ALERT MEMORANDUM

A Modest Proposal? Treasury's Report to the President on Core Principles for Regulating the U.S. Financial System

June 13, 2017

The Trump Administration's latest substantive recommendations on modifications to the U.S. financial regulatory regime strike a modest and practical tone, rather than "doing a big number" on the current state of regulation. On June 12, 2017, the Treasury Department released the first of several reports in response to President Trump's Executive Order 13772, which called on the Treasury Department to report on laws, regulations and other government policies that are inconsistent with enumerated core principles for regulating the U.S. financial system. The Treasury Department's Report covers depository institutions—generally "banking". Subsequent reports will cover capital markets, asset management and insurance industries and products and non-bank financial institutions (including fintech).

The Report recommends a significant number of changes, reevaluations and studies of the financial regulatory regime introduced primarily by the Dodd-Frank Act in 2010—some conceptual, some very specific. Even so, the Report takes a less aggressive approach than the recently proposed Financial CHOICE Act of 2017. Rather than advocating wholesale repeal of many Dodd-Frank Act post-crisis requirements (including the Volcker Rule), the Report focuses on recalibration and tailoring based on size, risk and cost/benefit analysis. This more modest and tailored approach may generate more support for the Report's recommendations on both sides of the aisle. As expected, the Report also includes recommendations that could be implemented by Administration appointees through interpretations or rules, without the need for legislation. Thus, although in parts highly conceptual, the Report may be a significant step towards implementable financial regulatory reform. The speed with which the Report's recommendations are translated into regulatory action will depend on the agencies involved, the nomination process and the extent of bipartisan agreement, among other things.

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In this Memorandum, we identify some major themes of the Report as well as its key recommendations.

<u>Fundamental Themes Supplementing the Core Principles</u>

— Post-crisis regulation has proven to be insufficiently tailored.

— Dodd-Frank Act requirements are overseen by multiple agencies with overlapping mandates and insufficient coordination.

— This complicated oversight structure has raised the cost of compliance, particularly for mid-sized and community financial institutions.

— Key aims of reforms are to boost economic growth through: (1) liquid and robust financial markets, and (2) increased availability of credit.

<u>Recalibrating the Volcker Rule</u>

— The Report heavily criticizes the Volcker Rule for its complexity and its effect on market liquidity and it calls for "substantial amendment" but not full repeal.

— It endorses the Volcker Rule's underlying principle—that banks with access to the federal safety net should not engage in speculative trading for their own account.

— To relieve the Volcker Rule's <u>compliance burden</u>, it recommends:

- Completely exempting banking organizations with less than $10 billion in total assets, and exempting banking organizations of any size from the Volcker Rule's proprietary trading (but not covered fund) restrictions if the consolidated organization has less than $1 billion in trading assets and trading liabilities and such assets and liabilities represent 10% or less of total assets.
- The five agencies should improve their coordination on interpretation and enforcement.

— With respect to the Volcker Rule's <u>proprietary trading</u> restrictions, it recommends:

- Narrowing and simplifying the definition of proprietary trading, including by eliminating the 60-day rebuttable presumption and the purpose test, thus leaving only the market risk capital test and the dealer status test.
- Providing more flexibility for market-making by focusing less on the need to justify inventories through the "reasonably expected near term demand" (RENTD) of clients, customers and counterparties, particularly for illiquid securities, block trades and OTC derivatives, and potentially permitting banking entities to opt out of RENTD measures in favor of other metrics or controls.
- Reducing the compliance burden of the hedging exemption by focusing on policies and procedures, reducing burdensome documentation requirements and reducing emphasis on the ongoing calibration and recalibration of hedges.
- Narrowing the scope of entities subject to the Rule's enhanced compliance program and metrics requirements to only those organizations with at least $10 billion in consolidated trading assets and liabilities and providing more flexibility for tailoring of compliance programs.
- Reevaluating the utility of currently mandated metrics reporting and eliminating those metrics that are not necessary for effective supervision.

— With respect to the covered fund restrictions, it recommends:

- Simplifying the definition of covered funds to focus on the characteristics of hedge funds and private equity funds, with appropriate exemptions, rather than the current overbroad Investment Company Act-based analysis.
- Incorporating the exemptions in Section 23A of the Federal Reserve Act into the "Super 23A" prohibition on covered transactions with a banking entity's sponsored or advised covered funds.
- Increasing seeding periods for covered funds from the current one year (with the possibility for extensions) to a three-year default seed period.
- Eliminating the name-sharing prohibition in cases where the banking organization affiliate sharing the name with its sponsored fund is not a depository institution or its holding company.
- Exempting foreign funds that are owned or controlled by a foreign affiliate of a U.S. bank or by a foreign bank with U.S. operations from the definition of banking entity.

