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Treasury Department releases first report on proposed changes to financial services regulation

The U.S. Department of the Treasury (Treasury) has released its first in a series of reports setting out recommendations to "simplify and reduce regulatory costs and burdens" in the financial services industry. The report, titled "A Financial System That Creates Economic Opportunities - Banks and Credit Unions" (Treasury Report), responds to President Trump's Executive Order 13772, "Core Principles for Regulating the United States Financial System", which instructs the agency to identify regulatory requirements that inhibit Federal regulation of the U.S. financial system in a manner consistent with the Core Principles.[1] It is directed toward only depository institutions; three additional reports will be issued over the next few months focusing on capital markets, asset management, insurance, retail and institutional investment products and vehicles, nonbank financial institutions, financial technology, and financial innovation.

The release of the Treasury Report follows on the heels of the Financial CHOICE Act of 2017 (CHOICE Act or H.R. 10), which passed the House of Representatives on June 8, 2017 and, like the CHOICE Act, calls for a "pull-back" of regulatory requirements, many of which were enacted as part of Dodd-Frank.2 There are, however, two key differences between the proposals: 1) Quite a few of the recommendations and reforms outlined in the Treasury Report could be attained through policy actions, including regulatory rulemakings and guidance, which conceptually could be achieved more easily than Congressional agreement and action; and 2) Many of the Treasury Report's recommended reforms would make changes at the edges of existing requirements – essentially tweaking the current parameters- where the CHOICE Act seeks more wholesale changes that would undo much of what has been put in place since the financial crisis, including some requirements the industry might like to keep.

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[1] Executive Order 13772, Core Principles for Regulating the United States Financial System, February 3, 2017. The "Core Principles" are to "(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; (b) prevent taxpayer-funded bailouts; (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; (d) enable American companies to be competitive with foreign firms in domestic and foreign markets; (e) advance American interests in international financial regulatory negotiations and meetings; (f) make regulation efficient, effective, and appropriately tailored; and (g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework."

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), P.L. 111-203, July 21, 2010.

In its press release, Treasury states that, along with the Administration, it will begin working with Congress, independent regulators, the financial industry and trade groups to implement the recommendations advocated in its report through changes to statutes, regulations and supervisory guidance. Nevertheless, it may take many months before widespread regulatory relief is realized, if at all, as the speed with which any changes can be implemented will be influenced by a number of factors:

- For those recommendations requiring legislative action, 60 votes will be required in the Senate to proceed to debate in the full chamber – meaning that a minority can block consideration. The majority Republicans have 52 votes. Minority Democrats are viewed as unlikely to support any overhaul that eases rules on large banks, threatens the standing of the Consumer Financial Protection Bureau (CFPB), or creates conditions or incentives similar to those that existed prior to the 2008 financial crisis; and
- For recommendations requiring policy action, regulatory rulemaking and supervisory coordination will be dependent on the ability of the Trump Administration to nominate/appoint individuals to fill, and obtain necessary Congressional approvals for, the many vacant positions within the regulatory agencies' leadership, as well as to bring agency staffing to levels sufficient to move their agenda forward.

Treasury Report vs. CHOICE Act

The Treasury Report is similar to the CHOICE Act in several respects, including:

- Recommending a "regulatory off-ramp" from all capital and liquidity requirements, nearly all aspects of the Enhanced Prudential Standards (EPS), and the Volcker Rule for depository institution holding companies and insured depository institutions (IDIs) if they maintain a sufficiently high level of capital, such as a 10 percent non-risk weighted leverage ratio.
- Supporting a significant reduction in the CFPB's supervisory authority.
- Encouraging increased oversight of the CFPB through enhanced congressional authority.
- Recommending simplified regulations for community banks.
- Remaining silent on repealing the Dodd-Frank Section 1075, the Durbin Amendment (a limitation on fees charged to retailers for debit card processing).
- Imposing a requirement for financial regulators to conduct a cost-benefit analysis of proposed regulations.

The Treasury Report diverges from the CHOICE Act in some significant areas by:

- Recommending significant changes to the Volcker Rule, rather than a full repeal.
- Not addressing the Dodd-Frank Title II Orderly Liquidation Authority (OLA) or the Financial Stability Oversight Council's (FSOC) authority to designate nonbanks financial entities and financial market utilities (FMUs) as systemically important financial institutions (SIFIs). Each of these provisions has been the subject of a Presidential Executive Order and Treasury will address these areas in separate reports to the President at a later date.
- Retaining rather than repealing the Office of Financial Research (OFR) and folding it under the Treasury's authority.
- Not providing recommendations for the Department of Labor Fiduciary Rule, which will likely be covered in a subsequent report.

