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ALERT MEMORANDUM

Senate Passes Regulatory Relief Bill

Prospects for Ultimate Enactment Now Depend on the House

March 15, 2018

Yesterday afternoon, the Senate passed a significant regulatory relief bill, the "Economic Growth, Regulatory Relief, and Consumer Protection Act," in a bipartisan 67-to-31 vote. The Bill, if ultimately enacted, would result in the first major revisions to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. It would leave the architecture and major features of Dodd-Frank intact, but would significantly recalibrate Dodd-Frank requirements in several areas important to banking organizations.

The prospects for the Senate Bill becoming law remain unclear. The House of Representatives passed a number of bills over the last year that would make more far-reaching changes to Dodd-Frank, including the Financial CHOICE Act, largely along party lines. Republican leaders in the House could now seek to add some of those changes to the Bill. However, preserving bipartisan support remains critical to passage in the Senate, and extensive House amendments could delay or even diminish the Bill's prospects. If Congress does pass the Bill, or something like it, President Trump is expected to sign it.

Most of the Bill's reforms seek to reduce burdens on mid-size and smaller banks and bank holding companies. Most significantly, the Bill would raise the asset threshold for application of Dodd-Frank's enhanced prudential standards from $50 billion to $250 billion. Banks and bank holding companies with assets of $10 billion or less would be exempted from the Volcker Rule, some aspects of the Federal Reserve's capital rules, and certain mortgage lending requirements. Large foreign banking organizations would generally remain subject to Dodd-Frank's enhanced prudential standards, and the revised asset thresholds would apply based on their global assets.

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As with Dodd-Frank, the ultimate impact and scope of the Bill's effects will depend significantly on how it is implemented by the Federal Reserve and other bank regulators.

The remainder of this Memorandum summarizes the Bill's major provisions and identifies a number of key take-aways and considerations.

Enhanced Prudential Standards

The Bill would make significant changes to the enhanced prudential standards ("EPS") provisions of Dodd-Frank. EPS include heightened capital, liquidity and risk management standards, as well as resolution planning requirements, mandatory stress testing and single counterparty credit limits, for large bank holding companies ("BHCs") and foreign banking organizations ("FBOs").

The Bill would also enhance the Federal Reserve's discretion to tailor EPS standards to BHCs and FBOs based on their risk profile.

1. Increased Asset Thresholds

— *$250 Billion EPS Threshold*

- Among the Bill's most significant reforms is a substantial increase in the threshold for subjecting a BHC to EPS. The Bill would raise the threshold from $50 billion in total consolidated assets to $250 billion, with staggered effective dates.
  - BHCs with less than $100 billion in assets would be immediately exempt from EPS.
  - BHCs with between $100 billion and $250 billion in assets would be exempt 18 months following enactment.
    - The Federal Reserve would be authorized to accelerate the off-ramp for BHCs with total assets between $100 billion and $250 billion during the 18-month transition period.
  - The Federal Reserve would retain discretion to apply any or all EPS to BHCs below $250 billion in total consolidated assets.
    - The Federal Reserve would need to determine that application of the EPS is appropriate to prevent or mitigate risks to U.S. financial stability or to promote the safety and soundness of the BHC (or group of BHCs), after taking into consideration capital structure, riskiness, complexity, financial activities, size and any other risk-related factors that the Federal Reserve deems appropriate.

— *G-SIBs*

- A BHC that qualifies as a Global Systemically Important Bank, or G-SIB, under the Federal Reserve's systemic indicator score would remain subject to the most stringent EPS, regardless of its asset size.
  - The Federal Reserve's systemic indicator score aligns with the Basel capital framework's methodology for identifying G-SIBs and takes into account size, interconnectedness, substitutability, complexity and cross-jurisdictional activity.

- There are currently 8 U.S. G-SIBs: JPMorgan Chase, Citigroup, Bank of America, Goldman Sachs, Wells Fargo, Morgan Stanley, State Street, and Bank of New York Mellon.

— *OCC and FDIC Regulatory EPS for Subsidiary Banks*

- Many of the changes in the Bill amend provisions of Dodd-Frank that apply at the BHC or FBO level, and not to subsidiary national banks or other insured depository institutions ("IDIs"). The Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") have adopted their own counterparts to some EPS for the bank subsidiaries that they regulate, including recovery and resolution planning. A key consideration will be whether the OCC and the FDIC take similar measures under their regulations and guidance to align asset thresholds with what is reflected in the Bill.
  - For example, the FDIC may have a different focus in evaluating thresholds for resolution planning as applied to mid-size IDIs. Regulatory changes at the bank subsidiary level will remain an area to watch. The FDIC is responsible for bank resolutions irrespective of the asset threshold or systemic importance of the bank, and the FDIC historically has been concerned about complications in resolving banks smaller than $100 billion. As a result, while a new Board and Chairman may consider simplifying the resolution planning requirements for some banks below the proposed BHC thresholds, it is unlikely that the FDIC will eliminate resolution planning requirements for those banks entirely.
  - At both the OCC and FDIC, regulatory changes at the bank subsidiary level will remain an area to watch.

