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Treasury Issues Report Outlining Reforms to U.S. Banking Regulation

On June 12, the U.S. Department of the Treasury issued the first of four reports to President Trump (the "Report," available here) in response to the executive order signed on February 3 (see our client alert here) (the "Executive Order") setting forth "Core Principles" intended to guide the reform of the U.S. financial regulatory system. This first report addresses the U.S. depository system, covering banks, savings associations and credit unions. The upcoming reports will cover the regulation of the following areas: capital markets; the asset management and insurance industries; and non-bank financial institutions, financial technology and financial innovation.

The first Report echoes a number of the bank regulatory reforms contained in the Financial CHOICE Act (see our client alert here) (the "CHOICE Act") recently passed by the House of Representatives. While the Report, like the Act, proposes the relaxation of significant portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), the Report's proposals are more limited in scope.

The Report's recommendations range from specific policy proposals to more general guidelines for improving the regulation of depository institutions. Key elements of the Report are summarized below.

Streamlining the U.S. Regulatory Structure

The Report recommends that Congress reduce fragmentation, overlap, and duplication in the U.S. regulatory structure. Although most of Treasury's recommendations on this topic lack specificity, the Report proposes to expand the mandate of the Financial Stability Oversight Council ("FSOC") to play a larger role in the coordination of regulatory and supervisory policies. The FSOC would have the authority to resolve overlap between agencies by appointing a lead regulator on an issue, and would facilitate information sharing between agencies. The Report further recommends that the Office of Financial Research ("OFR") become a functional part of Treasury, with the OFR's leadership and budget coming under Treasury control. Finally, in order to further reduce overlap and duplication, Treasury proposes increasing coordination of examination activities between agencies. This proposal includes a suggestion that agencies choose only one regulator to lead enforcement actions related to a single incident.

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Relaxation of Capital and Prudential Standards for Smaller Banks

The Report recommends that a variety of capital and prudential standards imposed by the Dodd-Frank Act be relaxed for smaller banks and credit institutions in order to tailor these standards to their risk profile.

- ***Thresholds for Enhanced Prudential Standards and Stress-Tests***. Currently, banks with assets greater than $50 billion are subject to most of the Dodd Frank Act's enhanced prudential standards. In addition, the Dodd-Frank Act currently subjects banks with assets over $10 billion and less than $50 billion to annual company-run stress test requirements and certain risk-management requirements. Banks with total assets of less than $10 billion are exempt from the stress-test requirements.

  The Report recommends raising both of these thresholds. Without setting a specific amount, the Report calls on Congress to amend the Dodd-Frank Act's enhanced prudential standards threshold to more appropriately tailor these standards to the risk profile of bank holding companies. In turn, the Report recommends that the threshold for participation in the stress tests imposed by the Dodd-Frank Act be raised to $50 billion in total assets from the current threshold of $10 billion. This threshold could be further raised, however, in order to tailor stress-testing to an institution's business model, balance sheet and organizational complexity. The burden imposed by the stress tests would be similarly relaxed, as the Report proposes that the mid-year stress test be eliminated.

- ***Liquidity Coverage Ratio***. The Report recommends that the scope of application of the Basel III liquidity coverage ratio ("LCR") rule be limited to global systemically important banks ("G-SIBs"), and a less stringent standard be applied to internationally active bank holding companies that are not G-SIBs. Any bank holding company that is not internationally active would be exempt from LCR rules. Treasury also recommends the single-counterparty credit limit only apply to banks that meet the threshold for enhanced prudential standards.

- ***"Off ramp" for Highly Capitalized Banks***. The Report also suggests offering highly capitalized banks a "regulatory off-ramp" from (a) all capital and liquidity requirements, (b) nearly all aspects of the Dodd-Frank Act's enhanced prudential standards and (c) the Volcker Rule. This option would be available to depository institution holding companies and insured depository institutions. It would require the institution to elect to maintain a sufficiently high level of capital, such as a 10% non-risk-weighted leverage ratio, consistent with the proposed "off-ramp" provisions contained in the Financial CHOICE Act.

- ***Revised CCAR and SLR Calculations***. The Report calls for the Comprehensive Capital Analysis and Review ("CCAR") calculation to be re-assessed, streamlined and standardized. Among other things, the Report suggests harmonizing the CCAR threshold with the enhanced prudential standards

threshold, and changing the process to a two-year cycle. Under Treasury's recommendations, the Federal Reserve could no longer use CCAR as the sole basis for objecting to an institution's capital plans. The CCAR process itself would be changed to a two-year cycle, with more frequent reviews permitted to allow revisions to capital plans in the case of extraordinary events.

In addition, the Report prescribes adjustments to the calculation of the Supplementary Leverage Ratio ("SLR"). Specifically, deductions from the leverage exposure denominator could be made for, among other things, (a) cash on deposit with central banks, (b) U.S. Treasury securities and (c) initial margin for centrally cleared derivatives.

- ***Tailoring Regulation for Community Banks***. The Report also recommends that banking regulators simplify the overall capital regime for community banks. The Treasury argues that the complex implementation of Basel III standards is not appropriately tailored to smaller institutions. As a result, the Report suggests that banking regulators should explore exempting community banks from the risk-based capital regime implementing the Basel III standards.

