Treasury Issues Regulatory Reform Recommendations for Banking Industry

June 20, 2017

Financial Services

On June 12, 2017, the U.S. Department of the Treasury released the first of a series of reports recommending changes to the financial system in a manner consistent with a set of Core Principles set forth in President Trump's Executive Order No. 13,772 of February 3, 2017 (the "Report"). The Report focuses on the depository system, including banks, savings associations, and credit unions, and notes that three subsequent reports will focus on capital markets; asset management and insurance; and non-bank financial institutions, financial technology, and financial innovation.

Some of the Report's recommendations would require legislation to accomplish. A substantial portion of the recommendations can be addressed through regulatory action – albeit mostly by independent agencies, some of which are still led by Obama Administration appointees.

Many of the Report's recommendations are similar to reforms proposed in H.R. 10, the Financial CHOICE Act of 2017, which Covington previously summarized. However, the Report includes some notable recommendations not included in the CHOICE Act and not previously endorsed by U.S. regulators. These new recommendations include:

- Raising the thresholds for application of enhanced prudential standards and the Comprehensive Capital Analysis and Review ("CCAR") exercise from $50 billion in total assets to a higher – but unspecified – number.
- Excluding from the denominator of the Supplementary Leverage Ratio ("SLR") (i) cash on deposit with central banks, (ii) U.S. Treasury securities, and (iii) initial margin for centrally cleared derivatives; and considering adjustment of the amount of leverage exposure attributable to credit provided to small- and medium-sized businesses.
- Delaying implementation of the Net Stable Funding Ratio ("NSFR") and the Fundamental Review of the Trading Book ("FRTB") until U.S. regulators can appropriately calibrate them.
- Narrowing application of the most stringent Liquidity Coverage Ratio ("LCR") requirement to U.S. global systemically important banks ("G-SIBs") only, and including high-grade municipal bonds as Level 2B High Quality Liquid Assets for purposes of the LCR.
- Applying enhanced prudential standards to a foreign banking organization ("FBO") based on its U.S. risk profile, not its global consolidated assets; recalibrating the internal total loss absorbing capacity ("TLAC") requirement for a U.S. intermediate holding

company ("IHC") of an FBO; and permitting an FBO to satisfy certain U.S. regulatory requirements by complying with comparable home country requirements.

- Simplifying the capital regime for community banks, potentially including through amendments to the Collins Amendment in the Dodd-Frank Act.
- Reviewing and tailoring the myriad regulatory requirements imposed on boards of directors.
- Providing the Financial Stability Oversight Council ("FSOC") the authority to designate a lead regulator on issues where multiple agencies have conflicting or overlapping jurisdiction.
- Reissuing the federal banking agencies' 2013 leveraged lending guidance for public comment, and putting less emphasis on the existing guidance's soft limit of borrower leverage in excess of a 6X ratio of Total Debt to Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA").
- Assessing how the Community Reinvestment Act ("CRA") could be improved to better align the CRA investments of financial institutions with the interests and needs of the communities they serve and to reduce compliance burdens.

The Report also recommends changes to the Volcker Rule and the Consumer Financial Protection Bureau (the "CFPB" or "Bureau") that are significant, but less drastic than the CHOICE Act's proposed approach of repealing the Volcker Rule outright and eliminating the CFPB's authority over unfair, deceptive, and abusive acts and practices ("UDAAP").

This client alert summarizes the Report's most significant recommendations by subject matter.

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Capital and Liquidity Standards and Stress Testing

In the wake of the financial crisis and in part as required by the Dodd-Frank Act, the federal banking agencies gradually put in place two stress testing regimes for large banking organizations – CCAR and the program mandated by section 165(i) of the Dodd-Frank Act (known as "Dodd-Frank Act Stress Tests" or "DFAST") – and an array of capital and liquidity requirements for all banking organizations. Some have not yet taken full effect or been finalized. Stating that these programs and rules have, as the U.S. economy has improved, stunted loan growth and in turn slowed economic growth, the Report proposes extensive changes to many of the programs and rules.

The Report contains two broad recommendations that would, if adopted, affect the application of many stress testing, capital, and liquidity requirements. Both recommendations would require amendments to the Dodd-Frank Act. First, the Report proposes a "regulatory off-ramp" much like the off-ramp proposed in the CHOICE Act: a banking organization of any size that maintains a sufficiently high level of capital, such as a non-risk-weighted leverage ratio greater than 10 percent, would be exempt from the capital and liquidity rules. Second, the Report recommends raising the asset threshold for the application of enhanced prudential standards to a bank holding company from the current $50 billion to an unspecified greater amount that would reflect the particular risk and complexity of a bank holding company. The new threshold would carry over to certain capital and liquidity rules, and the concept would narrow the reach of the stress testing regimes. Beyond these two broad recommendations, however, the Report also proposes a number of other important changes to the stress testing, capital, and liquidity regimes that the federal banking agencies could implement without legislation.

Stress Testing and Capital Planning

The Board of Governors of the Federal Reserve System (the "Federal Reserve") uses CCAR results primarily to assess whether a systemically important bank holding company may continue to make capital distributions without affecting its capital adequacy under stressed conditions. The Federal Reserve and the other federal banking agencies, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"), rely on the results of the DFAST, which involves various tests for bank holding companies and banks of different sizes, to evaluate capital plans. The Report recommends substantial changes to both stress testing regimes.

