June 22, 2017

U.S. Treasury Report Proposes Changes to the Financial Regulatory System

The U.S. Department of the Treasury has issued its first in a series of reports required by Executive Order 13772 examining the consistency, or lack thereof, of the United States' financial regulatory system with the seven core principles of regulation included in the executive order. [1] The report recommends a series of actions that can be undertaken in both the short term and in the ensuing years.

The report, *A Financial System That Creates Economic Opportunities*, focuses on proposed changes for depository institutions (i.e., banks and credit unions), but defers for the time being consideration of the Dodd-Frank Wall Street Reform and Consumer Protection Act's orderly liquidation framework. Three subsequent reports will focus on capital markets, asset management, insurance and non-bank financial institutions, including financial technology and innovation.

At a high level, one of the main positions of the first report is that the Dodd-Frank Act has increased the burden of regulatory compliance without adequate cost-benefit analysis and prolonged the moral hazard arising from regulations that could lead to taxpayer-funded bailouts. Many of the recommendations involve rolling back certain aspects of Dodd-Frank.

This first report concludes:

- Capital and leverage rules can be simplified to increase the flow of credit and to ensure U.S. banks are globally competitive.
- Market liquidity must be improved, which can be accomplished, in part, by amendments to the Volcker Rule.
- The Consumer Financial Protection Bureau (CFPB) must be reformed.

[1] The core principles are: 1) empower Americans to make independent financial choices; 2) prevent taxpayer bailouts; 3) foster economic growth and vibrant markets; 4) enable competitiveness of American companies; 5) enable American interests in international financial regulatory negotiations and meetings; 6) make regulation efficient, effective and appropriately tailored; and 7) restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

- Regulations need to be better tailored, more efficient and effective.
- Congress should review the organization and mandates of the independent banking regulators to improve accountability.

While many of the proposed changes in this report are similar to the Financial CHOICE Act in some aspects, it appears more practical in orientation and thus initial reactions are that the Treasury's proposals have a greater chance of adoption.

Although the Treasury's recommendations seek to "right-size" financial regulation and remove unnecessary regulatory duplication and overlap, key elements of the existing regulatory framework will be retained through any reform. These elements include: explicit, appropriately risk-sensitive capital standards; supervised stress-testing, appropriately tailored based on banking organizations' complexity; explicit, measurable and transparent liquidity requirements; actionable living wills for the largest systemically-important banks; and enhanced prudential standards, based on the size and complexity of financial institutions.

This paper provides greater detail on the Treasury's recommended changes in each of the individual areas of focus.

Capital and Liquidity

The proposed changes relating to capital and liquidity aim to result in a more efficient use of capital and liquidity by better tailoring the rules according to an institution's size and complexity. They also aim to reduce perceived regulatory burdens, increase the transparency of regulatory requirements, and strengthen regulatory coherence to improve the ability of banks to promote liquid markets.

DFAST

Under the proposals, the Dodd-Frank Act Stress Test (DFAST) requirements, which are currently applicable to institutions with $10 billion in total assets, will apply only to institutions over $50 billion in total assets. However, regulators would have the authority to calibrate that threshold *upward* commensurate with the risk profile and complexity of the institution. The mid-year DFAST cycle is proposed to be eliminated, and the number of supervisory scenarios reduced from three to two — the baseline and severely adverse scenario would remain, and the adverse scenario would be removed.

The report also suggests that banks should be able to determine the appropriate number of models that are sufficient to develop appropriate output results, aligned with the scale, complexity and asset mix of the banking organization.

All the proposed changes to DFAST would require the passage of legislation.

CCAR

The threshold for enhanced prudential standards set out in the Dodd-Frank Act is recommended to be better tailored to the complexity of bank holding companies, which will be matched by the threshold for the application of the Comprehensive Capital Analysis and Review (CCAR). Only banks that exceed this threshold would be brought into the scope of the liquidity coverage ratio (LCR), the single counterparty credit limit and living wills. Further, the application of the LCR should be narrowed to apply only to internationally active banks, with a "less stringent standard" applied to internationally-active bank holding companies that are not global systemically important banks (G-SIBs).

