The Department of the Treasury Issues Recommendations on the Regulation of U.S. Depository Institutions

“"A Financial System that Creates Economic Opportunities: Banks and Credit Unions,” a Report by the Department of the Treasury, identifies potential reforms that would promote the “Core Principles for Regulating the United States Financial System” identified in an executive order issued by President Trump.

Some of the recommendations would require amending or repealing certain provisions of the Dodd–Frank Act. However, the report’s remaining suggestions could be implemented via administrative actions. These recommendations, which are the primary focus of this Jones Day White Paper, include a coordination of cybersecurity obligations, adjustments to capital and liquidity requirements, and improvements to the Volcker Rule, to name a few.

While the current political climate makes broad legislative changes to Dodd–Frank problematic, except for smaller institutions, the Federal Reserve, OCC, and the FDIC appear to be receptive to most of the Report’s recommendations.
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The President issued Executive Order 13772 “Core Principles for Regulating the United States Financial System” (“Core Principles”) on February 3, 2017. The Core Principles directed the Treasury Secretary to consult with the federal financial regulators on the extent to which existing laws, treaties, regulations, guidance, and other government policies promote the Core Principles. A report was required to identify any laws, regulations, guidance, and other government policies that are inconsistent with the Core Principles.

The Department of the Treasury (“Treasury”) issued its first report in response to the February 2017 executive order, “A Financial System that Creates Economic Opportunities: Banks and Credit Unions” (“Report”), on June 12, 2017. The Treasury states that the recommendations outlined in the Report, which are summarized below, “could meaningfully simplify and reduce regulatory costs and burdens, while maintaining high standards of safety and soundness and ensuring the accountability of the financial system to the American public.” This Report is the first in a series of reports to be issued in response to this executive order. Three subsequent reports are expected to address capital markets; asset management, insurance, and investment products; and fintech.

On June 21, 2017, Treasury official Craig Phillips stated that the implementation of the Treasury’s recommendations falls largely on the bank regulators because many of the recommendations rely on regulatory interpretations of existing rules. Federal Reserve Governor Jerome Powell, FDIC Chairman Martin Gruenberg, Acting Comptroller of the Currency Keith Noreika, and NCUA Acting Chairman J. Mark McWatters appeared supportive of the Treasury’s recommendations during a June 22, 2017, Senate Banking Committee hearing and are already preparing to review and revise a number of regulations cited in the Report. The Report provides further impetus and support for a recalibration that various regulators had been considering in light of their experience. It provides guidance and perspective as new leaders are appointed to the bank regulatory agencies.

OVERVIEW

The Report identifies numerous reforms that the Treasury believes would promote these Core Principles. The Treasury summarizes its recommendations as:

- Improving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap, and duplication across regulatory agencies;
- Aligning the financial system to help support the U.S. economy;
- Reducing regulatory burden by decreasing unnecessary complexity;
- Tailoring the regulatory approach based on size and complexity of regulated firms and requiring greater regulatory cooperation and coordination among financial regulators; and
- Aligning regulations to support market liquidity, investment, and lending in the U.S. economy.

General economic goals include increasing economic growth, meeting credit needs of consumers and business, and maintaining liquid markets. Common themes include a need to modernize financial regulations and to enhance policy coordination among federal bank regulators, including supervisory and enforcement policies.

Although the Report will influence and guide regulatory attitudes and approaches, several of the Report’s recommendations will require amendment or repeal of certain provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) including:

- Reducing regulatory and examination overlap and duplication;
- Raising the minimum asset thresholds required by the Comprehensive Capital Analysis and Review (“CCAR”), Dodd-Frank Act stress testing (collectively, with CCAR, “stress testing”) and enhanced prudential standards asset thresholds, eliminating midyear stress testing cycles, and appropriately tailoring the standards governing the stress testing and enhanced prudential standards;
- Creating a regulatory “off-ramp” for certain well-capitalized banks in which all capital and liquidity requirements, most of the enhanced prudential standards, and the Volcker
Rule would not apply if the institution maintained a sufficiently high level of capital (i.e., a 10 percent non-risk weighted leverage ratio).\(^7\)