Treasury Report Recommendations

The Treasury Report contains dozen of specific proposals aimed at the regulatory framework of the banking sector. They focus on:

- Improving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap and duplication across regulatory agencies;
- Aligning the financial system to help support the U.S. economy;
- Reducing regulatory burden by decreasing unnecessary complexity of the rules;
- Tailoring the regulatory approach based on size and complexity of regulated firms and requiring greater regulatory cooperation and coordination among financial regulators; and

— Aligning regulations to support market liquidity, investment, and lending in the U.S. economy.

Highlights of the individual recommendations follow. Recommendations that would require Congressional action are presented in blue.

Regulatory Engagement or Regime

Treasury recommendations address "appropriate" tailoring of the Enhanced Prudential Standards, reductions in unnecessary "burdens" such as redundant actions by different regulators, and improvements in the functioning of capital markets. Specific recommendations would:

— Raise the $50 billion Dodd-Frank Section 165 (Enhanced Supervision and Prudential Standards) asset thresholds (no specific amount recommended) for capital, liquidity, and living wills.

— Create an "off-ramp" from "nearly all aspects" of the EPS requirements for entities meeting a revised asset threshold (no specific amount recommended) that maintain a sufficiently high level of capital (such as the 10 percent non-risk-weighted leverage ratio proposed in the CHOICE Act).

— Change the living will asset threshold to match the revised threshold for EPS; Change the -process to a two-year cycle; Remove the Federal Deposit Insurance Corporation from the living will process.

— Broaden the statutory mandate of the FSOC, allowing it to assign a lead regulator as primary regulator on issues where agencies have conflicting or overlapping jurisdiction.

— Review the collective requirements imposed on boards of directors to reassess and better tailor aggregate expectations and restore balance between regulators, boards, and management. Enhance accountability of board and management; Better definition of roles and responsibilities.

— Repeal provisions of Dodd-Frank Section 1071 (Small Business Data Collection).

— Modernize the Community Reinvestment Act (CRA), harmonize regulatory oversight, and provide greater clarity in remediating deficiencies.

— Establish processes for coordinating cybersecurity-related regulatory tools and examinations across state and federal levels; Harmonize regulations and guidance.

— Require agencies to conduct rigorous cost-benefit analyses for all "economically significant" proposed regulations (actions expected to have an annual economic impact of $100 million or more).

Capital and Liquidity

Treasury recommendations would provide an "off-ramp exemption for DFAST, CCAR, and certain other prudential standards" for institutions that maintain a sufficiently high level of capital (such as a 10 percent non-risk-weighted leverage ratio). In addition, Treasury seeks to reduce unnecessary "burdens," improve transparency by revising the capital supervisory process and guidance, and simplify the capital regime for community banks. Specific recommendations would:

— Raise the company-run DFAST (Dodd-Frank Act Street Test) participation threshold from $10 billion to $50 billion or more based on risk and complexity; Reduce the number of DFAST stress scenarios from three to two, and the frequency of the exercise (i.e., eliminate the mid-year cycle).

— Raise the CCAR (Comprehensive Capital Asset Review) asset threshold to match the revised EPS asset threshold; Change the process to a two-year cycle; Remove the qualitative element as the sole basis for objection to a capital plan.

— Re-evaluate: i) implementation of the international G-SIB (global systemically important bank) risk-based surcharge; ii) mandatory minimum debt ratio in Total Loss-Absorbing Capacity (TLAC) and minimum long-term debt rule; and iii) calibration of the Enhanced Supplementary Leverage Ratio (eSLR) and Supplementary Leverage Ratio (SLR).

— Establish a global risk-based capital floor to promote a more level playing field for U.S. firms.

— Apply the U.S. Liquidity Coverage Ratio (LCR) to G-SIBs only; Delay adoption of the Net Stable Funding Ratio; Delay adoption of the

Fundamental Review of the Trading Book standard.

Foreign Banking Organizations

In a move back to the long historic doctrine of factoring in the "strength of the foreign parent company" into the analysis, Treasury recommends applying EPS to Foreign Banking Organizations (FBOs) based on their U.S. rather than their global footprint and recalibrating but not eliminating the Intermediate Holding Company (IHC) requirements. Specific recommendations are intended to encourage international investment in the U.S. financial markets and would:

- Apply the EPS and living will requirements to FBOs based on their U.S. risk profile (rather than global assets), using the same asset threshold used for the application of EPS.
- Apply the revised EPS threshold to CCAR compliance for IHCs.
- Recalibrate: i) IHC regulatory standards, such as resolution planning and liquidity, to place greater emphasis on the degree to which home country regulations are comparable to the regulations applied to similar U.S. bank holding companies (BHCs); and ii) the internal TLAC requirement to include consideration of the foreign parent's ability to provide capital and liquidity resources to their U.S. IHC, provided arrangements are made with home country supervisors for deploying unallocated TLAC from the parent.