Reforming the Consumer Financial Protection Bureau ("CFPB")

The Report proposes a number of reforms of the CFPB intended to limit the scope of its authority and curb its independence. The Report embraces a number of industry criticisms of the agency, including that:

- the Dodd-Frank Act's prohibition on "unfair, deceptive or abusive acts or practices" ("UDAAP") is ill-defined;
- the agency relies excessively on enforcement action, rather than rules and guidance, to regulate conduct;
- the agency uses administrative enforcement proceedings to avoid protections offered in federal court;
- the agency civil investigative demand ("CID") process lacks appropriate safeguards; and
- the agency's "no-action" letter process is burdensome and ineffective.

The Report also finds that the CFPB's supervisory and examination authorities are "unnecessary" with respect to large banks, in light of the federal prudential regulator's role, and "unjustified" with respect to nonbanks, which have traditionally been subject to state licensing and supervision.

The Report's recommendations are broadly similar to, but somewhat more limited than, those proposed in the Financial CHOICE Act. Among other things, the Report proposes that the CFPB be:

- headed by a director removable at will by the President, or, alternatively, restructured as a multi-member commission (rather than the current single director, removable only for cause);
- stripped of its supervisory authority over banks and nonbanks;
- funded through the annual appropriations process;
- made subject to Office of Management and Budget ("OMB") apportionment, and be required to obtain OMB approval for a plan to use its budgetary resources (rather than being able to set its own budget); and
- permitted to retain and use only those funds necessary for payments to the bona fide victims of activities for which the CFPB has imposed civil money penalties.

The Report also recommends that the CFPB adopt regulations that more clearly delineate its interpretation of the UDAAP standard and seek monetary sanctions only when a regulated party has reasonable notice (by virtue of CFPB regulation, judicial precedent or precedent of the Federal Trade Commission) that its conduct was unlawful. Further, the Report recommends that the CFPB be required to bring enforcement actions in federal district court rather than in administrative proceedings. The Report also calls on the CFPB to make the underlying data in its Consumer Complaint Database confidential from the general public. In addition, the Report includes recommendations for revising various CFPB regulations, such as those addressing mortgage origination and servicing.

Limitation of the Volcker Rule

Section 619 of the Dodd-Frank Act, known as the "Volcker Rule," generally prohibits insured depository institutions from engaging in proprietary trading or investing in hedge funds or private equity funds. This prohibition also applies to banks' affiliates and holding companies, as well as certain foreign banking organizations with U.S. operations. Banking organizations have been required to comply with most provisions of the Volcker Rule since July 2015.

The Report finds that the Volcker Rule has "far overshot the mark" and recommends "significant changes," including "changes to the statute, regulations and supervision." The Report's proposed changes are targeted at providing regulatory relief for smaller banking organizations. As such, they are significantly less extensive than those proposed by the Financial CHOICE Act, which would repeal the Volcker Rule in its entirety. Among other things, the Report recommends that small banks not be subject to the Volcker Rule because of their small risk to the financial system in the event of their failure and because most small banks do not engage in proprietary trading or invest or sponsor hedge funds or private equity funds. Accordingly, the Report proposes that banking organizations with $10 billion or less in total consolidated assets be entirely exempt from all aspects of the Volcker Rule. The Report further

recommends an exemption from the proprietary trading prohibition for all consolidated banking organizations, regardless of size, that have less than $1 billion in trading assets and trading liabilities and whose trading assets and trading liabilities represent 10% or less of total assets.

The Report also proposes a number of provisions intended to simplify and, in some cases, relax regulations governing proprietary trading, market making, hedging and investments in certain types of funds.

Relaxation of Living Wills Requirement

Section 165(d) of the Dodd-Frank Act requires large bank holding companies ("BHCs") and nonbank financial companies designated by the FSOC to prepare living wills for their rapid and orderly resolution under the U.S. Bankruptcy Code or other applicable law. The Report recommends changing the threshold for compliance with living will requirements for BHCs from the current threshold of $50 billion to match the revised threshold for application of enhanced prudential standards – an amount left undetermined, but generally tailored to an institution's size and complexity. The Report also recommends that the process be changed from an annual cycle to a two-year cycle and, like the Financial CHOICE Act, recommends removing the Federal Deposit Insurance Corporation from the living wills process.

Foreign Banking Organizations

The Report suggest a number of revisions to the regulatory regime applicable to foreign banking institutions ("FBOs") intended to promote a level playing field between domestic banks and foreign banks operating in the United States. Among other things, the Report proposes the application of enhanced prudential standards for FBOs based upon their U.S. footprint rather than their global consolidated assets. As is the case for their domestic counterparts, the threshold amount for imposing enhanced prudential standards on FBOs would be determined by size and complexity of the institution, rather than by a generically applied nominal amount.

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Although any legislative changes to the Dodd-Frank Act would need at least limited bipartisan support, other changes could be effected by the regulatory process alone. Indeed, the Report contains a series of tables indicating which recommendations would require legislative action, regulatory action, or both. Importantly, however, changes effected through regulation would require the cooperation of the relevant financial regulatory agencies, which traditionally operate independently from the White House and Treasury. President Trump's appointees are gradually filling out the leadership ranks of these agencies, although the process is still underway. Moreover, depending on the circumstances, regulatory changes may require complex interagency processes and notice-and-comment rulemakings, thus suggesting the need to prioritize.

The Report notes that President Trump also issued two separate presidential memoranda calling for review of certain features of the Dodd-Frank Act — the Orderly Liquidation Authority and the FSOC's designation authority (see our client alert here). We will continue to provide updates on these reports and changes affected from this report as the situation develops.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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