- Simplifying community banks’ capital requirements by exempting such banks from Basel III capital requirements;\(^8\)
- Raising the asset threshold for the Federal Reserve’s Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (“Small Bank Policy Statement”) to $2 billion;\(^9\)
- Allowing credit unions to rely on supplemental capital to meet their risk-based capital requirements;
- Raising the asset threshold for smaller banks eligible for the 18-month exam cycle;
- Improving the Community Reinvestment Act;
- Raising the threshold for resolution plans (“living wills”), eliminating the FDIC from the living will process and requiring the Federal Reserve to review and provide feedback on living will submissions within 6 months;
- Limiting the application of enhanced prudential standards and living will requirements on foreign banking organizations based on their U.S. risk profile and size;
- Exempting banks with $10 billion or less in assets from the Volcker Rule and exempting banks with more than $10 billion in assets that are not subject to market risk capital rules from the Volcker Rule’s proprietary trading rules;
- Eliminating the “purpose test” from the Volcker Rule’s definition of proprietary trading and reevaluating the “reasonably expected near-term demand” (“RENTD” or “Expected Near Term Demand”) framework under the Volcker Rule’s market-making exception by providing an opt-out if firms’ trading mandates ensure market-making activity only and transactions are hedged;
- Making various statutory changes to focus and simplify the Volcker Rule’s covered fund restrictions and creating a regulatory “off-ramp” for well-capitalized banks;
- Making structural changes to the CFPB by having the director removable at-will by the president, funding the CFPB though the congressional appropriations process, subjecting the CFPB to Office of Management and Budget apportionment and reforming funding mechanisms so that excess funds not paid to victims are remitted to the Treasury;
- Permitting persons who receive a civil investigative demand (“CID”) from the CFPB to file a motion in federal court to modify or set aside the demand, rather than limiting recourse to an appeal to the CFPB director;
- Limiting access to the CFPB’s Consumer Complaint Database to federal and state agencies;
- Repealing the CFPB’s supervisory authority;
- Repealing or revising the Residential Mortgage Risk Retention Requirement and providing additional protections to investors in private mortgage-backed securities; and
- Improving small businesses’ ability to access credit at reasonable rates.

H.R. 10, The Financial CHOICE Act of 2017 (“CHOICE Act”) was passed by the U.S. House of Representatives on June 8, 2017. Although not identical to the Report, the CHOICE Act does overlap in certain areas with the Report.\(^10\) Many of the Treasury’s legislative recommendations and the CHOICE Act appear to lack bipartisan support, and are unlikely to pass the Senate. Bipartisan support appears to exist for changing the regulation of smaller, community financial institutions.

The Report’s remaining recommendations can be unilaterally addressed by state and federal regulators and could be implemented timely by administrative action. Such recommendations include the following, which are the focus of this White Paper:

- Cybersecurity;
- Capital and liquidity;
- Community financial institutions and de novo activity;
- Improving the regulatory engagement model;
• Living wills;
• Foreign banking organizations;
• Improving the Volcker Rule;
• The CFPB;
• Residential mortgage lending;
• Leveraged lending; and
• Small business lending.

REGULATORY RECOMMENDATIONS

Cybersecurity
The Report highlights the importance of technology and cybersecurity to the proper functioning of U.S. financial markets and the operations of financial institutions. The Report states that better coordination among state and federal regulators is needed to protect financial institutions from such cybersecurity risks. As part of that effort, state and federal agencies should harmonize and reduce redundant regulations, interpretations, rules, and guidance governing cybersecurity. This could be spearheaded by the Financial and Banking Information Infrastructure Committee, a group of 18 federal agencies and state organizations charged with improving the security and reliability of the financial infrastructure.

Capital and Liquidity
The U.S. banking system collectively holds significantly more capital than it did prior to the financial crisis. Common equity tier one capital has increased by $500 billion since 2009 and common equity tier one capital ratios have more than doubled. Moreover, U.S. banks hold 24 percent of their assets in high-quality liquid assets, which is five times higher than precrisis levels. Although the capital adequacy standards provided by the Dodd–Frank Act and the Basel Committee on Banking Supervision (“Basel Committee”) have increased capital and liquidity in the U.S. banking system, the Report finds that the availability of bank credit to consumers in various segments of the economy is restrained. Loan growth has lagged prior recoveries and has been particularly weak in small business and mortgage lending. The Treasury’s recommendations in this area include: regulatory tailoring, reducing burdens, and improving regulatory coherence.

Regulatory Tailoring. The Treasury states that some of the most burdensome regulations include enhanced prudential standards applicable to institutions with $50 billion or more in consolidated assets and company run Dodd-Frank Act stress tests applicable to institutions with more than $10 billion in consolidated assets. Stress testing alone now covers more than 100 firms, well beyond the 19 banks that underwent the original Supervisory Capital Assessment Program. Moreover, enhanced prudential standards apply to more than 30 bank holding companies (“BHCs”).

The Report states that regulatory reforms should foster clear and objective standards that are not unduly burdensome and are based on the size and complexity of a bank’s balance sheet. Accordingly, the Treasury recommends that the bank regulators take the following actions:

• Narrow the liquidity coverage ratio to global systemically important banks (“G-SIBs”) and apply a less stringent standard to internationally-active BHCs that are not G-SIBs; and
• Limit single-counterparty credit limits to the largest banks that are subject to the revised threshold for enhanced prudential standards.