Volcker Rule

Recommendations directed toward the Volcker Rule are intended to reduce the scope and complexity of the rules and make improvement that would allow banks to more easily hedge the risks of their activities and conduct market-making activities. Specific recommendations would:

- Exempt banking entities with $10 billion or less in assets from the Volcker Rule.
- Exempt banking entities with more than $10 billion in assets that are not subject to the market risk capital rules from the Volcker Rule's proprietary trading prohibitions.
- Provide an "off-ramp" for well-capitalized banking entities that have adequately mitigated their proprietary trading risks with sufficient capital to opt out of the Volcker Rule while remaining subject to trader mandates and ongoing supervision and examination.
- Simplify the definition of proprietary trading; Suggest assessing whether to eliminate the purpose test from the proprietary trading definition.
- Ease compliance burdens; Eliminate the requirement for banks to maintain ongoing calibration of a hedge over time as well as the requirement to maintain documentation of the specific assets and risks being hedged.
- Apply the existing "enhanced" compliance program only to those banking entities with at least $10 billion in trading assets and liabilities on a consolidated basis.
- Focus and simplify covered funds restrictions; Restore Section 23A exemptions; Extend the "seeding period" exemption; and Exempt foreign funds owned or controlled by a foreign affiliate of a U.S.

Consumer Financial Protection Bureau

Treasury recommends structural and procedural changes to the CFPB:

- Make the CFPB Director removable at-will by the President. Alternatively, restructure the CFPB as an independent multi-member commission or board.
- Fund the CFPB through annual congressional appropriations process and subject the CFPB to Office of Management and Budget (OMB) apportionment.
- Repeal the CFPB's supervisory authority, leaving the supervision of banks to the prudential regulators and returning the supervision of nonbanks to state regulators.
- Reform the CFPB's Consumer Complaint Database to make the underlying data available only to federal and state agencies, and not to the general public.
- Adopt regulations that more clearly delineate the CFPB's interpretation of the Unfair, Deceptive, or Abusive Acts and Practices (UDAAP) standard and seek monetary sanctions only in cases in which a regulated party has had reasonable notice— by virtue of

a CFPB regulation, judicial precedent, or FTC precedent— that its conduct was unlawful.

Additional recommendations focus on changes to residential mortgage lending legislation and regulation. These changes include: i) increasing the total asset threshold for small creditor Qualified Mortgages; ii) improving the flexibility and accountability of the Loan Originator Compensation Rule; iii) placing a moratorium on additional mortgage servicing rulemakings; iv) repealing or revising the residential mortgage risk retention requirement; v) delaying 2018 Home Mortgage Disclosure Act (HMDA) reporting; and vi) considering shifting HMDA responsibility back to the federal prudential regulators.

Community Financial Institutions

Community banks are defined to include BHCs and banks with less than $10 billion in assets. With regard to community financial institutions (community banks and credit unions combined), Treasury recommendations focus on "right-sizing" capital requirements, enabling capital formation, encouraging new charters, and reducing regulatory burdens. In particular, some recommendations would:

- Explore exempting community banks from the risk-based capital regime implementing the Basel III standards and determine if an amendment to the Dodd-Frank Section 171 (Collins Amendment) would be required. Review and recalibrate the capital and stress-testing requirements applicable to credit unions.
- Raise the asset threshold of the Federal Reserve's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement to $2 billion from the current $1 billion.
- Streamline current regulatory reporting requirements for all community financial institutions.
- Provide special supervisory consideration to agriculture and rural banks' compliance challenges.

Conclusions

Treasury Secretary Mnuchin has stated that he supports the CHOICE Act but with the Treasury Report it appears he is looking for things that the Administration can do to reduce overlapping regulatory requirements and burden through regulatory changes that do not require passing legislation through Congress. He has estimated that eighty percent of the recommendations in this first report can be accomplished in this way. Notably, definitive terms for a number of recommendations, including the proposed revision to the EPS asset threshold, are not identified and will need to be set by Congress.

The focus on interagency coordination for policy, supervision, and enforcement is prevalent throughout the recommendations and the report suggests a desire to effect potentially larger and longer-term changes to the financial services regulatory framework, including the possibility of combining overlapping regulators.

This one report puts forth a mixture of broad concepts and specific proposals for the regulation of depository institutions though it is only one of several reports due from Treasury recommending changes to the regulation of the financial services industry as a whole. It seems highly likely that the forthcoming three additional reports responding to Executive Order 13772 as well as reports addressing the authority of the FSOC to designate nonbank and FMU SIFIs, the Dodd-Frank OLA, and the future state of the government-sponsored enterprises (GSEs – Fannie Mae and Freddie Mac) will be prepared similarly, containing scores of additional recommendations. The industry anticipates that none of these additional reports will be released before the beginning of September. Adding to that, any regulatory changes implemented through the notice and comment process may take more than a year, leaving firms to continue compliance with existing requirements for some time to come.

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