With regard to CCAR, a program developed and revised over a number of years by the Federal Reserve, the Report proposes the following changes:

- The Federal Reserve would raise the current $50 billion threshold for required participation in CCAR – to an unspecified level – to match the increased threshold for the application of enhanced prudential standards. The new threshold would apply to U.S. bank holding companies and IHCs of FBOs.
- The CCAR program includes a qualitative assessment by the Federal Reserve of a bank holding company's management and operations. The Federal Reserve has in the past rejected capital plans based solely on a deficient qualitative assessment. The Report recommends that the Federal Reserve no longer assert such authority as part of the CCAR process. However, the recommendation would not necessarily eliminate the qualitative assessment process. The Federal Reserve could continue to make these

assessments and could take account of any such deficiencies in the Federal Reserve's horizontal capital review. As part of its regular supervision of a bank holding company, the Federal Reserve could require management or operational changes to correct deficiencies found in the qualitative assessment, and adjust the company's ratings accordingly. The Federal Reserve has already taken a partial step in this direction: it recently exempted bank holding companies that are not G-SIBs and that have less than $250 billion in assets and less than $75 billion in nonbank assets from the qualitative assessment process.

- The Report calls for the Federal Reserve to review and assess several other aspects of CCAR. In accordance with the recommendations, the Federal Reserve would revisit any assumptions that create "unrealistically conservative" results. One such assumption identified in the Report is that, even in the severely adverse scenario, a bank holding company would continue to make capital distributions, grow its balance sheet, and increase its risk-weighted asset amounts.
- The Report also recommends that the Federal Reserve improve its own modeling practices for CCAR and consider changing the CCAR process to a two-year cycle from the current one-year cycle.
- The material parameters and methodologies of the CCAR process, including models and economic scenarios, would be subject to public notice and comment.
- The Federal Reserve would provide greater certainty to the management of a bank holding company about the capital buffers that the Federal Reserve deems necessary after conducting its own test under the severely adverse scenario. According to the Report, the Federal Reserve could do so by changing the sequence of the CCAR process or by integrating the risk-based capital and CCAR regimes without increasing post-stress capital requirements.

Because CCAR is structured largely on the basis of the Federal Reserve's supervisory discretion, the Federal Reserve could effect nearly all of these changes through revised regulations or new policy statements and without legislation.

The Report's recommended changes to DFAST include the following:

- Banking organizations with assets of more than $10 billion but less than $50 billion no longer would be required to conduct annual company-run tests. Only banking organizations with assets of greater than $50 billion would be subject to DFAST. Although the new threshold would remain a fixed number, the Report recommends that the banking agencies receive authority to raise the threshold above the $50 billion level based on the risk and complexity of a banking organization.
- The mid-year test currently required for a bank holding company with $50 billion or more in assets would be eliminated.
- The "adverse" scenario would be removed from the set of scenarios for which banking organizations currently must conduct stress tests. Going forward, DFAST would include tests only for a baseline scenario and a severely adverse scenario.
- Bank holding companies and banks would have a degree of discretion to determine the number of models needed to generate appropriate outputs for DFAST.

All of these changes to DFAST except for the last one would require legislation.

Capital Requirements for G-SIBs and Other Large Banking Organizations

The Report recommends several changes to the capital requirements for the largest banking organizations. The federal banking agencies, or in some cases the Federal Reserve acting alone, can implement these changes without legislation.

- ***G-SIB Surcharge.*** For the U.S. bank holding companies that have been designated as G-SIBs, a risk-based capital surcharge is now being phased in and will take full effect on January 1, 2019. The Basel Committee on Banking Supervision has developed an international standard methodology for calculating a G-SIB surcharge. For U.S. G-SIBs, however, the Federal Reserve has developed a second methodology that results in a higher surcharge for many of these institutions. The principal factor driving the Federal Reserve's surcharge is the assessment of a G-SIB's wholesale short-term funding, a factor not currently taken into account in the international methodology (but which the Basel Committee has proposed to take into account). The Report does not recommend that the Federal Reserve eliminate its surcharge for U.S. G-SIBs, but it does recommend that the Federal Reserve revisit the implementation schedule for the surcharge, particularly including the wholesale short-term funding component. The Report also suggests that the Federal Reserve undertake a broader review of its surcharge, but does not recommend particular changes.
- ***Long-Term Debt Requirement.*** The Report recommends that the Federal Reserve revisit the long-term debt requirement issued as part of the TLAC final rule in December 2016, but it does not specify particular changes.
- ***Supplementary Leverage Ratio.*** "Advanced approaches" banking organizations[1] will be required to maintain a minimum SLR of 3 percent beginning January 1, 2018. The Report recommends that in calculating the leverage exposure denominator for the purpose of the SLR, a banking organization be allowed to deduct from its leverage ratio denominator cash on deposit with central banks, U.S. Treasury securities, and initial margin provided to it in a centrally cleared derivative transaction.
- ***Enhanced Supplementary Leverage Ratio.*** The enhanced supplementary leverage ratio (eSLR) requirement will apply beginning January 1, 2018 to bank holding companies with more than either $700 billion in total consolidated assets or $10 trillion in assets under custody and to any of their subsidiary banks with assets of more than $10 billion (effectively, the eight U.S. G-SIBs). For a bank holding company, the eSLR is set at 2 percent above the minimum SLR requirement; for a bank, it is 3 percent above. Failure to meet the applicable eSLR requirement will result in restrictions on capital distributions and discretionary bonus payments. The eSLR is a significant "gold-plating" of the minimum SLR requirement that applies internationally. The Report recommends that the Federal Reserve recalibrate the eSLR to make U.S. firms more competitive internationally.
- ***Countercyclical Capital Buffer.*** Consistent with the international standard included in Basel III, the Federal Reserve has implemented a countercyclical capital buffer ("CCyB")

[1] Advanced approaches banking organizations are generally bank holding companies, savings and loan holding companies, and insured depository institutions with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion.

as a macroprudential tool for advanced approaches banking organizations whereby the Federal Reserve can require those institutions to maintain additional capital as greater downside risk appears in the economy. The Federal Reserve released its framework for setting the CCyB in September 2016, but currently has set the CCyB at zero. The Report recommends that the CCyB cease to be a stand-alone capital requirement and that the Federal Reserve instead impose individual buffer requirements through the CCAR and DFAST programs.