Consistent with proposals set out in the Financial CHOICE Act, the Treasury recommendations propose that well-capitalized institutions with a 10 percent non-risk-weighted leverage ratio be eligible for a regulatory "off-ramp." That means these organizations would be exempt from DFAST, CCAR and nearly all aspects of Dodd-Frank's enhanced prudential standards, as well as the Volcker Rule.

The proposed changes to CCAR could be enacted through revisions to existing regulations since most of the current requirements are at the Federal Reserve's supervisory discretion.

Capital Regime

The Treasury is in favor of simplifying the capital regime by keeping the standardized approaches for calculating risk-weighted assets but reducing reliance on advanced approaches for calculating firms' overall risk-based capital requirements. The report calls for the method of calculating operational risk capital requirements under the advanced approaches to be made more transparent than the current approach.

The Treasury generally supports efforts to finalize remaining elements of the international reforms at the Basel Committee, including establishing a global risk-based capital floor to promote a more level playing field for U.S. firms and strengthen the capital adequacy of global banks. It warns that banking agencies should carefully consider the implications on U.S. credit intermediation and systemic risk from the implementation of a revised standardized approach for credit risk under the Basel III capital framework.

Community banks should be exempt from the risk-based capital regime implementing the Basel III standards, says the report, adding that the asset threshold of the Federal Reserve's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement should increase to $2 billion (from the current $1 billion). Regulators are further recommended to continue to streamline current regulatory reporting requirements for all community financial institutions.

These changes will be enabled by the federal banking agencies under revised regulations and guidelines.

Living Wills

Currently, all large bank holding companies (those with $50 billion or more in total consolidated assets) and nonbank financial companies designated by the Financial Stability Oversight Committee (FSOC) are required to prepare living wills for their rapid and orderly resolution under the U.S. Bankruptcy Code. The Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) review the wills to determine if a plan is credible or not.

Although the Treasury supports the ongoing requirements of living wills, it suggests raising the threshold from $50 billion in total consolidated assets to match the revised threshold for the enhanced prudential standards, and to change the requirement of an annual submission to a two-year cycle. The Treasury also seeks to assist firms by providing better regulatory guidance in response to living will submissions. All these changes can be enacted by the regulators alone, but the call for the FDIC to be eliminated from the living will process, leaving the Federal Reserve alone to review and provide feedback within six months, will require legislation.

Foreign Banking Organizations

The Treasury recognizes the importance of foreign banking organizations (FBOs) in the United States. FBOs represent 20 percent of total U.S. banking system assets and provide approximately one-third of U.S. business loans. The Treasury report states that the post-crisis regulatory framework has discouraged foreign banks' appetite for participating in U.S. markets. The 110 FBOs in the United States exceed the statutory threshold of $50 billion in global total consolidated assets and are thus subject to some form of the U.S. enhanced prudential standards, even though many of the 110 firms do not have a large U.S. presence.

The Treasury report calls for a reassessment of the regulations applicable to foreign banks to ensure that FBOs are not unduly constrained by these regulatory requirements. Suggested changes include basing the threshold for compliance with the enhanced prudential standards, CCAR and living wills on the foreign bank's U.S. risk profile rather than the company's global consolidated assets, with an increased emphasis on substituted compliance when FBOs comply with comparable home country regulations.

It is further suggested that internal total loss absorbing capacity (TLAC) requirements should be recalibrated for FBOs that consider the foreign parent's ability to provide capital and liquidity resources to the United States. These changes can all be made by the Federal Reserve and will not require any legislation.

The Volcker Rule

The Treasury report describes the Volcker Rule, which prohibits insured depository institutions from engaging in proprietary trading or investing in hedge funds or private equity funds, as an "extraordinarily complex and burdensome compliance regime," which has "hindered both market-making functions necessary to ensure a healthy level of market liquidity and hedging necessary to mitigate risk."