2. Recalibration of Stress Testing Requirements

— *Supervisory Stress Tests*

- BHCs with more than $250 billion in total consolidated assets would continue to be subject to annual supervisory stress tests, although the Bill would reduce the number of stress test scenarios from three to two by eliminating the "adverse" scenario (leaving only the "baseline" and "severely adverse" scenarios).
- Eighteen months after enactment, BHCs with total consolidated assets between $100 billion and $250 billion would be subject to periodic supervisory stress tests to evaluate whether they have capital sufficient to absorb losses under adverse economic conditions. The frequency of these periodic tests remains to be determined.
- BHCs with less than $100 billion in total consolidated assets would no longer be subject to capital stress testing.

— *Company-Run Stress Tests*

- The Bill would exempt all banking organizations—including not only BHCs, but also depository institutions and savings and loan holding companies ("SLHCs")—with less than $250 billion in total consolidated assets from the current requirement to conduct company-run stress tests.

- Banking organizations with $250 billion or more in total consolidated assets would still be required to conduct company-run stress tests on a periodic basis but would no longer be required to do so on a semi-annual or annual basis.
- Consistent with the proposed changes to the supervisory stress tests, the Bill would also reduce the number of scenarios for the company-run stress tests from three to two.

3. Foreign Banking Organizations

— *Asset Thresholds*: The Bill generally applies the asset-based thresholds to domestic BHCs and FBOs similarly.

- FBOs are treated as BHCs for purposes of the EPS requirements, and the increase in asset thresholds for domestic BHCs would apply to FBOs. However, the Federal Reserve has interpreted the Dodd-Frank asset threshold to apply to FBOs based on their global assets, rather than U.S. assets, and the Bill appears not to change that approach.

— *Intermediate Holding Companies of FBOs*: In response to criticism from Senator Brown and other opponents of the Bill who claimed that it would provide preferential treatment for large FBOs, Senator Crapo and his Democratic co-sponsors inserted a rule of construction for foreign banks.

- Under the rule, nothing in the Bill may be construed to: (1) affect the legal effect of the Federal Reserve's intermediate holding company ("IHC") rules as applied to FBOs with $100 billion or more of total consolidated assets, or (2) limit the Federal Reserve's authority to require the establishment of an IHC, impose EPS, or tailor regulation of an FBO with $100 billion or more of total consolidated assets.
- The existing IHC asset threshold is $50 billion in U.S. non-branch assets. As written, the Bill would not change that threshold. Any revisions to the threshold would need to be made by the Federal Reserve amending its regulations (since the threshold, like the IHC requirement itself, was created by the Federal Reserve and was not a feature of Dodd-Frank).

4. Credit Exposure Reports

— The Bill would amend Dodd-Frank to authorize, instead of require, the Federal Reserve to promulgate rules regarding BHCs' reporting of credit exposure to the Federal Reserve, the Financial Stability Oversight Council ("FSOC") and the FDIC. The Federal Reserve had proposed credit exposure reporting requirements in connection with its resolution planning rulemaking, but it never finalized those requirements pending completion of its single-counterparty credit limit rules.

5. Assessments

— The Bill would eliminate assessments on BHCs with less than $250 billion in total assets to fund the Financial Research Fund, which is used to fund expenses of the Office of Financial Research.

Regulatory Capital and Liquidity Requirements

1. Supplementary Leverage Ratio

— The Bill would require the federal banking agencies to amend the Supplementary Leverage Ratio ("SLR") to exempt from the SLR denominator funds on deposit with certain central banks for BHCs and their subsidiaries that are "predominantly engaged in custody, safekeeping and asset servicing" activities, provided that the funds are less than or equal to deposits linked to fiduciary, custodial or safekeeping accounts.

- The large custody banks have argued that cash they hold on deposit at the Federal Reserve in connection with their trust and fiduciary businesses should not result in SLR capital requirements. Other large banking organizations have argued to exclude cash from the SLR calculation more broadly, but the Bill takes a narrower approach.