- ***Reduced Reliance on "Advanced Approaches."*** The implementation of Basel II's risk-based capital regime has required large, internationally active U.S. banking organizations to use the "advanced approaches" to measure their risk-weighted assets using models, data, and methodologies developed by each organization (after being approved by the federal banking agencies). Other U.S. banking organizations use the "standardized" approach as the primary way to measure their risk-weighted assets, with risk weights established by the agencies. Due to the Collins Amendment to the Dodd-Frank Act, however, internationally active U.S. banking organizations are required to comply with *both* the advanced approaches and the standardized approaches. The Report encourages the regulators to reduce their reliance on the advanced approaches for risk weighted assets and apply the standardized approach to a greater extent. But the Report also suggests that the regulators introduce into the standardized approach greater risk sensitivity in the measurement of derivatives and securities lending exposures.
- ***Proposed Delay of the Fundamental Review of the Trading Book.*** Last year, the Basel Committee finalized the "Fundamental Review of the Trading Book," which is a standard intended to improve the measurement of risk-based capital required for trading activities. The Report recommends that the federal banking agencies delay adoption of any rule that would implement the Basel Committee standard.
- ***Current Expected Credit Losses.*** The Financial Accounting Standards Board ("FASB") recently finalized a new standard for measuring loan loss reserves based on assessing "current expected credit losses" ("CECL"). The Report indicates that the revised standard could have a substantial effect on a bank's total loan loss reserves. It accordingly recommends that the federal banking agencies analyze the impact of the new CECL standard on bank capital levels and to harmonize the application of this standard with their supervision programs.

Liquidity Requirements for G-SIBs and Other Large Banking Organizations

The Report makes several recommendations for recalibrating liquidity requirements. The federal banking agencies can implement these recommendations through changes to regulations.

- ***Liquidity Coverage Ratio.*** The LCR is designed to ensure that a banking organization has at least enough liquid assets in a stressed scenario to cover expected and other possible net cash outflows over a 30-day horizon. The regulatory requirement is conservative: among other things, it assumes that typically liquid assets will lose a degree of liquidity, and thus it discounts such assets in determining the numerator of the ratio. The Report recommends three changes. First, the LCR requirement would be limited to advanced approaches institutions. The LCR rules currently have one limit for these institutions and impose a less stringent requirement on other banking

organizations with more than $50 billion or more in assets. In addition, the current LCR requirement of 100 percent would apply only to U.S. G-SIBs. Other internationally active institutions would be subject to a lower requirement. Second, for the numerator of the ratio, the Report recommends adding high-grade municipal bonds to the class of liquid assets available to meet cash outflows as Level 2B High Quality Liquid Assets, which receive a 50 percent haircut. Third, as to the denominator of the ratio, total net cash outflows, the Report urges regulators to ratchet down the degree of conservatism in their cash flow assumptions to better reflect banks' historical experience with calculation methodologies.

- ***Proposed Net Stable Funding Ratio.*** The Report encourages the regulators to delay finalizing the NSFR – a liquidity ratio requiring large banking organizations to maintain stable funding relative to the liquidity of their assets over a one-year horizon. The federal banking agencies last year proposed an NSFR requirement that would apply to the same banking organizations that are currently subject to the LCR.

Proposed Single Counterparty Credit Limit

The Federal Reserve in 2011, and again in 2016, proposed a single counterparty credit limit ("SCCL") requirement to implement one of the enhanced prudential standards required by section 165 of the Dodd-Frank Act, and has yet to finalize the rule. The SCCL would apply to a banking organization with $50 billion or more in assets and would create three tiers of increasingly stringent limits based on a banking organization's size. The Report makes two recommendations: (1) that the Federal Reserve raise the threshold above $50 billion for application of the SCCL to match the increased threshold for enhanced prudential standards, and (2) that the Federal Reserve consider introducing greater risk sensitivity in the measurement of derivative and securities lending exposures in the SCCL than was proposed in 2016.

Capital Requirements for Smaller Banking Organizations

The Report's recommendations for changes to the capital requirements for banking organizations below the $50 billion threshold are fewer in number but still quite significant. These recommendations are discussed below in "Community Banks and Credit Unions."

Volcker Rule

Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, prohibits banks and their affiliates ("banking entities") from engaging in proprietary trading and acquiring an ownership interest in or sponsoring a private equity or hedge fund (generically referred to in the Rule as a "covered fund"). The law, which five federal financial agencies have implemented through a common rule,[2] has been the target of extensive criticism by the industry and even some regulators. Among other things, critics have asserted that the Volcker Rule, as implemented, is unduly complex, and imposes too steep a compliance burden on small banks that do not engage in proprietary trading or covered fund activities. They further assert that the proprietary

[2] The five agencies with responsibility for the Volcker Rule are the Federal Reserve, OCC, FDIC, Securities and Exchange Commission, and Commodity Futures Trading Commission.

trading restrictions are exceptionally complex, impose costly compliance burdens, and have made trading markets significantly less liquid.