Reduce Unnecessary Burdens and Improve Transparency.
Although strong capital requirements mitigate the economic effects of an undercapitalized banking system, studies suggest that higher capital requirements lead to increased capital costs that are ultimately borne by borrowers. Redundancies within the capital and liquidity regulatory regimes also increase costs. For instance, the largest banks are required to calculate capital requirements under both the advanced approach and standardized approach. Moreover, a host of potential rules could also increase funding costs. The Treasury states that initiatives to reduce such burdens should:

• Reassess the assumptions for stress testing, including the assumptions that firms continue to distribute capital and grow balance sheets and risk-weighted asset exposure in severely adverse scenarios;
• Improve the Federal Reserve’s modeling practices to recognize unique risks;

• Change stress testing to a two-year cycle with more frequent reviews permitted to allow for revisions;

• Delay the implementation of the net stable funding ratio and the fundamental review of the trading book until they can be appropriately calibrated;

• Reduce reliance on the advanced approaches for calculating risk-weighted capital requirements while considering whether it is appropriate to introduce more appropriate risk sensitivity; and

• Review the effects of the Financial Accounting Standards Board’s current expected credit loss standard.\textsuperscript{15}

The Report recommends that the transparency of stress testing and other supervisory processes be improved as follows:

• The Federal Reserve subject stress testing and capital planning review frameworks to public comment;

• The qualitative element should no longer be the basis for objection to a capital plan and should be adjusted to conform to the horizontal capital review standard the Federal Reserve already has implemented for noncomplex institutions with assets less than $250 billion;

• The process should provide firms with an accurate understanding of the capital buffers they would be subject to after considering the projected results of the Federal Reserve’s supervisory models under adverse conditions;

• Countercyclical capital requirements should be implemented through stress testing rather than through the counter cyclical capital buffer included in the risk-based capital rules; and

• The method of calculating operating risk capital requirements under the advanced approaches should be more transparent.

Implications of the Capital and Liquidity Recommendations.

If adopted, the capital, liquidity, and various other recommendations made in the Report would enable banks to return more capital to shareholders, increase returns on equity, and enhance the industry’s ability to attract capital and utilize it productively.
The Report sets forth a framework to consider areas where regulation is duplicative or otherwise not improving safety and soundness. The Dodd-Frank Act’s multiple statutory and regulatory solutions to the same problem can inappropriately restrict the economy and have unexpected adverse effects. For example, as a result of the Volcker Rule’s proprietary trading restrictions and the Basel III capital rules, Federal Reserve studies have shown the liquidity in the securities markets have decreased. Liquidity, especially market liquidity, is essential to financial stability.

Critics believe that the recommendations in the Report could decrease a bank’s TLAC and jeopardize the strength of the financial system as a whole. However, the recommendation that money held in central banks, U.S. Treasury securities, and initial margin for centrally cleared derivatives be excluded from leverage exposure for purposes of the supplemental leverage ratio could provide a significant boost to the leverage ratios of large banks. Moreover, the G-SIB surcharge that the largest banks face could result in an additional 2.8 percent increase in capital levels once the surcharge is fully phased-in. The Treasury’s proposal to recalibrate the G-SIB surcharge could free up capital. The Treasury’s proposal that regulators revisit the TLAC rules, could likewise free up capital. These recommendations could provide a needed boost to leverage ratios if the CHOICE Act’s 10 percent “regulatory off-ramp” leverage ratio is passed by Congress.

Community Banking Financial Institutions and De Novo Activity
The number of federally insured banks has declined from 17,901 in 1984 to less than 5,913 in 2016. The decrease has been particularly pronounced in institutions with assets of less than $100 million, which declined by 85 percent between 1985 and 2013. Only a handful of FDIC-insured depository institutions have been started de novo since 2008. To reverse this trend, the Treasury recommends:

- Right-sizing capital requirements;
- Enabling capital formation and encouraging de novo charters;
- Reducing the number of regulatory burdens; and
- Increasing the threshold for “Qualified Mortgages.”

