and the *Truth in Lending Act* that are implemented in Regulation Z and commonly referred to as the "*Know Before You Owe*" mortgage disclosure rule. In addition to certain clarifications and technical amendments, the Bureau is proposing amendments to:

- Include tolerance provisions for the total of payments that parallel existing tolerances for the finance charge and disclosures affected by the finance charge;
- Clarify that recording fees and transfer taxes may be charged in connection with certain housing assistance loans without losing eligibility for the partial exemption;
- Extend coverage to all cooperative units; and
- Add commentary to clarify how a creditor may provide separate disclosure forms to the consumer and the seller.

The comment period will remain open through October 18, 2016. [Press Statement]

Agencies Release White Paper Outlining Principles for Future Loss Mitigation Programs

On July 25, 2016, the U.S. Department of the Treasury, the U.S. Department of Housing and Urban Development, and the Federal Housing Finance Agency (FHFA) jointly released a white paper outlining guiding principles for developing loss mitigation programs in the residential mortgage market. The white paper draws on lessons learned from the crisis-era foreclosure prevention programs, such as the *Making Home Affordable* program and the *Home Affordable Modification Program*, which will close at the end of 2016. The agencies identify the following five principles as critical to the success of these programs and suggest they should serve as a foundation for any future loss mitigation programs:

- <u>Accessibility</u>: Ensuring that the process by which mortgage is made available to homeowners is simple and easy
- <u>Affordability</u>: Providing homeowners with meaningful payment relief that addresses the needs of the homeowner, the servicer, and the investor to support long-term performance.
- <u>Sustainability</u>: Offering solutions designed to resolve the delinquency and be effective in the long-term for the homeowner, the servicer, and the investor.
- <u>Transparency</u>: Ensuring that the process to obtain assistance, and the terms of that assistance, are as clear and understandable as possible to homeowners, and that information about options and their utilization is available to the appropriate parties.

- Accountability: Ensuring an appropriate level of oversight exists regarding the process to obtain mortgage assistance. [Press Release]

Insurance

Federal Reserve Extends Comment Period for Capital Standards Frameworks for Institutions Engaged in Insurance

The Federal Reserve Board (Federal Reserve) is extending until September 16, 2016, the comment period applicable to its advance notice of proposed rulemaking (ANPR) on two conceptual frameworks for capital standards that would apply to systemically important insurance companies (nonbank financial companies that the Financial Stability Oversight Council has designated for supervision by the Federal Reserve and that have significant insurance activities) and to insurance companies that own a bank or thrift (depository institution holding companies significantly engaged in insurance activities). One approach, the consolidated approach, would apply to systemically important insurance companies. It would categorize an entire insurance firm's assets and insurance liabilities into risk segments, apply appropriate risk factors to each segment at the consolidated level, and set a minimum ratio of required capital. The second approach, the building block approach, would apply to insurance companies that also own a bank or thrift. This approach would aggregate existing capital requirements across a firm's different legal entities to arrive at a combined, group-level capital requirement, subject to adjustments to reflect the supervisory objectives of the Federal Reserve. The Federal Reserve has noted that it currently supervises 2 systemically important insurance companies and 12 insurance companies that own a bank or thrift. [Press Statement] [KPMG Analysis]

U.S. and China Representatives Meet to Discuss Insurance Issues

On July 26, 2016, the National Association of Insurance Commissioners (NAIC) announced that regulatory representatives from the U.S. and China recently met to discuss issues facing their respective insurance markets. Policymakers discussed retirement security, China's Risk Oriented Solvency System (C-ROSS), the NAIC's group capital calculation, natural catastrophes, reinsurance, and cybersecurity.

The regulatory meeting followed discussions during the 10th China-U.S. Insurance Dialogue, where representatives from the U.S. met with members of the China Insurance Regulatory Commission (CIRC), to discuss cybersecurity, consumer protection, and industry innovations. The U.S. delegation was comprised of individuals from the U.S. Trade Representative, U.S. Department of Commerce, the NAIC and U.S. insurers. [Press Statement]

Capital Markets and Investment Management

OFR Publishes Working Paper on Incentives to Centrally Clear OTC Derivatives

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CFTC Issues Staff Advisory on Chief Compliance Officer Reporting Lines

The Commodity Futures Trading Commission's (CFTC) Division of Swap Dealer and Intermediary Oversight issued a staff advisory on July 26, 2016, regarding chief compliance officer reporting line requirements for swap dealers, major swap participants, and futures commission merchants under the CFTC's Regulation 3.3. The Advisory clarifies the requirements of the Regulation and addresses additional supervisory relationships that a chief compliance officer may have with senior management in addition to those with the board or the senior officer of the registrant. [Press Statement] [Staff Advisory]

CFTC Announces Whistleblower Award

The Commodity Futures Trading Commission (CFTC) awarded approximately $50,000 to a whistleblower who voluntarily provided key original information that led to a successful CFTC enforcement action. The July 26, 2016, announcement indicated this was the fourth award made by the CFTC's Whistleblower Program and the third such award made in the last ten months. The award represents between ten percent and thirty percent of the monetary sanctions collected to date, and the whistleblower will be entitled to the same percentage of any additional amounts collected. [Press Release]

Enforcement Actions

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

- The SEC announced that a financial services firm agreed to pay more than $382 million to settle charges it mislead mutual funds and other custody clients regarding costs associated with certain foreign currency exchange trades. The firm has agreed to pay approximately $167 million in disgorgement and penalties to the SEC, a $155 million penalty to the Department of Justice, and at least $60 million to ERISA plan clients in an agreement with the Department of Labor. The firm has also agreed to a related, second SEC order that will address violations associated with the trade confirmations and monthly transaction reports provided to the firm's registered investment company custody clients that were found to be materially misleading because of the previous misrepresentations. In this order, the firm will be required to pay more than $92 million in disgorgement and interest to harmed clients as well as a $75 million penalty.

- The CFTC obtained an Order of Final Judgment by Default against two foreign web-based binary options firms regarding the CFTC's charges they unlawfully traded in off-exchange binary options as well as engaged in related frauds and registration violations. The CFTC charged the defendants with operating as unregistered Futures Commodity Merchants and violating the *Commodity Exchange Act*'s ban on off-exchange options trading and off-exchange swaps trading by entering into binary commodity option contracts with retail U.S. customers. The court order requires the defendants to jointly pay a civil monetary penalty of $3 million and $1.5 million in restitution to the defrauded customers. The order also imposed permanent injunctions and trading bans against the two entities.

Alternative Finance

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Comments on the proposed guidance will be accepted through September 12, 2016. [FIL-50-2016] (*This item was also covered under the Safety and Soundness section*)

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