- This provision would cause the U.S. SLR to diverge from the Basel leverage framework in its treatment of central bank deposits. While the so-called "Basel IV" revisions of December 2017 allow for national discretion to exempt central bank reserves from the leverage ratio exposure measure, the exemptions are permitted only temporarily and in exceptional macroeconomic circumstances, and they must be accompanied by a corresponding increase in the calibration of the minimum leverage ratio to offset the impact of exempting central bank reserves. However, the federal banking agencies have previously diverged from the Basel leverage ratio in the direction of greater conservatism by imposing an "enhanced" SLR buffer requirement on U.S. G-SIBs and their subsidiary IDIs.

2. Liquidity Coverage Ratio

— The Bill would require the banking agencies to amend their liquidity coverage ratio ("LCR") rules to permit more favorable treatment of municipal bonds—as Level 2B high quality liquid assets (50% haircut)—so long as the bonds are liquid, readily-marketable and investment grade.

- The Federal Reserve amended its LCR rule in 2016 to permit certain municipal securities to be treated as level 2B assets, subject to a number of limitations in addition to the requirements in the Bill. However, the OCC and the FDIC have not adopted or proposed similar amendments.

3. Risk Weight for Certain High-Risk Real Estate Loans

— The Bill would prohibit federal banking agencies from assigning heightened risk weights to high volatility commercial real estate ("HVCRE") exposures unless the exposures are classified as HVCRE acquisition, development, and construction loans.

— Currently, a 150% risk weight applies to loans classified as HVCRE under the U.S. capital rules. The federal banking agencies issued a proposal in September 2017 to simplify the treatment of HVCRE and to create a new category of commercial real estate loans—"high-volatility acquisition, development or construction" ("HVADC") exposures—with a lower risk weight of 130%.

- The most significant difference between the Bill and the agencies' HVADC proposal arises from the Bill's preservation of the exemption for projects where the borrower has contributed at least

15% of the real property's appraised "as completed" value. The agencies' HVADC proposal would eliminate this exemption in the interest of simplification.

Volcker Rule

— Banks and BHCs with $10 billion or less in total consolidated assets and with total trading assets and liabilities of 5% or less of total consolidated assets would be exempt from the Volcker Rule.

— Any banking entity would be able to share its name with a hedge fund or private equity fund for which it serves as an investment adviser, provided that (1) the investment adviser is not, and does not share a name with, an IDI, a company that controls an IDI, or an FBO, and (2) the name does not contain the word "bank."

— Although not related to the Volcker Rule amendments in the Bill, a provision designed to provide relief for certain small venture capital funds would have Volcker Rule implications. The Bill would expand the exemption from the definition of "investment company" under Section 3(c)(1) of the Investment Company Act of 1940 (the "1940 Act") for venture capital funds that have fewer than 250 investors and $10 million or less in capital commitments. This would have the possibly unintended consequence of sweeping these funds into the scope of the Volcker Rule, since the agencies' definition of "covered funds" uses the Section 3(c)(1) exemption as a baseline definition.

Acquisitions of Interests in Nonbanks

— As amended by the Bill, Dodd-Frank would require FHCs with assets of $250 billion or more (up from $50 billion or more) to obtain prior Federal Reserve approval if the non-bank target engaged in Gramm-Leach-Bliley Act "financial in nature" activities has assets of more than $10 billion.

Community Banks

1. Capital Rules

— Banks and BHCs that have less than $10 billion in total consolidated assets and that maintain a "community bank leverage ratio" (defined as tangible equity capital to average total consolidated assets) of at least 8-10% would be exempt from U.S. risk-based capital rules imposed under Basel III and the generally applicable leverage ratio and would be deemed well-capitalized.

- The federal banking agencies would maintain discretion to disqualify banks and BHCs from this relief if they determine the relief is not appropriate to the bank's or BHC's risk profile.

— The threshold for qualifying for the Federal Reserve's "Small Bank Holding Company Policy Statement" would be increased from $1 billion to $3 billion, provided the small BHC or SLHC is not engaged in significant non-banking activities, is not engaged in significant off-balance sheet activities and does not have a material amount of debt or equity registered with the Securities and Exchange Commission (the "SEC").

2. Risk Committee

— The Bill would raise the total asset threshold from $10 billion to $50 billion for the Dodd-Frank risk committee requirement for publicly traded BHCs, although the Federal Reserve retains discretion to require a risk committee at smaller institutions.

3. Savings Association Election to Operate as a National Bank

— Federal savings associations with total consolidated assets of $20 billion or less would have the option to operate as national banks and to have the same privileges and duties as national banks without converting their charters.