In this context, the Report makes a number of recommendations, beginning with three proposed legislative exemptions to the Volcker Rule. First, any banking entity with $10 billion or less in assets should be exempt from the Rule in its entirety. (The CLEAR Relief Act, S. 1002, a recently introduced bipartisan bill in the Senate, proposes this exemption.) Second, a banking entity of *any* size that is not subject to the market risk capital rules[3] should be exempt from the proprietary trading restrictions. Third, any banking entity should be permitted to opt out of the Volcker Rule if it is sufficiently well-capitalized such that the risks posed by its proprietary trading are adequately mitigated by its capital, so long as the entity remains subject to trader mandates and ongoing supervision and examination. The Report does not provide any guidance as to how regulators would determine that an entity's capital adequately mitigates the risks posed by the entity's proprietary trading activities.

In addition, the Report proposes reforms to the proprietary trading restrictions that are intended to clarify the line between impermissible proprietary trading and permissible market-making, provide greater clarity as to the covered fund restrictions, and otherwise reduce compliance burdens:

- ***Simplify the Definition of Proprietary Trading.*** Under the Volcker Rule, an account is a "trading account" (and therefore used for impermissible proprietary trading) if a banking entity uses it to buy or sell financial instruments principally for the "purpose" of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging any of the foregoing transactions (though certain hedging transactions are exempted, as discussed below). An account is presumed to be a trading account if it is used to acquire or take a covered financial position that a covered banking entity holds for a period of 60 days or fewer. The Report recommends eliminating the 60-day rebuttable presumption and assessing whether to eliminate the "purpose" test, though the Report does not state whether they should be replaced by a different presumption and test. These changes would not require legislation, but would require concerted action by all five federal financial agencies with authority over the rule.
- ***Increase Ability of Banking Entities to Utilize Market-Making Exemption.*** The Report recommends a number of adjustments to the market-making exemption from the proprietary trading prohibition, including giving a banking entity additional flexibility to adjust its determinations of the reasonable amount of market-making inventory for securities (with particular focus on enhancing flexibility with respect to illiquid securities) and OTC derivatives, as well as enhancing flexibility for a banking entity that has not established a market-making presence in a particular asset class. These changes would not require legislation. The Report also raises the possibility of allowing a banking entity to opt out of the "reasonably expected near-term demand" or "RENTD" requirement in the market-making exemption altogether if the entity fully hedges all significant risks from its inventory and develops narrowly-tailored trader mandates to ensure its market-

[3] The market risk capital rules apply to any banking organization with aggregate trading assets and trading liabilities of (i) 10 percent or more of its total assets, or (ii) $1 billion or more.

making activities comply with other conditions of the market-making exemption. The RENTD requirement is statutory, so creating an opt-out from it would require legislation, and it is not clear how an entity could fully hedge all risks arising from market making activities.

- ***Reduce the Burden of Hedging Business Risks.*** The existing regulation exempts hedging transactions from the Volcker Rule's proprietary trading restrictions, but only so long as the hedges satisfy a number of conditions. The Report recommends elimination of the condition that a banking entity maintain ongoing calibration of a hedge over time to ensure that it meets regulatory requirements, as well as elimination of the condition that the entity maintain documentation regarding specific assets and risks being hedged. In lieu of these existing conditions, the Report recommends that a banking entity be required to monitor risks as part of its standard business practices and take reasonable action to mitigate material new risks that develop over time. These changes would not require legislation.
- ***Reduce the Burdens of the Volcker Rule's Compliance Regime.*** In an effort to reduce the burden of compliance with the Volcker Rule, the Report recommends that: (i) the Rule's existing "enhanced" compliance program apply only to banking entities with at least $10 billion in trading assets and liabilities on a consolidated basis, and (ii) banking entities be given greater ability to tailor their compliance programs to particular activities in which they engage and the particular risk profile of those activities. These changes would not require legislation.

The Report also proposes reforms to the covered funds restrictions of the Volcker Rule:

- ***Definition of "Covered Fund."*** The Volcker Rule restricts proprietary investments in hedge funds and private equity funds, and by statute, defines these funds as those that would be investment companies under the Investment Company Act but for the exemptions provided in sections 3(c)(1) and 3(c)(7) of that Act ***or*** similar funds that the federal financial agencies by rule determine. As implemented in regulation, the Rule focuses on the Investment Company Act test and includes a second technical test that captures commodity pool operators. The Report recommends that regulators adopt a simple, less technical definition that covers only actual private equity and hedge funds. Because the statute provides the federal financial agencies with authority to define private equities and hedge funds on a basis other than the Investment Company Act test, this change likely would not require legislation. The Report, however, provides no guidance as to how the Rule should define hedge funds and private equity funds.
- ***Super 23A.*** A provision of the Volcker Rule commonly known as "Super 23A" outright prohibits most transactions between a banking entity and the covered funds that it advises, sponsors, or organizes that would be "covered transactions" as defined in Section 23A of the Federal Reserve Act, if the banking entity were a member bank and the covered fund were an affiliate of the member bank. The Report recommends restoring the "exemptions" in Section 23A of the Federal Reserve Act. While the Report's reference to "exemptions" is not entirely clear, it appears the Report is suggesting that "covered transactions" between a banking entity and the covered funds it advises, sponsors, or organizes should be permitted if those transactions meet the requirements of Section 23A of the Federal Reserve Act, including that they be quantitatively limited, in some cases collateralized, and not involve the banking entity purchasing a low quality asset. This change would require legislation.