Right-Sizing Capital Requirements. Although exempt from the stress-testing and liquidity standards that apply to large organizations, community banks are often subject to capital regimes applicable to larger banks, including the Basel III risk-based capital standards. The Treasury recommends simplifying the overall capital regime applicable to community banks by:

- Exempting community banks from the risk-based capital standards of Basel III while retaining an emphasis on common equity tier one standard;
- Simplifying and clarifying the definition of high volatility commercial real estate loans;
- Providing relief from the Federal Reserve’s Small Bank Policy Statement requirements by increasing the threshold for compliance from $1 billion to $2 billion in total consolidated assets;
- Permitting Community Development Financial Institutions and Minority Depository Institutions (“MDI”) the ability to utilize subordinated debt as capital, particularly capital that is borrowed by a MDI’s bank holding company and injected into the bank. Most MDIs are permitted to do this under the Federal Reserve’s Small Bank Policy Statement, which the Report suggests expanding to banks with up to $2 billion in assets;
- Eliminating risk-based capital requirements for credit unions with a leverage ratio of 10 percent or higher and raising stress testing asset thresholds from $10 billion to $50 billion.

Encouraging De Novo Activity. To encourage the formation of de novo institutions, the Treasury recommends implementing changes to existing capital requirements discussed above for de novo institutions and streamlining the FDIC application process for deposit insurance.

Simplifying Regulation. Bank Call Reports are over 80 pages long with many line items that are inapplicable to community banks. The Treasury recommends regulators further their recent efforts to streamline the reporting requirements by focusing on the applicability of each line item. Although bank regulators recently expanded the threshold for qualifying for an 18-month examination cycle to $1 billion in assets, the NCUA should
consider expanding the threshold applicable to credit unions. Moreover, regulators should expand efforts to coordinate and rationalize their examination and data collection procedures.

**Increasing the Threshold for Qualified Mortgages.** The Treasury also recommends that the CFPB change its Ability-to-Repay and Qualified Mortgage Rule (“Qualified Mortgage Rule”) by raising the total asset threshold from $2 billion to between $5 and $10 billion.

**Improving the Regulatory Engagement Model**

In an effort to make the regulatory process more efficient and appropriately tailored, the Treasury has identified areas of focus in the reassessment of bank regulation, including:

- Requirements of a banking organization's board of directors;
- Enhanced use of regulatory cost-benefit analyses; and
- Improvements in the process of remediating regulatory issues.

**Reducing the Regulatory Burdens for Boards of Directors.** The Report notes that there are more than 800 provisions of law, regulation, and guidance that impose obligations on bank directors, which prevents time from being allocated to oversight of the business. Nonstrategic regulatory matters requiring board attention blur the lines between management of the bank and the board's duties. Moreover, the regulatory requirements that boards face are inconsistent at the federal and state level, which results in significant overlap. A shift in the involvement of the board in regulatory matters could be made with little risk posed to the financial system.

**Enhanced Use of Regulatory Cost-Benefit Analysis.** Executive Order 12866 directed executive agencies to assess the cost and benefits of new rule with particular focus on evaluation and review of economically significant regulations (i.e., those that are expected to have an impact of $100 million or more). Congress also adopted discrete cost-benefit analysis requirements applicable to the independent financial regulatory agencies (the CFTC, SEC, FDIC, Federal Reserve, OCC, and CFPB), which have been exempt from Executive Order 12866. The Treasury states that financial regulators' application of cost-benefit analyses has been inconsistent and has sometimes lacked analytical rigor. Requiring these agencies to apply cost-benefit analyses to all economically significant regulations in a uniform manner would improve the design and implementation of the bank regulatory framework and improve transparency. The Treasury recommends that the cost-benefit analyses should also be subject to public review and comment and coordinated among regulators when proposing joint regulations.

**Improving Process for Remediation of Regulatory Issues.** Boards of directors and management play a key role in regulatory compliance, oversight, and remediation of problems. The Report states that this requires both financial institutions and their regulators maintain an appropriate “tone at the top,” with mutual accountability and a common understanding of responsibility. Regulatory and industry relationships depend upon transparency and clear rules and guidance. The Treasury recommends that the regulatory agencies assess the volume and nature of matters requiring attention (“MRAs”), matters requiring immediate attention (“MRIAs”), and consent orders to evaluate their impact consistency and overlap and to establish consistent standards across all agencies. Many organizations report multiyear delays in resolving and clearing regulatory actions, particularly when there is lack of transparency in rules. Thus, regulators must develop an improved approach to address clearing regulatory actions.

**Living Wills**

Section 165(d) of the Dodd-Frank Act requires that large BHCs with $50 billion or more in total consolidated assets and non-bank financial companies designated as systematically important by FSOC prepare resolution plans or “living wills,” which are reviewed and subject to approval by the Federal Reserve and the FDIC. The Treasury generally supports the requirement of living wills at institutions larger than the current asset threshold. Even for the largest institutions, the lack of guidance for living wills without the benefit of public notice and comment imposes unpredictable and heavy burdens on participating institutions.