Modifying Capital and Liquidity Requirements

— "[T]he continual ratcheting up of capital requirements is not a costless means of making the banking system safer."

— Risk-based capital adequacy should be subject to greater use of standardized approaches, provided greater risk sensitivity is introduced.

— Appropriately tailored stress testing is an important goal, given that the Comprehensive Capital Analysis and Review (CCAR) stress test is now the binding capital constraint for most large banks:

- The Dodd-Frank Act Stress Test (DFAST) requirements, currently applicable to institutions with $10 billion in total assets, should apply only to institutions over $50 billion in total assets, and exemptions should be offered even for certain institutions over that threshold.
- The DFAST should be annual, with a reduced set of stress scenarios, thus eliminating the mid-cycle test. CCAR should be every two years.
- The $50 billion threshold for enhanced prudential standards should be increased, thus also raising the threshold for mandatory participation in the CCAR, as well as the thresholds for application of the liquidity coverage ratio (LCR), the single counterparty credit limit and living wills.
- Similar to the Financial CHOICE Act, maintenance of a high level of capital (such as a 10% leverage ratio) should exempt institutions from DFAST, CCAR and other enhanced prudential standards, including the Volcker Rule.

— Transparency of stress testing standards and procedures should be paramount:

- The Federal Reserve should subject stress testing and capital planning review frameworks to public notice and comment.
- The CCAR qualitative assessment should be eliminated as a sole reason for rejection of a capital plan, due to its subjectivity and lack of transparency.
- Countercyclical capital requirements should not be a separate buffer under the risk-based capital rules, but should be effected through the stress scenarios of the CCAR and DFAST.

- The Report also appears to endorse the stress capital buffer (SCB) originally proposed by Governor Tarullo in 2016 by advocating for "integrating the risk-based capital and CCAR stress testing regimes" and inexplicably asserting this would increase certainty. The SCB, as proposed by Governor Tarullo, would replace the current 2.5% capital conservation buffer with an institution-specific SCB based the firm's projected losses in supervisory stress testing.

— Community banks should benefit from a reduction in capital burden:

- Banks with less than $10 billion in total assets should be exempted from various capital provisions, given that the Basel III regime was not generally tailored for smaller banks; the "Small Bank Holding Company Policy Statement" threshold should be raised from $1 billion to $2 billion.
- Changes should be proposed to reduce the capital burden associated with asset classes of particular importance to community banks, such as mortgage servicing assets and high volatility (and other) commercial real estate loans.

— Even for global systemically important banks (G-SIBs), recalibration of a number of provisions could reduce complexity and unnecessary burden, including re-evaluating the "gold-plated" capital regulations (those made more stringent than agreed in international fora) such as the G-SIB surcharge calculations, the mandatory minimum debt ratios under total loss-absorbing capacity (TLAC) rules and the enhanced supplementary leverage ratio (SLR).

— Leverage exposure under the SLR should be reduced for cash on deposit with central banks, U.S. Treasuries and initial margin for cleared derivatives.

— The LCR should be limited to a much smaller set of institutions, while also reversing some of the baked-in conservatism in relation to cash flow and net outflow calculations as well as the general exclusion of high-grade municipal bonds from qualifying as high quality liquid assets.

— The Report supports international efforts to complete the Basel III (or "Basel IV") capital rules, including a risk-based capital floor focused on leveling the playing field for U.S. banks already subject to the Collins Amendment floor. Yet, rigorous thought should be given to increasing transparency and accountability of international standard-setting bodies so that external stakeholder views can be considered on a timely basis.

— Delay of both the Net Stable Funding Ratio and the Fundamental Review of the Trading Book is urged, in order to conduct further review of their impact, as they may be duplicative of other rules. Review or modification of the impact of the Current Expected Credit Loss (CECL) standard on bank capital is also suggested.

Reducing Burden of Living Wills

— Consistent with many of the Report's other recommendations, the threshold for application of the living will requirement should be raised and living will submissions moved to a two-year cycle.

— Living will assessment frameworks and guidance should be published for public comment; the Federal Reserve should be given sole responsibility for rulemaking and plan evaluation and the FDIC should be removed from the living will process; and the Federal Reserve should face a six-month deadline to provide feedback on living will submissions.

