Financial Services Management

U.S. Regulatory Relief

Cite

S. 2155, Economic Growth, Regulatory Relief, and Consumer Protection Act

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Impact Assessment

- Although BHC relief is expressly authorized by size thresholds, the measure retains FRB flexibility also to craft an indicator-based approach to reduce Dodd-Frank burden on regional BHCs.
- FBOs could also receive relief from the $50 billion threshold at which IHCs are now required.
- Custody banks would get significant LR relief, boosting deposit-taking capacity and/or earnings.
- Small BHCs could use only an LR capital standard, advancing work by some to move the U.S. away from risk-based capital.
- Consumers would get national credit-freeze rights at the cost of more stringent ones in certain states.

Overview

Senate Banking Committee Chairman Crapo (R-ID) has gathered enough support from moderate Democrats on his panel to advance regulatory-reform legislation that, while not sweeping, nonetheless addresses an array of community- and regional-bank concerns. Most significant among these for larger BHCs is language that would alter the Dodd-Frank thresholds in Section 165 for "enhanced regulation."[1] These currently hit at the $50 billion threshold, but the legislation now reserves the most stringent standards only

[1] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

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for BHCs above the $250 billion level, giving the Board additional flexibility to redesign the "SIFI" standards as desired. The bill would also alter the leverage ratio (LR) denominator for custody banks along lines in comparable House legislation[2] and give BHCs with less than $10 billion in assets the option to use only an LR standard raised to somewhere between eight and ten percent.

Impact

This legislation structurally alters the Dodd-Frank SIFI framework for regional BHCs. Companies between $50 billion and $250 billion in assets would thus be less constrained, most notably with regard to the FRB's CCAR standards and the significant constraints these place on both regulatory capital and corporate resources. M&A among regional BHCs in this group may thus proceed without the artificial constraint of regulatory burden triggered by exceeding a specific size threshold by even $1.

As noted, these size thresholds are not altered above the $250 billion level. Many, most notably FDIC Vice Chairman Hoenig, have argued that retaining any size threshold even for large BHCs creates artificial distinctions that may not well capture the risk of non-traditional business models at smaller BHCs and unduly burden large, but traditional banking organizations. Legislation has advanced in the House Financial Services Committee and is pending in the Senate[3] to use an "indicator" approach to SIFI standards for BHCs. Reportedly, moderate Democrats were strongly opposed to any provisions in the compromise bill that could be said to benefit the largest BHCs and thus opposed an indicator-based approach. Even so, the measure expressly reserves FRB authority to use the indicator approach without size constraints, giving the central bank power to follow this approach in concert with easing standards on smaller BHCs should it choose to do so. Newly-appointed FRB Vice Chairman for Supervision Quarles has recently shown interest in such an indicator-based approach and no legislative change is likely necessary should the FRB decide to pursue it absent statutory changes other than those in this bill.

These regulatory-threshold questions are usually understand as core to regional banks, which they are. However, they also have significant implications for foreign banking organizations (FBOs) in the U.S. The FRB's rules require FBOs to form an intermediate holding company (IHC) if non-branch assets in the U.S. exceed $50 billion. Treasury has already recommended that the U.S. govern FBOs based on their U.S. risk profile, not the parent-bank one the FRB sought to capture in this rule.[4] With any change to the SIFI level for U.S. banks will come strong pressure for the

2 See **LEVERAGE10**, *Financial Services Management*, May 19, 2017.

3 See **SIFI23**, *Financial Services Management*, October 19, 2017.

4 See *Client Report* **FBO6**, June 20, 2017.

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FRB also to revise the IHC size threshold, pressure we expect the FRB to take very seriously.

The legislation would also make two substantive changes in the U.S. leverage ratio. None goes as far as pending House-passed legislation,[5] which would mandate a ten percent LR in return for an "off-ramp" from the rules adjusted, but not eliminated, by aspects of the Senate measure. Nonetheless, the approach of an LR-only standard for smaller BHCs is likely to encourage many larger banks that oppose the risk-based capital rules also to seek relief. The change proposed to the LR denominator for custody banks – also under active FRB consideration under current law – might also be advanced to other banks holding excess reserves at the FRB, making the LR particularly attractive to larger, traditionally-focused regional banking organizations with large positions in assets that score high capital requirements under the risk-based approach.

The FRB has been and is likely to remain insistent that the LR act only as a backstop to risk-based capital and it is likely to strongly oppose a complete realignment to an LR-only approach for larger banking organizations. In response to this pressure, the FRB however is likely to reconsider the U.S. advanced approach[6] and permit far greater reliance on the standardized approach following changes to it either in concert with implementing Basel III revisions or on its own should these negotiations finally break down.

Despite how controversial some of the provisions in the Senate bill are proving with both conservative Republicans and progressive Democrats, the measure omits many complex and contentious questions now advancing in the House that in several cases are also pending as freestanding, sometimes bipartisan Senate legislation. Some of these additional provisions – e.g., modest changes to the living-will process, restoring the "valid-when-made" doctrine – are likely to be added in mark-up without much controversy. Other changes – e.g., to the FRB's monetary-policy authority and emergency-liquidity powers – will likely be resisted by Sen. Crapo and be brought up in the Senate separately, if at all, prior to conference with the House. The real challenge in the mark-up is likely to be over arguably-germane provisions such as the repeal Sen. Toomey (R-PA) long has sought to Dodd-Franks OLA process, more sweeping changes to stress testing, the qualified-mortgage rules,[7] a restructuring of the CFPB into a commission, and an end to systemic designation for financial-market utilities.