Real Estate and Mortgage Lending

1. Mortgage Lending Requirements for Small Banks

— Certain mortgage loans that are (1) originated by an IDI or an insured credit union with less than $10 billion in total consolidated assets, (2) held in portfolio, and (3) satisfy certain other criteria would be deemed to satisfy the Truth in Lending Act's "ability to repay" requirements and therefore be treated as "qualified mortgages."

— The Bill would direct federal banking agencies to issue regulations exempting certain IDIs and insured credit unions with assets of $10 billion or less from the requirement to establish escrow accounts in connection with certain residential mortgage loans.

— Certain mortgage loans of $400,000 or less made with respect to property in rural areas would be exempt from appraisal requirements under the Financial Institutions Reform, Recovery, and Enforcement Act, provided that the originator makes a good faith effort to find a state-certified or state-licensed appraiser and is unable to do so.

2. Home Mortgage Disclosure Act Reporting

— IDIs and insured credit unions that originated fewer than 500 closed-end mortgage loans or 500 open-end lines of credit in each of the two preceding years would be exempt from a subset of disclosure requirements (recently imposed by the Consumer Financial Protection Bureau) under the Home Mortgage Disclosure Act ("HMDA"), provided they have received certain minimum Community Reinvestment Act ratings in their most recent examinations.

— The Bill would also direct the Comptroller General to conduct a study assessing the effect of the exemption described above on the amount of HMDA data available at the national and local level.

Brokered Deposits

— The Bill would provide a limited exemption from treatment as "brokered deposits" for certain "reciprocal deposits" placed by an IDI through a deposit placement network. Reciprocal deposits of an agent institution are not considered to be brokered deposits up to the lesser of $5 billion or 20% of the IDI's total liabilities, provided that the IDI (1) has an "outstanding or good" composite condition examination rating and is well capitalized, (2) has obtained a waiver, or (3) if it has a rating less then outstanding or good, or is less than well-capitalized, the reciprocal deposits received do not exceed certain average amounts held prior to receiving a rating or capital downgrade.

Securities Laws

1. Investment Company Act Exemptions

— Venture capital funds with less than $10 million in capital commitments and fewer than 250 investors would be permitted to rely on the exemption from the definition of "investment company" in Section 3(c)(1) of the 1940 Act.

— The Bill would eliminate the Section 6(a)(1) exemption from registration under the 1940 Act for companies organized under the laws of Puerto Rico and the U.S. territories.

2. State Blue Sky Laws

— The Bill would expand the federal exemption from state Blue Sky Laws to cover securities qualified for trading in the national market system, rather than those listed on a limited number of specified exchanges.

3. Algorithmic Trading

— The Bill would direct the SEC to conduct a study on the costs and benefits of algorithmic trading and to make a recommendation about whether the SEC should change any of its regulations based on its analysis and, if so, whether it needs additional legal authorities or resources.

4. Closed-End Funds

— The Bill would direct the SEC to issue rules permitting publicly listed closed-end funds to use the securities offering and proxy access rules available to other issuers and to consider the disclosures necessary to treat such funds as well-known seasoned issuers.

Consumer Financial Protection

1. Identity Theft, Fraud, and Exploitation

— The Bill would institute a number of consumer protection reforms, including measures targeting identity fraud, permitting consumers to place freezes on their credit reports without charge, and providing protection for whistleblowers who report the exploitation of senior citizens by financial institutions.

2. Student Loans

— Private student loan borrowers and co-signors would be protected by a number of measures that generally prohibit counting the bankruptcy or default of a borrower or co-signor as an event of default. Government-funded loans would not be affected.

— The Bill would ease requirements for private student loan borrowers to remove defaults from consumer credit reports if they participate in loan rehabilitation programs offered by lenders.

Cybersecurity

The Bill would direct the Secretary of the Treasury to issue a report assessing the threat of cyber-attacks on U.S. financial institutions, evaluating current efforts to address such risks, and recommending additional legal authorities or resources for financial regulatory agencies.

What the Bill Does Not Cover

— It does not alter the Consumer Financial Protection Bureau's authorities, governance structure, or appropriations.

— It does not change the composition or role of FSOC.

— It leaves intact core elements of Dodd-Frank adopted in response to the financial crisis, such as the resolution planning process, the orderly liquidation authority, FSOC's authority to designate nonbanks as systemically important financial institutions, and the power to force troubled BHCs to divest certain assets if they pose a grave threat to financial stability.

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