The Treasury proposals would exempt banking entities with $10 billion or less in assets from the Volcker Rule. Banks with assets over $10 billion that are not subject to the market risk capital rules would also be exempt from the proprietary trading prohibitions of the Volcker Rule. Regulators would be required to strengthen the consistency and coordination of their guidance and enforcement of the Volcker Rule. The report also calls for the definitions of the Volcker Rule's proprietary trading restrictions to be simplified, for regulators to provide more flexibility for market-making and to reduce the compliance burden of the hedging exemption by focusing on policies and procedures, reducing burdensome documentation requirements and simplifying the covered funds restrictions.

Many of these proposals would not require legislation, but critics warn that concerted action by all five federal financial agencies with authority over the rule would be necessary to enact change. Legislation would be required to make changes to the more complex sections of the rule, including: restoring exemptions to the so-called Super 23A rule (which currently prohibits most transactions between a banking entity and the covered funds it advises, sponsors or organizes); extending the seeded fund period to three years; and permitting a covered fund to share the name of any banking entity that is not a depository institution.

Agency Reform

One of the key aims of the Treasury report is to reduce the perceived fragmentation, overlap and duplication in financial regulation. The report states that the mandate of the FSOC should be broadened so that it can assign a lead regulator as the primary regulator on issues where agencies have conflicting or overlapping jurisdiction.

The Treasury calls for the FSOC to be reformed to further facilitate information sharing and coordination among member agencies.

The Treasury recommends that the structure and mission of the Office of Financial Research (OFR), which was created by Dodd-Frank as an independent resource to support the FSOC in advancing the FSOC's financial stability mission, to be reformed by Congress to enhance its effectiveness and to ensure greater accountability. To that end, the report states that the OFR should become part of the Treasury, with its director subject to appointment by the Treasury secretary, without a fixed term and subject to removal at will. The OFR budget is recommended to fall under the control of the Treasury appropriations and budget process.

CFPB

The proposed reform and restructure of the Consumer Financial Protection Bureau (CFPB) are a major focus in the Treasury report. The recommendations include making the CFPB's director removable at-will by the U.S. President, or giving the CFPB a multi-member commission; funding the agency through annual appropriations; having the CFPB issue rules and guidance before taking any enforcement actions; no-action relied requirements should be less onerous and align CFPB policy with other regulators; enforcement actions should be brought in federal district court rather than use administrative proceedings; and repeal the CFPB's supervisory authority in favor of prudential federal and state regulators. Furthermore, the Treasury recommends access to the CFPB's complaints database be restricted to government agencies rather than the general public.

The Treasury report also calls for the reform of the CFPB's qualified mortgage regulation, which analysts regard as being the easiest changes for regulators to make of all of the proposals. The recommendations seek to simplify the rules by increasing allowable points and fees and expanding the number of institutions eligible to make small creditor qualified mortgage (QM) loans. The report calls for the CFPB to increase the total asset threshold for making small creditor QM loans from the current $2 billion to a higher asset threshold of between $5 and $10 billion to accommodate loans made and retained by small depository institutions.

The Treasury report calls for a delay in new reporting requirements under the Home Mortgage Disclosure Act (HMDA) “until borrower privacy is adequately addressed and the industry is better positioned to implement the new requirements.” Also, the Trump administration wants a moratorium on additional rulemakings related to mortgage servicing.

Governance

The report also focuses on the advantages of properly defining the role and responsibilities of banks’ boards of directors for regulatory oversight and governance — the failure of which the Treasury says was a major contributor to the financial crisis. To enhance accountability, the Treasury says that boards should engage with regulators to ensure the highest standards when developing and implementing comprehensive regulatory compliance procedures.