- ***Seeded Fund Period.*** The Volcker Rule contains a limited exemption that permits a banking entity to sponsor and seed a covered fund, so long as, among other things, the banking entity's investment in the fund does not exceed 3 percent of the total amount or value of the outstanding ownership interests in the fund at any time after one year from the date of the fund's establishment. This exemption is intended to allow banking entities to help establish track records for new funds so that they can attract outside investment, but is limited in its usefulness due to the short time period provided. The Report recommends extending this period to three years, a change that would require legislation.
- ***Sponsored Funds.*** Another condition to a banking entity sponsoring a covered fund is that the fund may not share the name (or any variant) of the banking entity for corporate, marketing, promotional or other purposes. The Report recommends permitting a covered fund to share the name of any banking entity that is not a depository institution or depository institution holding company. This change would require legislation.
- ***Foreign Funds.*** Under the statute and rule, a "banking entity" generally includes any U.S. insured depository institution, bank holding company, or FBO, and any affiliate or subsidiary of the foregoing entities. As a result, some foreign funds that are affiliates or subsidiaries of an insured depository institution, bank holding company, or FBO are themselves deemed "banking entities" subject to the restrictions of the Volcker Rule, which can significantly limit their investment activities. This result also has the effect of imposing the Volcker Rule on an extraterritorial basis. The Report recommends exempting from the definition of "banking entity" a foreign fund owned or controlled by a foreign affiliate of a U.S. bank or FBO. Because the statute includes a definition of "banking entity," this change may require legislation, though the agencies already have implemented exceptions to the statutory definition. We note that the Report does not propose any changes to the extraterritorial application of the Volcker Rule's proprietary trading restrictions.

The Report also calls for an improvement in regulatory coordination and consistency among the five federal financial agencies responsible for the Volcker Rule. Such coordination and consistency presumably could be achieved by FSOC appointing a lead regulator with respect to the Volcker Rule, which the Report recommends Congress provide FSOC the authority to do.

Resolution Planning

Section 165 of Dodd-Frank requires a bank holding company with $50 billion or more in assets and any nonbank systemically important financial institution to submit to the Federal Reserve and FDIC on an annual basis a resolution plan (also known as a "living will") demonstrating that it can be resolved in an orderly manner under the Bankruptcy Code. If the Federal Reserve and FDIC find that an institution's plan is deficient, the consequences can be severe: if a banking organization is not able to remedy deficiencies jointly identified by the Federal Reserve and FDIC, the agencies can jointly decide to subject the institution or any of its subsidiaries to more stringent capital, leverage, and/or liquidity requirements, and/or restrictions on growth, activities, or operations, and eventually, depending on the circumstances, can jointly order the institution to divest jointly identified assets or operations.

The Report recommends a number of changes to the resolution planning process, including:

- Raising the threshold for compliance from $50 billion in total assets to the higher threshold adopted for application of enhanced prudential standards.
- Limiting the frequency of section 165 resolution plan submissions to two-year cycles, except that the agencies could require institutions to provide notice and, potentially, submit revised resolutions plans upon the occurrence of material events between biennial submissions.
- Publishing detailed resolution plan guidance in a public notice-and-comment process. The Report specifically notes that the agencies have effectively required banking organizations to increase and track their capital and liquidity through Resolution Liquidity Execution Need (RLEN) and Resolution Liquidity Adequacy and Positioning (RLAP) requirements, but without going through notice-and-comment procedures to establish those requirements.
- Removing the FDIC from the section 165 resolution planning process.
- Requiring the Federal Reserve to provide feedback on resolution plans within six months of the date of their submission.

These recommendations are very similar to the changes proposed in the CHOICE Act and, with the exception of removing the FDIC from the resolution planning process, can be accomplished without legislation.

Foreign Banking Organizations

The Report notes that foreign investment in the U.S. banking system helps diversify the risk of the financial system and facilitates economic growth by, among other things, enhancing foreign corporate investment in the United States. Accordingly, the Report makes three important recommendations for the regulation of FBOs and their U.S. IHCs.

First, under Federal Reserve rules, a variety of enhanced prudential standards, including risk management requirements and resolution plan requirements, apply to an FBO with $50 billion or more in total *worldwide* consolidated assets, regardless of the size of its U.S. footprint. The Report recommends amending these requirements so that they apply based only on the size of an FBO's U.S. footprint.

Second, the Report recommends a recalibration of regulatory standards that apply to IHCs, such as resolution planning and liquidity, and recommends that where an FBO's home country regulations are sufficiently comparable to U.S. regulations, it be allowed to meet those requirements through compliance with its home country regime.

Third, the Federal Reserve implemented in 2016 an internal TLAC requirement for the IHCs of foreign G-SIBs that FBOs have argued amounts to inappropriate "ring fencing" of their resources within the United States. The Report recommends a recalibration of the internal TLAC requirement that takes into account the foreign parent's ability to provide capital and liquidity resources to the IHC, provided U.S. regulators are able to make arrangements with the FBO's home country supervisor for the deployment of resources to the IHC.

The Federal Reserve can make each of these three changes on its own, without legislation.

Consumer Financial Protection Bureau Structure, Authority, and Processes

In evaluating the authorities and processes of the CFPB, the Report echoes many of the concerns that Bureau critics have raised since the passage of Dodd-Frank. However, while substantial and focused on similar goals, the proposed reforms are somewhat different and generally less aggressive than those proposed in the CHOICE Act. Moreover, the Report identifies many changes that the Bureau could make on its own without congressional approval, a tacit admission that altering the Bureau by legislation will be a difficult task, and a signal of the Administration's expectations for the Bureau once President Trump has his own appointee in place as Director.

This first set of reforms addresses longstanding concerns that the Bureau's structure and funding make it unaccountable. While Treasury agrees with the authors of the CHOICE Act that a single Director removable only for cause is a significant concern, the Report offers two possible solutions: retaining the single Director but making him or her removable at-will (mirroring the House-approved version of the CHOICE Act) or establishing a multi-member commission (as proposed in the original draft of the CHOICE Act). In addition, the Report proposes altering the Bureau's 'protected' funding so that it is subject to the traditional appropriations process, prohibiting the use of civil money penalties for anything other than victim payments,[4] and subjecting the Bureau to Office of Management and Budget ("OMB") apportionment.