The Report recommends that:

- Section 165(d) of the Dodd-Frank Act does not specify a timeframe for submitting living wills, but banking agencies have required annual submission though a 2011 joint rule-making. The Treasury proposes a two-year cycle with a requirement that firms provide notice of material events that occur between submissions.
• Agencies should develop clear and specific guidance for living will submissions and the assessment framework that is subject to public notice and comment. Additionally, any guidance that effectively acts as a regulation should be minimized and subject to public notice and comment.

• Raising the threshold asset size for living wills to greater than $50 billion, consistent with the recommended changes in the threshold for enhanced prudential supervision.

The Treasury would like to limit the review of living wills to the Federal Reserve, and eliminate the FDIC’s jurisdiction over these.

Foreign Banking Organizations
Foreign banking organizations (“FBOs”) represent 20 percent of total U.S. banking assets, provide one-third of U.S. business loans, and comprise more than half of the 23 primary dealers of the Federal Reserve Bank of New York. Reforms have been introduced to improve the supervisory framework and create a level playing field between domestic and foreign banks. However, the Treasury recommends that the requirements need further reevaluation so that FBOs are not overly constrained.

The Report states that the postcrisis regulatory framework for FBOs has discouraged foreign participation in the U.S. markets, and some view U.S. capital and liquidity requirements as excessive for FBOs because the ultimate parent company generally must be supervised and capitalized on a comprehensive, consolidated basis as determined by the Federal Reserve under applicable international standards. In addition, the Treasury states that too many FBOs with little United States presence are subject to U.S. regulations. Of the 110 FBOs with $50 billion or more in global consolidated assets that are subject to enhanced prudential standards, 80 percent have less than $50 billion in U.S. assets and nearly 60 percent have less than $10 billion in U.S. assets.

The Report generally supports FBO regulation, with changes to level the playing field for FBOs compared to U.S. banking organizations and to promote consolidated supervision over FBOs’ U.S. banking and nonbanking operations by evaluating their U.S. operations and home country supervision.

Intermediate Holding Company Requirements. The Federal Reserve requires a FBO with $50 billion or more in U.S. non-branch assets to establish an intermediate holding company (“IHC”) over its U.S. banking and nonbanking subsidiaries. These IHCs must meet the same risk-based capital, capital planning, and leverage standards applicable to U.S. BHCs with $50 billion or more in total assets.

The Treasury states that the threshold for compliance with stress testing requirements should be raised from the current $50 billion level to match the application of the proposed revisions to the enhanced prudential standards. Resolution planning and liquidity standards should also emphasize the degree to which home country regulations are comparable to regulations applied to U.S. BHCs.

TLAC Rule. The Treasury recommends the Federal Reserve consider recalibration of the internal TLAC requirement. The Federal Reserve should consider the foreign parent’s ability to provide capital and liquidity resources to the foreign organization’s IHC, provided arrangements are made with home country supervisors for deploying unallocated TLAC from the parent, among other factors.

Improving the Volcker Rule
Section 619 of the Dodd-Frank Act prohibits insured depository institutions from engaging in proprietary trading or sponsoring or investing in, and certain relationships with, hedge funds and private equity funds. The rule is complex and has created uncertainty. The Treasury’s recommendations are designed to reduce the scope and complexity of the Volcker Rule and allow banks to more easily hedge their risks and engage in market-making activities.

During the Senate Banking Committee hearing on June 22, 2017, Federal Reserve Governor Powell stated that the Federal Reserve has a “significant amount of freedom” to make changes to how the Volcker Rule is implemented and enforced and is currently assessing whether the Volcker Rule “most efficiently achieves its policy objectives.” For instance, changes to the definition of “trading account” could alter the magnitude of supervision. The OCC also appears to be actively considering how it may implement changes without legislation. Similar regulations were also adopted by the SEC, CFTC, and FDIC pursuant to BHC Act, Section 13, and changes may need to be coordinated among all five of these agencies.

Improve Regulatory Coordination. Currently, five separate regulators are responsible for implementing the Volcker Rule, and in some cases, two or more agencies have responsibility for
a single entity, including BHCs and their bank and nonbank subsidiaries, which results in fragmentation and confusion. Agencies should ensure that their guidance and enforcement is consistent and coordinated.

Clarify and Simplify the Proprietary Trading Prohibition and Exemptions. The Volcker Rule’s definition of “proprietary trading” involves three tests, one of which has generated undue complexity. The “purpose test” requires a banking entity to determine whether a trade was made principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging such a position. Regulators developed a rebuttable presumption that any position held for fewer than 60 days constitutes proprietary trading, which replaces a problem of subjectivity with overbreadth.