Encouraging Foreign Banking Organizations (FBOs)

— The Report affirms the importance of FBOs to the U.S. financial system and takes note of their important roles in commercial and infrastructure lending and capital markets activities. Several of its recommendations are expressly intended to encourage foreign investment into the U.S. banking system.

— As with domestic banks, thresholds for application of enhanced prudential standards to FBOs should be raised and tailored to their activities. In particular, relevant asset thresholds triggering regulatory requirements should be based on an FBO's U.S. footprint, rather than the current test of global consolidated assets.

— The Report endorses the Federal Reserve's intermediate holding company (IHC) requirement as a platform for consolidated supervision of an FBO's U.S. operations, but it recommends that enhanced prudential standards be recalibrated to apply to IHCs in a more tailored way, in line with its recommendations for domestic banks and with an increased emphasis on substituted compliance when FBOs are in compliance with comparable home country regulations.

— Internal TLAC requirements imposed on IHCs should be recalibrated to give greater weight to the parent's ability to deploy capital and liquidity to the U.S. IHC.

Reducing the Burden on Community Financial Institutions

— Modifications should be made to streamline further the process of forming *de novo* banks, including the application process for FDIC insurance and capital requirements for *de novo* approval.

— Regulatory reporting requirements should be further streamlined.

— Congress should raise the threshold for eligibility for the 18-month examination cycle from its current $1 billion.

— Regulators should apply special consideration and tailoring to agricultural and rural banks.

— Reform and restructure the Consumer Financial Protection Bureau (CFPB), including by making the CFPB's Director removable at-will by the President, or giving the CFPB a multi-member commission; subjecting the agency to annual appropriations; limiting the ability of the CFPB to take enforcement actions without first promulgating rules and guidance; reducing the requirements for obtaining no-action positions; requiring enforcement actions be brought in federal district court, instead of as administrative proceedings; and repealing the CFPB's supervisory authority in favor of prudential federal and state regulators.

Enhancing Availability of Consumer and Commercial Credit

— Increase the institution size threshold for eligibility to make small creditor Qualified Mortgage (QM) loans.

— Reduce regulatory burdens to rejuvenate the private label mortgage-backed securities market, by leveling the playing field between the government-sponsored mortgage entities (GSEs) and the private sector with respect to the QM rule and the capital treatment of residential mortgage-backed securitizations, and by repealing the residential mortgage risk retention requirement.

— Reduce ambiguity created by the 2013 Leveraged Lending Guidance by re-issuing the guidance for public comment and allowing internal models for determination of leveraged lending rather than bright-line rules.

— Reduce the burden of regulatory compliance on institutions serving financing needs of small businesses by simplifying financial regulations for community banks and reconsidering guidance regarding real estate collateral concentration risks.

Improving Regulatory Structure, Coordination and Engagement

— Congress and the regulatory agencies should reduce overlap and increase coordination among the agencies, including through consolidation of regulators, expansion of the role of the Financial Stability Oversight Council in coordinating and directing the various regulators (including through appointing a lead regulator on issues of overlapping jurisdiction) and increasing coordination on examination and enforcement (including through a single lead regulator on an issue or set of facts).

— Greater coordination among federal and state regulatory agencies is especially needed in relation to the possibility of significant overlap and fragmentation on setting cybersecurity standards.

— The Report recommends several areas for further attention and study that could improve engagement between financial regulators and the industry. Among other things, it supports reassessment and tailoring of regulatory expectations placed on bank boards of directors, and it calls for a reassessment of the way in which regulatory actions (such as MRAs, MRIAs and consent orders) are applied to remedy compliance issues, noting industry concerns about how delays in the implementation, remediation and clearing of regulatory actions can cloud business activities in the interim.

— Treasury expects to comprehensively review the Community Reinvestment Act to improve alignment of benefits and costs, to harmonize regulatory oversight among the several responsible regulators and to provide greater clarity on remediating deficiencies.

What this Treasury Report Does Not Cover

— Housing finance reform and the future state of GSEs.

— Orderly liquidation authority (to be covered by further review under Presidential Memorandum to the Secretary of the Treasury, April 21, 2017).

— Designation of non-bank systemically important financial institutions (to be covered by further review under Presidential Memorandum to the Secretary of the Treasury, April 21, 2017).

— The subjects of future Treasury Reports, including:

- Capital markets and derivatives;
- Asset management and insurance industries and products;
- Non-bank financial institutions; and
- Fintech.

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