The second set of reforms focuses on concerns that the Bureau brings enforcement actions – particularly those alleging UDAAP violations – without providing sufficient notice to regulated entities that certain conduct is prohibited. According to the Report, this practice results in significant monetary penalties and creates uncertainty that "chill[s] innovation." To address these issues, the Report proposes that the CFPB issue a regulation that limits monetary sanctions to only those cases where a regulated entity had "reasonable notice" – pursuant to a regulation or judicial or FTC precedent – that the conduct was illegal. Interestingly, the Report does not suggest that a CFPB consent order would provide sufficient notice. Rather, the Report encourages the Bureau to conduct formal rulemaking to prohibit conduct that it believes to be unlawful.[5] These proposals stand in stark contrast to the CHOICE Act, which proposes eliminating the Bureau's authority to prosecute UDAAP violations entirely. Indeed, in somewhat of a surprise and perhaps reflecting the more pragmatic approach of these recommendations, the Report does not even suggest eliminating the "abusiveness" prong, one of the most frequently criticized aspects of CFPB authority. Instead, it would leave the substance of the Bureau's authority in place and focus on the fairness of its application.

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[4] The Dodd-Frank Act expressly permits (but does not require) the Bureau to use civil penalty funds for the purpose of consumer education and financial literacy programs if victims cannot be located or payments to victims are not otherwise practicable.

[5] The report also states that the Bureau "should adopt regulations that more clearly delineate its interpretation of the UDAAP standard." It is not clear, in context, if this is an independent recommendation for the Bureau to provide more detail on what unfairness, deception, and abusiveness mean or rather that the method of more clearly delineating those standards is through rulemaking prohibiting specific practices.

Related to issues about enforcement actions, the Report recommends revamping the Bureau's "no-action letter" policy, which has so far resulted in zero no-action letters, so that it applies to a broader range of products and services (not only "new" ones) and addresses a broader range of conduct, among other changes.

The Report also focuses on the *process* of enforcement proceedings. Specifically, the Report recommends that the Bureau bring enforcement actions exclusively in federal court, which would provide defendants with the full range of procedural protections that are not available in the Bureau's administrative forum. Additionally, the Report recommends that, should the Bureau not agree to bring all cases in federal court, it should at least issue criteria that will determine which cases are heard in the administrative forum and which are heard in federal court. The Report further recommends that the CFPB include enhanced detail in the notification of purpose in Bureau Civil Investigative Demands ("CIDs") and reform internal procedures so that challenges to CIDs can remain confidential, and that Congress allow challenges to CIDs to be appealed directly to federal district court (similar to the current process for False Claims Act CIDs).

On the rulemaking front, Treasury's proposed reform to the Bureau's authority is rather modest in contrast to the CHOICE Act's proposals,[6] recommending only that the CFPB commit to a regular review of regulations to identify outdated or unnecessary rules and that all federal financial agencies more fully apply OMB guidance on cost-benefit analysis (as described below).[7] Given the many concerns that have been expressed about Bureau rulemaking processes and rulemakings in general, that Treasury proposed only these few, relatively modest (though not insignificant) changes is notable.

The reforms also address the Bureau's complaint database, which is another frequent target of industry criticism. As was proposed in the CHOICE Act, the Report recommends making the database confidential, giving access to law enforcement without exposing to the general public complaints that have not been validated, which would make the database similar to the Federal Trade Commission's Consumer Sentinel.

One of the Report's most substantial recommended changes is to eliminate the Bureau's supervisory authority entirely. This is the same approach proposed in the CHOICE Act. Such a change would leave banks supervised for consumer compliance by federal prudential banking regulators and non-bank financial services entities supervised – to the extent such supervisory regimes exist – solely by state authorities. This recommendation is notable, since some in the banking industry have been pleased that the Bureau has sought to place banks and non-banks on a level playing field when it comes to federal oversight.

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[6] The CHOICE Act would eliminate the use of UDAAP in rulemaking, remove the Bureau's authority to ban arbitration, roll back the Bureau's auto-lending guidance, subject Bureau rules to additional cost-benefit analysis, and reduce judicial deference to Bureau interpretations.

[7] As noted below, the Report makes some specific recommendations regarding residential mortgage rules. The Report also recommends that the Bureau hold off on further mortgage servicing rules while the industry updates its operations, that it better coordinate with prudential and state regulators on mortgage servicing rules and examinations, and that it engage in formal rulemaking to establish clear standards for enforcement of the Loan Originator Compensation rule.

While, as noted, several proposals from the CHOICE Act are included in some form in the Report, there are some major proposed legislative changes that are missing entirely from the Report. For instance, the Report does not recommend eliminating offices and functions of the Bureau, such as the offices of fair lending, consumer education, and research, nor does it recommend terminating Bureau authority over small-dollar lenders. Whether the Report's more modest package of CFPB reforms is able to gain traction will be closely watched over the coming months.

Community Banks and Credit Unions

The Report asserts that the overall risk-based capital regime for community banks (defined as those with $10 billion or less in assets, except as where otherwise stated) is inadequately tailored, and it recommends that federal banking regulators explore ways to exempt community banks from the risk-based capital regime implementing the Basel III capital standards, while retaining Basel III's heightened emphasis on common equity. The Report specifically endorses amending section 171 of the Dodd-Frank Act, also known as the Collins Amendment, which statutorily constrains regulators' ability to set lower minimum risk and leverage capital requirements for a selected class of insured depository institutions and their holding companies,[8] if the provision presents an obstacle to this goal.