The Report states that the Volcker Rule’s market-making exemption also has problems. Specifically, a bank’s market-making inventory must not exceed Expected Near Term Demand of the bank’s customers and counterparties. Forecasting demands and the rule’s detailed planning requirements create considerable uncertainty with regard to the market-making exemption. Regulators should provide flexibility when determining Expected Near Term Demand such that banks can focus on anticipated changes in the market that could increase demand for illiquid securities, not just predicting future demand based on past patterns. For over-the-counter derivatives, regulators should focus on making sure that banks appropriately hedge their positions.

Although the Volcker Rule exempts risk-mitigating hedging transactions, the Treasury states that the compliance program and documentation requirements are overly burdensome. For instance, banks should not be required to maintain ongoing calibration of a hedge over time and maintain documentation of the specific assets and risks being hedged. Rather, a bank should only be required to monitor risks as part of its standard practices and should be responsible for taking action to mitigate material new risks.

Volcker Rule compliance involves extensive compliance programs, trading metrics collection and reporting requirements. These requirements become progressively more stringent as the bank’s size and involvement in covered activities, especially trading, increase. However, the Treasury believes that banks with less than $10 billion in assets should be exempt from the rule. Moreover, banks should be given greater flexibility to tailor compliance programs to particular activities and the risk profile of such activities. The Treasury states that the regulators should eliminate metrics banks are required to collect that are unnecessary for effective supervision.

The Treasury believes that changes to the covered fund provisions can greatly assist in formation of venture and other capital. First, the definition of covered funds is too broad and goes beyond private equity and hedge funds. Moreover, the current approach involves a highly technical, fact-specific legal analysis to determine whether the fund would be deemed an investment company under the Investment Company Act.

The CFPB
The Dodd-Frank Act established the CFPB as the primary federal regulator of consumer financial products and services. The Dodd-Frank Act generally gives the CFPB the exclusive authority to prescribe rules and issue orders and guidance under federal consumer financial laws, grants it enforcement and supervisory authority over most nonbanks engaged in the provision of consumer financial products and services and over insured depository institutions and insured credit unions with total assets of more than $10 billion, and requires it to establish a publicly-available consumer complaint database. As of May 2017, the CFPB has publicly announced 185 enforcement actions and issued 62 final and interim final rules.

During the June 22, 2017, Senate Banking Committee hearing, the bank regulators expressed mixed reviews of the CFPB. Acting Comptroller of the Currency Noreika stated that the CFPB was not enforcing its rules and was wasting regulatory resources, while FDIC Chairman Gruenberg stated that the CFPB was not a threat to bank regulatory functions.

The Report states that the CFPB is unaccountable and has unduly broad regulatory powers, and its approach to enforcement and rulemaking has hindered access to credit, limited innovation, and imposed undue compliance burdens, particularly on small institutions. The Treasury recommends the following reforms to address these issues:

Adequate Notice of CFPB Interpretations. The Treasury recommends that the CFPB issue rules or guidance before bringing enforcement actions in areas where guidance is lacking or its
position departs from historical interpretations of law. It should adopt regulations that clearly delineate its interpretations of the “unfair, deceptive, or abusive acts and practices” ("UDAAP") standard and should only seek monetary sanctions in cases when a regulated entity has notice that its conduct was unlawful.

The CFPB's no-action letter policy has been hampered by the strict standards that must be met prior to consideration of a no-action letter request. To make the policy more useful, the Report states that the CFPB should:

- Expand the scope of the policy beyond “new” products;
- Require a consumer benefit, but not a “substantial” consumer benefit;
- Address a broader number of UDAAP questions; and
- Revisit the requirement that applicants share proprietary data with the CFPB.

**Procedural Reforms to Curb Excessive and Abusive Investigations and Enforcement Actions.** The Report also states that the CFPB should bring enforcement actions in federal district court rather than use administrative proceedings because of the added procedural protections in federal district court. Moreover, it should promulgate regulations specifying binding criteria it will use when deciding whether to bring an action in federal court or an administrative law judge.

The Report supports reform of the CFPB's use of CIDs. Specifically, the CFPB should adopt guidance to ensure that all CIDs conform with the standards outlined in *CFPB v. Accrediting Council for Independent Colleges and Schools*, No. 1:15-cv-01838 (D.C. Cir. Apr. 21, 2017). The CFPB should also adopt policies that ensure that an appeal of a CID remains confidential, if requested.

**Expanding Retrospective Review.** The Treasury recommends that the CFPB review its regulations at least every 10 years to identify and eliminate regulations that are outdated or unnecessary. This review should include an opportunity for public comment on regulations that are outdated, unnecessary, or unduly burdensome. This would be consistent with the Economic Growth and Regulatory Paperwork Reduction Act of 1996 applicable to the Federal Reserve, FDIC, and OCC.