5 See **CAPITAL215**, *Financial Services Management*, June 16, 2017.

6 See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

7 See **MORTGAGE110**, *Financial Services Management*, January 10, 2013.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

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What's Next

S. 2155 was introduced by ten Republicans, nine Democrats, and one Independent on November 16. It will be marked up by Senate Banking on December 5.

Much in the Senate bill is included in varying ways in the Choice Act passed earlier this year by the House on a highly-partisan vote. The House Financial Services Committee is now proceeding to report dozens of bills addressing these same issues often in ways better designed to advance in a conference committee with the Senate once S. 2155 has been passed by the full Senate (which is expected despite continuing strong opposition to the bill by progressive Democrats). This conference committee will be complex and contentious but could well result in significant legislation providing an array of structural changes to banking organizations of all sizes and charters that do business in the U.S.

Analysis

The analysis below generally focuses on provisions that affect larger financial institutions. S. 2155 also includes numerous sections designed to reduce community-bank regulatory burden.

A. Community-Bank Leverage Ratio

Eligible banks meeting the terms below would be deemed to comply fully with the other LRs and risk-based capital ratios necessary to be considered well-capitalized and meet other relevant capital ratios.

1. Qualifying Community Banks

Banks eligible for the LR option are within depository institution holding companies with total consolidated assets of less than $10 billion as long as they or their DIHCs are not in a class specified by the applicable federal banking agency as too risky to rely on the LR. Risk considerations determining ineligibility would need to take into account:

- off-balance sheet assets;
- trading assets and liabilities;
- total notional derivatives exposures; and
- other considerations deemed relevant by the regulator.

2. Leverage Ratio

Each federal banking agency would determine the community-bank LR within a range of eight to ten percent.

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B. Custody-Bank LR

As noted, this bill also eliminates qualifying excess reserves and similar central-bank or assets from the LR denominator for banks that meet the bill's criteria for "custody" institutions.

C. Regional-BHC Relief

The bill creates an escalating exemption from the Dodd-Frank enhanced-supervision standards for BHCs with assets above $50 billion. The new standards would provide relief that gradually increases the scope of the Federal Reserve's oversight as a BHC's asset size exceeds thresholds to the maximum-relief ceiling of $250 billion. Above that threshold, the FRB's suite of existing additional prudential standards would apply. Relief would proceed as follows, with the legislation making it clear that nothing in it limits the Board's ability to tailor rules or sanction BHCs based on individual or categorical indicators:

- BHCs with assets between $50 and $100 billion would be completely freed of all enhanced standards upon enactment.
- BHCs with assets above $100 billion but below $250 billion could be subject to the Dodd-Frank rules based on an FRB rule or order to that effect. To apply the standards, the FRB would need to find this necessary to preserve financial stability or to the safety and soundness of a specific BHC or class of BHCs above this asset threshold taking into account factors detailed in the legislation.
- Otherwise, BHCs with assets between $100 billion and $250 billion would be exempt eighteen months after enactment unless the FRB chose to act more quickly.

D. Stress Tests

BHCs between $100 billion and $250 billion could be subject to stress tests if the FRB or other agencies think this is appropriate. These tests would be "periodic" and test resilience only under an adverse scenario, not the baseline or severely-adverse ones still required of the largest BHCs.

The current Dodd-Frank supervisory stress-test regime would be revised to eliminate the "adverse" scenario from the three now required of SIFI BHCs[8] and the tests would be "periodic," not semi-annual. GSIBs would be considered BHCs with assets over $250 billion and thus subject to these more stringent stress tests even if their assets fall below this threshold. The

8 See *Client Reports* in the **STRESS** series.

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current company-run stress-test regime would apply only to BHCs with assets over $250 billion, would be "periodic" and not semi-annual, but would retain the baseline, adverse and severely-adverse scenarios.

E. Additional Provisions

1. Credit Bureaus

Credit bureaus would be required to give consumers one annual free credit freeze covering extensions of credit (but not apparently offers of employment or any of the other uses to which personal consumer data and scores are used) upon the request of the consumer that is also removed at the consumer's request. More than one such freeze/release cycle per year could apparently involve a fee. The legislation preempts state law and thus those states that provide for unlimited freezes and releases in a year would need to comply with the no-more-than one cycle standard imposed by the federal government. The legislation also adds a freeze right for minors on the above terms when a credit bureau maintains information on them. The freeze pertaining to minors is more sweeping and covers all information and scores related to the minor, not just those pertinent to extensions of credit.

2. Volcker Rule

BHCs with less than $10 billion in assets and trading assets that are less than five percent of total assets would no longer come under the Volcker Rule. Further, as recommended in the Treasury report,[9] certain funds could share names with bank-affiliated investment advisers.

3. Municipal Bonds

The legislation tracks previously-introduced measures[10] to provide that a qualifying municipal investment-grade municipal obligation is to be treated as Level 2B high-quality liquid assets for purposes of the U.S. liquidity coverage ratio.[11] The agencies would presumably be free not to do so should they finalize the pending net stable funding ratio.[12]

4. Studies

The bill would require these from various agencies on:

- cyber-security; and
- algorithmic trading.

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9 See *Client Report* **PROPTRADE22**, June 19, 2017.

10 See **LIQUIDITY19**, *Financial Services Management*, May 7, 2015.

11 See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

12 See **LIQUIDITY18**, *Financial Services Management*, November 18, 2014.

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