The Report calls on regulators to simplify and clarify the definition of high volatility commercial real estate ("HVCRE") loans to avoid the application of excessively stringent post-crisis capital requirements and concentration limits related to such loans, but does not identify specific changes. Similarly, the Report recommends exploring ways to simplify and improve the calculation of capital requirements for mortgage servicing assets ("MSAs"), but again does not recommend specific changes. Changes to the treatment of HVCRE loans and MSAs under the capital rules would not require legislation.

To facilitate ownership transfers of small institutions, which can result in such an institution assuming temporary but substantial acquisition debt, the Report recommends doubling the asset threshold of the Federal Reserve's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement to $2 billion in assets. Relatedly, the Report notes that it "may be appropriate" to grant Community Development Financial Institutions (CDFIs) and Minority Depository Institutions (MDIs) greater flexibility to utilize subordinated debt or capital, including capital borrowed by a holding company or capital in the form of program-related investments (PRIs) from foundations or impact investors.

The Report also calls on the National Credit Union Administration ("NCUA") to explore ways to simplify and reduce the burden of credit union capital requirements, particularly in light of the agency's October 2015 final rule that will implement greater risk-based capital requirements for

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[8] In relevant part, the Collins Amendment requires the federal banking agencies to implement minimum risk-based capital requirements that shall not be less than the generally applicable risk-based capital requirements, which shall serve as a floor for any capital requirements that the agencies may require. The statute defines the term "generally applicable risk-based capital requirements" as the risk-based capital requirements established by the federal banking agencies to apply to insured depository institutions under Prompt Corrective Action regulations implementing section 38 of the Federal Deposit Insurance Act.

credit unions with over $100 million in assets beginning in 2019. The Report recommends either exempting credit unions with less than $10 billion in assets from the risk-based capital requirements or exempting credit unions satisfying a 10 percent simple leverage (net worth) test. The Report also recommends that the NCUA reduce the need for credit unions to retain earnings by designating certain supplemental capital instruments that credit unions could rely on to meet part of their risk-based capital requirements. The Report also recommends exempting federally-insured credit unions with $50 billion or less in assets from stress testing, an increase from the current $10 billion threshold, which is consistent with the Report's recommendations for the threshold above which DFAST applies to banks.

The Report supports the FDIC's recent exploration of ways to encourage the formation of *de novo* insured depository institutions. It further recommends exploring ways to lessen the capital requirements applicable to *de novo* activity and to streamline the application process for obtaining deposit insurance.

The Report recommends that regulators explore other ways to reduce regulatory compliance burdens for smaller financial institutions. First, it recommends exploring ways to simplify reporting requirements for all community financial institutions, including by eliminating inapplicable line items on Call Reports. Second, the Report calls on regulators to promote accountability and clarity in their examination and data collection procedures. Third, the Report cites with approval recent legislation that expanded the number of smaller banks eligible for an 18-month examination cycle by doubling the dollar threshold for this eligibility to $1 billion, and calls on Congress to consider passing legislation further raising the $1 billion threshold. The Report recommends that the NCUA implement similar changes to expand the eligibility of smaller credit unions for longer examination cycles. Fourth, the Report exhorts regulators to provide special consideration to the unique challenges rural and agricultural lenders face given that they operate in areas in which key service providers such as appraisers and other legal and compliance staff are often unavailable.

Cost-Benefit Analysis

To improve regulations and accountability in their development, the Report endorses a 2011 Government Accountability Office report that recommended that the federal financial regulatory agencies more fully apply OMB guidance on cost-benefit analysis through the use of more rigorous and consistent methods. Such a change would require legislation, and the Report notes that the Senate considered a bipartisan proposal to accomplish this result in the previous Congress, the Independent Agency Regulatory Analysis Act of 2015, S. 1607, sponsored by Senators Portman (R-Ohio) and Warner (D-Va.).

In particular, the Report recommends that federal financial regulatory agencies conduct and make available for public comment a cost-benefit analysis for at least all economically significant proposed regulations, which are rules expected to have an annual economic impact of at least $100 million.

Interagency Reviews

The Report recommends an interagency review of the collective requirements imposed on banking organizations' boards of directors. Echoing calls from the industry in recent years, the Report asserts that such requirements are excessive, lacking in coherence, and redundant – which places unnecessary compliance burdens and reduces the time and attention that a board

can dedicate to oversight of broader business risk and strategy. The Report also states that regulatory requirements on boards have increasingly and inappropriately blurred the line between board duties and management duties.

In addition, the Report recommends an interagency review to improve the process by which regulated entities remediate identified regulatory issues. It calls on the federal financial regulatory agencies to review the volume and nature of matters requiring attention ("MRAs"), matters requiring immediate attention ("MRIAs"), and consent orders, and the use and impact of regulatory ratings on banking operations and effectiveness. The review would seek to improve the clearing of regulatory actions by evaluating the impact, consistency, and overlap of these actions and by establishing consistent interagency standards.

Regulatory Structure

The Report recommends that Congress provide FSOC the authority to assign a lead regulator on issues where multiple regulators have conflicting or overlapping jurisdiction. Providing more authority to FSOC would be a significant departure from the approach of previous regulatory reform proposals, including the CHOICE Act, which consistently proposed to diminish FSOC's authority.

The Report also recommends bringing the Office of Financial Research more fully into Treasury, including giving Treasury responsibility for appointing and removing the Office's director, and subjecting the Office to Treasury's appropriations and budget process.

Finally, the Report recommends that Congress take action to reduce fragmentation, overlap, and duplication in financial regulation, including, potentially, by consolidating regulators with similar missions and more clearly defining regulatory mandates. The Report does not, however, state which specific agencies should be consolidated or what mandates should be more clearly defined.