**Residential Mortgage Lending**

After examining continuing tight residential mortgage lending conditions, the Treasury found that:

- The regulatory regime disproportionately discourages private capital from taking mortgage credit risk. Instead, the current regulations encourage lenders to channel loans through federal insurance or guarantee programs, or Fannie Mae or Freddie Mac;
- Regulatory requirements have significantly and unnecessarily tightened credit for new mortgage originations, denying many qualified Americans access to mortgages;
- Increased regulatory requirements have significantly increased the cost of origination and servicing activities, which, when passed on to borrowers in the form of higher mortgage rates or more rigid underwriting requirements, have decreased the number of Americans that can qualify for mortgages;
- Some regulatory regimes or approaches are viewed by industry participants as lacking transparency and mutual accountability, thus creating uncertainty and risk-aversion among lenders in serving certain market and client segments; and
- Capital, liquidity, and other prudential standards, in combination with a wide range of capital market regulations, have inhibited both private originate-to-hold lenders as well as lenders focused on mortgage originations and secondary sales through private-label securitization market.

The Report's recommendations for regulatory reform of the mortgage origination process, mortgage servicing standards, and private sector secondary market activities that advance the Core Principles include:

**Mortgage Origination.** The Treasury recommends that the CFPB revise its Qualified Mortgage Rule by ultimately phasing out the exemption from the Qualified Mortgage Rule for loans eligible for purchase by Fannie Mae or Freddie Mac called the Qualified Mortgage Patch. Instead, all market participants should be subject to the same Qualified Mortgage Rule requirements, even if some criterion is deemed to fall outside the exiting framework. Appendix Q of the Qualified Mortgage
Rule should be simplified and the CFPB should release clearer guidance for its use that eliminates prescriptive or rigid requirements. The $103,000 loan threshold for application of the three percentage points and fees cap also should be increased. The Report states that the Small Creditor Qualified Mortgage loan threshold of $2 billion should be increased to between $5 and $10 billion. Clear written guidance from the CFPB through rulemaking subject to public notice and comment and/or the publication of FAQs is needed for the Truth in Lending Act’s and Real Estate Settlement Procedures Act’s Integrated Disclosure rules, and the CFPB should consider a more streamlined waiver for the mandatory waiting periods. Additionally, the CFPB should allow creditors to cure errors in a loan file within a reasonable period after the loan closing. Greater flexibility and accountability, particularly when errors are discovered postclosing, and clear standards that clarify the CFPB’s enforcement priorities under the Loan Originator Compensation Rule are needed.

Finally, the CFPB should delay the implementation of Home Mortgage Disclosure Act reporting requirements until borrower privacy is adequately addressed and the industry is better positioned to implement the new requirements.

Mortgage Servicing. The Report also states that the CFPB should place a moratorium on additional mortgage servicing rules and prudential regulators should better coordinate regulations and examinations, which could help to decrease costs and increase mortgage availability.

Private Sector Secondary Market Activity. The Treasury recommends that the CFPB should clarify assignee liability for secondary market investors related to errors in the origination process when such errors were not apparent on the face of the disclosure statement and are not asserted as a defense. Prudential bank regulators should review the regulatory framework for risk-weighting applicable to securitizations in order to better align the framework with the risk of the asset and with international standards for securitized products. The Treasury further states that the SEC should amend its Regulation AB II, “Asset-Backed Securities Disclosure and Registration Final Rule,” as it applies to registered securitizations to reduce the number of required reporting fields.37

Leveraged Lending
The Treasury recommends that the Interagency Guidance on Leverage Lending (Mar. 31, 2013) issued by the OCC, Federal Reserve, and FDIC be reissued for public comment. Additionally, banks should be encouraged to incorporate a clear set of metrics when underwriting leveraged loans, instead of relying on the 6x leverage ratio discussed in the Guidance.

Small Business Lending
The Report states that high due diligence and loan review costs as well as increased regulatory scrutiny and compliance costs for small business loans make such loans less attractive for lenders than loans to larger businesses. As such, small loans’ underwriting costs can be disproportionately large compared to the returns on small business loans. These costs ultimately affect the cost and availability of small business credit. The Treasury's recommendations in this area focus on reducing the regulatory burden on those institutions making small business loans, including:

- Reducing regulations and reconsidering guidance on real estate collateral; and
- Addressing the calibration of the supplemental leverage ratio for lines of credit to small and midsized businesses.