The Treasury recommends an interagency review of the collective requirements imposed on boards to reassess and better tailor these aggregate expectations and restore balance in the relationship between regulators, boards and bank management.

The report calls for an interagency reassessment of the volume and nature of matters requiring attention (MRAs), matters requiring immediate attention (MRIAs) and consent orders (COs) to evaluate impact, consistency and overlap and to establish consistent interagency standards. It further recommends that regulators and banking organizations develop an improved approach for addressing and clearing regulatory actions.

Leveraged and Small Business Lending

Banking regulators are advised to re-issue the 2013 Leveraged Lending Guidance for public comment to help reduce ambiguity and improve access to capital for small and midsize businesses. Moreover, the Treasury states that banks should be encouraged to incorporate a clear but robust set of metrics when underwriting a leveraged loan, instead of relying solely on the six times leverage ratio as set out in the 2013 Leveraged Lending Guidance.

The proposals also seek to reduce the regulatory compliance burden on institutions lending to small businesses, which is considered to be more high risk, and calls for recalibration of the supplementary leverage ratio (SLR) for lines of credit to small and mid-sized businesses to help banks provide additional access to working capital lines for small businesses.

The report also seeks to repeal Section 1071 of the Dodd-Frank Act that requires the CFPB to establish regulations and issue guidance for small business loan data collection, which is an additional compliance and cost burden for small banks. The CFPB recently issued a request for information to initiate the rulemaking process for this data collection action.

Cybersecurity

For cybersecurity rules, the Treasury report recommends that federal and state financial regulatory agencies establish processes for coordinating regulatory tools and examinations across subsectors, and work to harmonize regulations as well as interpretations and implementation of specific rules and guidance around cybersecurity.

Final Thoughts

The U.S. Treasury and the Trump administration plan to begin working with Congress, independent regulators, the financial industry, and trade groups to implement the recommendations advocated in the report through changes to statutes, regulations and supervisory guidance.

The Treasury proposals set out a "wish list" from the Trump administration. Although there are many details to flesh out, the report sets out a practical approach for rethinking — if not repealing — many of the requirements enacted in the immediate aftermath of the global financial crisis.

Unlike the Financial CHOICE Act, many of the Treasury's proposals do not require a great deal of legislative change; – for example the Financial CHOICE Act advocates repealing the Dodd-Frank Act, while the Treasury report suggests amendments. Optimistically, Treasury Secretary Steven Mnuchin believes that "70 to 80 percent" of the changes could be enacted by working with the regulators and the FSOC and using executive actions.

About Protiviti

Protiviti is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and our independently owned Member Firms provide consulting solutions in finance, technology, operations, data, analytics, governance, risk and internal audit to our clients through our network of more than 70 offices in over 20 countries.

We have served more than 60 percent of Fortune 1000® and 35 percent of Fortune Global 500® companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Protiviti's global financial services team brings a blend of proven experience and fresh thinking through a unique mix of "home grown" talent combined with former industry professionals, including risk and technology executives, operations managers, internal auditors, quantitative modelers and financial regulators. We have served more than two-thirds of the world's largest banks, many of the largest and mid-sized brokerage and asset management firms, as well as a significant majority of life as well as property and casualty insurers.

Contacts

Cory Gunderson
Managing Director and Global Financial Services Practice Leader
+1.212.708.6313
cory.gunderson@protiviti.com

Matthew Moore
Managing Director
+1.704.972.9615
matthew.moore@protiviti.com

Michael Brauneis
Managing Director
+1.312.476.6327
michael.brauneis@protiviti.com

Michael Thor
Managing Director
+1.317.510.4685
michael.thor@protiviti.com

Kim Dickerson
Managing Director
+1.571.382.7256
kimberly.dickerson@protiviti.com

Tom Andreesen
Managing Director
+1.312.476.6318
thomas.andreesen@protiviti.com

Michael Schuchardt
Managing Director
+1.415.402.3620
michael.schuchardt@protiviti.com

protiviti®