Community Reinvestment Act

The Report states that Treasury expects to assess comprehensively how the CRA could be improved to better align the CRA investments of financial institutions with the interests and needs of the communities they serve, as well as to reduce compliance burdens by harmonizing CRA supervision across agencies and potentially altering the frequency of examinations. The Report expresses Treasury's intent to solicit input in its review from individual consumer advocates and other stakeholders, and states that CRA reform will be a "high priority" of the Treasury Secretary.

Residential Mortgage Lending

The Report includes a lengthy list of recommendations to ease residential mortgage lending, ranging from product terms, disclosure, reporting, servicing, and securitization requirements. These recommendations include, but are not limited to, the following:

- ***QM Rule.*** The CFPB has implemented a temporary exemption from the 43 percent maximum debt-to-income ratio that otherwise is required for a loan to be a "Qualifying Mortgage" if the mortgage is eligible for purchase by a Government-Sponsored Entity ("GSE"). This exemption will expire when the GSEs exit federal conservatorship or in

January 2021, whichever is earlier. The Report recommends phasing out this so-called "GSE-patch" in order to level the playing field for all market participants. The Report also recommends that the CFPB permit a loan to be a "Qualifying Mortgage" even if one particular criterion is deemed to fall outside the bounds of the existing framework – *e.g.*, a loan to a borrower with higher than a 43 percent debt-to-income ratio – if there are other compensating factors. These changes would not require legislation.

- ***TRID Rules.*** The Report notes that the TILA / RESPA Integrated Disclosure ("TRID") rules have generated significant uncertainty and confusion among lenders and investors, and can result in lenders being unable to sell loans to investors because of minor technical errors. Accordingly, the Report recommends that the CFPB publish robust and detailed guidance on what constitutes a violation of the TRID rules, allow a more streamlined waiver for mandatory waiting periods, and allow creditors to cure errors in a loan file within a reasonable period after closing. These changes would not require legislation.
- ***HMDA Requirements.*** The Report recommends that the CFPB delay the 2018 implementation of new Home Mortgage Disclosure Act ("HMDA") requirements released in 2015, and re-assess the new requirements through a cost-benefit lens, particularly for smaller institutions, and for their impact on borrower privacy. These changes would not require legislation. The Report also states that Congress should consider moving authority for HMDA back to bank regulators.
- ***Risk Retention Requirements.*** The Report recommends that Congress repeal, or the federal financial agencies substantially revise, the "mortgage risk retention requirement." While not entirely clear, it appears this recommendation calls for changes to be made to the securitization risk retention requirements under section 941 of the Dodd-Frank Act as those requirements apply to mortgage loan securitizations, and not with respect to other asset classes. The Report further recommends that, should the residential mortgage risk retention requirement not be repealed, Congress designate one agency from among the six rule-writing agencies to be responsible for interpretation of the risk retention rule.

Business Lending

In 2013, the federal banking agencies issued guidance on leveraged lending that set forth factors that banks should consider when making leveraged loans. Among other factors, the guidance states that a borrower's leverage level in excess of 6X Total Debt/EBITDA following a loan "raises concerns for most industries." In practice, the 6X Total Debt/EBITDA factor has become a hard limit for many banks that are unwilling to risk receiving a MRA or becoming subject to an enforcement action based on a violation of the guidance. The guidance also contains ambiguities regarding the definition of "leveraged lending," leaving examiners with substantial discretion to interpret the guidance and apply it to different institutions. The industry has criticized these ambiguities as chilling the origination of leveraged loans, and therefore impeding companies' access to financing needed to fund productive projects. Some have also argued that the guidance is a "rule" under the Administrative Procedure Act and Congressional Review Act, and therefore should have been issued through a notice-and-comment process and submitted to Congress in order to have legal effect. The Government Accountability Office recently agreed to a request by Senator Toomey (R-Pa.) to review the legality of the guidance under the Congressional Review Act.

The Report recommends that the agencies re-issue the guidance for public comment, with the objectives of reducing ambiguity in the definition of “leveraged lending” and achieving consistency in supervision, examination, and enforcement. The Report also recommends encouraging banks to incorporate clear and robust metrics when underwriting leveraged loans, instead of relying solely on the 6X ratio of a borrower’s Total Debt to EBITDA. These changes would not require legislation.

The Report also makes several recommendations intended to facilitate access to credit by small businesses:

- ***CRE Lending.*** The banking agencies’ interagency guidance on commercial real estate (“CRE”) lending currently provides that regulators should further analyze an institution’s CRE concentration risk if (1) total reported loans for construction, land development, and other land represent 100 percent or more of the institution’s total capital, or (2) total CRE loans represent 300 percent or more of the institution’s total capital and the outstanding balance of the institution’s CRE loan portfolio has increased 50 percent or more during the prior 36 months. The Report states that regulators should assess concentration risks more flexibly and consider alternative approaches to the existing guidance. This change would not require legislation.
- ***SLR Treatment.*** The Report recommends recalibrating the SLR requirement for working capital loans and unfunded lines of credit to small businesses, but does not state specifically how the leverage exposure attributable to such credit should be changed. The federal banking agencies could make any such change without legislation.
- ***Section 1071 of the Dodd-Frank Act.*** Section 1071 of the Dodd-Frank Act requires the CFPB to establish regulations for small business loan data collection. While the CFPB has yet to issue the small business loan data collection rule, it recently issued a request for information to initiate the rulemaking process. The Report recommends repeal of section 1071.

The Report notes that its recommendations for community financial institutions, discussed above, would also promote access to capital by small businesses.

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