CONCLUSIONS
The Report recommends significant regulatory relief for depository institutions. However, the current political environment and opposition to changing the Dodd-Frank Act and related regulations may make most recommendations requiring amending or repealing certain aspects of the Dodd-Frank Act unlikely in the near term. Even recommendations that can be addressed administratively are expected to receive significant political scrutiny. For example, Senator Elizabeth Warren cautioned the bank regulators at the June 22, 2017, Senate Banking Committee hearing, “All of you, at the banking regulatory agencies, have a lot of power whether to hold the line on financial rules or to make [a] wish come true for giant banks.”38 Bipartisan and regulatory support does exist for some right-sizing of rules applicable to smaller institutions.

The Federal Reserve, OCC, and the FDIC generally appear sympathetic to the Treasury's recommendations, particularly with respect to the recommendations regarding the Volcker Rule, the CFPB, and the “systemically important financial institution” asset threshold. Ten years after the financial crisis and seven
years after the enactment of the Dodd-Frank Act, experience with regulatory reforms adopted in response to the financial crisis and slow economic growth make recalibration important.

The Report’s emphasis on consistent, practical, predictable, and transparent regulation is significant and informs the regulatory agencies’ views and actions, especially as new regulators are appointed. Similarly, the Acting Comptroller of the Currency’s June 22, 2017, testimony to the Senate Banking Committee emphasized ending regulators’ “conflicting messages and inconsistent interpretations.” The Report also considers international standards and how to rationalize these with the U.S. system, which is very different from those of most countries represented on the Basel Committee. While seeking economic growth as a result of better regulation, the Treasury “endorses rigorous procedures and accountability for the regulation of Depository Institutions.”

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ENDNOTES

1 82 Fed. Reg. 9965 (Feb. 8, 2017). The Core Principles are: (i) empower American to make independent, informed financial decisions, save for retirement, and build individual wealth; (ii) prevent taxpayer bailouts; (iii) foster economic growth and markets through regulatory impact analysis addressing systemic risk and market failures; (iv) enable American companies to be competitive with foreign firms; (v) advance American interests in international financial regulatory matters; (vi) make regulation efficient, effective, and appropriately tailored; and (vii) restore public accountability within Federal financial regulatory agencies and rationalize the financial regulatory framework.

2 The Treasury Secretary is required to consult the heads of the member agencies of the Financial Stability Oversight Council (“FSOC”). In addition to Treasury, the FSOC member agencies include the Board of Governors of the Federal Reserve System (“Federal Reserve”), the Office of the Comptroller of the Currency (“OCC”), the Consumer Financial Protection Bureau, the Securities and Exchange Commission (“SEC”), the Federal Deposit Insurance Corporation (“FDIC”), the Commodity Futures Trading Commission (“CFTC”), the Federal Housing Finance Agency, the National Credit Union Administration.


4 Id. at 10.


8 Prior to the Dodd-Frank Act, the Federal Reserve applied certain international capital guidelines only to larger, “internationally active” organizations.

9 This threshold was raised from $500 million to $1 billion pursuant to Public Law 113-250 and revisions to the Federal Reserve’s Small Bank Holding Company Policy adopted in 72 Fed. Reg. 20153 (Apr. 15, 2015).


13 See FDIC Quarterly Bank Profile, Fourth Quarter 2016 (Feb. 28, 2017).


15 FASB Accounting Standard Update 2016-13, “Financial Instruments – Credit Losses (Topic 326)” (June 16, 2016) effective for SEC reporting companies for fiscal years beginning after December 15, 2019, and over the next two years for others.


20 See American Association of Bank Directors to Janet Yellen, Federal Reserve Chairwoman (Jan. 28, 2016).


23 See Section 3(b) of Executive Order 12866.

24 12 C.F.R. §243.3.

25 See Federal Reserve Regulation K, §211.21(o).

26 Federal Reserve Bank of New York, Primary Dealers.


28 Dodd-Frank Act, Section 165 and Federal Reserve Regulation YY, §252.153.

29 Codified as Bank Holding Company Act (“BHC Act”), Section 13. The SEC and the Federal bank regulatory agencies jointly adopted regulations required by BHC Act, Section 13. The CFTC separately adopted similar regulations. See, for example, Federal Reserve Regulation VV. BHC Act, Section 13 and its implementing regulations are called the “Volcker Rule.”


32 12 C.F.R. § 248.3(b)(2).

33 12 C.F.R. § 248 Subpart D; 12 C.F.R. § 248 Appendix A and Appendix B.

34 12 C.F.R. § 248.10(b) and 12 U.S.C. § 1851(h)(2).


36 See Brian Cheung, “Banking regulators brainstorm opportunities for Volcker, threshold reform,” SNL (Jun. 22, 2017). The President has announced that the current FDIC Chairman will be succeeded by former House Financial Services Committee counsel Jim Clinger, when the current Chairman's term ends in November 2017.
