First take A publication of PwC's financial services regulatory practice

June 22, 2017

Ten key points from Treasury's first financial regulation report

On June 12, the Treasury Department released its highly anticipated first report (Report) on financial regulation in response to President Trump's February Executive Order (EO).[1] The Report analyzes requirements that apply to the depository system (i.e., banks, savings, associations, and credit unions) against the Administration's "Core Principles"[2] and makes recommendations to streamline and rationalize post-crisis regulations that have cast a wider-than-desired net over the financial system.

The recommendations were largely unsurprising and although they closely aligned to industry "wish lists," they did not represent a large scale rollback of the Dodd-Frank Act as suggested in some Administration rhetoric. Several of the recommendations also have corresponding provisions in the Financial CHOICE Act of 2017 (CHOICE Act) that recently passed the House of Representatives, which we have previously said will not pass the Senate. However, many of the provisions in both the legislation and the Report can be directly enacted by the regulatory agencies. This sentiment was confirmed on June 22 as regulators from the Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) testified before the Senate Banking Committee that they have leeway to change regulations that their agencies administer. The regulators did not fully endorse the Report, but they did indicate support for reviewing regulation on small banks and requirements for stress testing, resolution planning, and the Volcker Rule.

The relatively limited recommendations in the Report indicate that this Administration has realized what the regulatory agencies and industry already knew – the core post-crisis regulatory framework is here to stay. However, our prediction that targeted changes to financial services regulation will come from changing the referees (i.e., regulators) still stands.[3] That being said, the following ten points outline our expectations for potential results from Treasury's recommendations:

1. **Relief for community and mid-size banks.** In our view, some of the most likely recommendations to be enacted are those that roll back Dodd-Frank Act requirements for small and mid-size institutions.[4] Regulators have already started to take action to ease requirements for smaller banks (e.g., providing the option to streamline their next resolution plan filing),[5] and we expect this trend to continue. While regulators can make piecemeal changes to regulations, significant action to exempt smaller banks will have to take a legislative route. For example, an act of Congress would be needed to implement the regulatory "off-ramp" included in both the CHOICE Act and the Report that would exempt well-capitalized banks (i.e., those with a 10% leverage ratio) from the Dodd-Frank Act Stress Test (DFAST), Comprehensive Capital Analysis and Review (CCAR), Volcker Rule requirements, and other prudential standards. Though community bank relief is an area with clear bipartisan support, such reforms are unlikely to garner enough Democratic votes to pass the Senate. Further, while a 10% leverage ratio could be appealing to smaller institutions, it is not a practical alternative for the largest firms.

2. **A tailored approach to regulation.** Another recommendation in the Report that would favor mid-size banks is raising the $50 billion threshold for application of enhanced prudential standards (EPS). While there are clear signs of bipartisan agreement on this issue, we do not think it extends far enough to raise the threshold across all requirements. The Report further recommends tailoring regulations to banks of different sizes, including the largest banks. For example, the Report suggests basing the threshold requiring Foreign Banking Organizations (FBOs) comply with US regulations on their US rather than global footprint, and that the Liquidity Coverage Ratio (LCR) only be applied to G-SIBs. We do not expect Congress to act to change these thresholds, but do expect regulators to remove certain requirements for smaller banks and tailor requirements for larger banks to risk and complexity rather than just size.

3. **Power to the Treasury.** Previous regulatory rationalization attempts have focused on combining or eliminating agencies, which can be a hard sell in Congress. The Report tries to get around this difficulty by recommending instead that the Financial Stability Oversight Council (FSOC) be given the authority to appoint a lead regulator on any issue on which multiple agencies have conflicting or overlapping jurisdiction.[6] This recommendation would give Treasury a larger role in setting regulatory direction, but is likely to be vigorously opposed by regulators, especially the larger agencies like the Fed and Securities and Exchange Commission (SEC). Further, Congress would need to grant FSOC the necessary authority and ultimately amend the agencies' statutory responsibilities – neither of which are likely. Nevertheless, we expect FSOC to become a vehicle for coordinating regulators to streamline existing regulations.

4. **The Volcker Rule will survive.** Unlike the CHOICE Act, the Report does not seek to repeal the Volcker Rule. Instead, it proposes significant changes to the statute, regulations, and supervision aimed at restoring market liquidity and reducing the cost and burden of compliance on banks. The most impactful recommendations include smaller bank exemptions, simplification of the proprietary trading definition and a reduction in compliance program burdens. The Report also puts forward a proposal that would enable well-capitalized banks to potentially "opt out of the Volcker Rule" entirely, though they would remain subject to trader mandates, supervision, and examinations.

   While the recommendations made by the Report would provide some flexibility to larger banks, they are not as impactful as they would have been if they were made earlier as banks have already implemented Volcker processes and controls. In any case, there are signs that change is a high possibility – in the June 22 Senate Banking Committee hearing on regulation, the three witnesses from the Fed, FDIC, and OCC all endorsed streamlining the rule. Specifically, Governor Powell said the Fed is looking at the possibility of changing the definition of a trading account and a covered fund as well as exempting smaller banks from rule requirements.

5. **CFPB in the crosshairs**. It is no surprise that the Report includes a number of suggested reforms to the Consumer Financial Protection Bureau's (CFPB's) authority and independence. Like the CHOICE Act, the Report recommends that the CFPB director be removable at will, but – unlike the CHOICE Act – the Report also left the door open to restructuring the CFPB as a multi-member commission. Such proposals to change the CFPB's structure have been through Congress several times before, but it now appears that Republicans are in favor of waiting out the ongoing court case on the CFPB's governance structure,[7] or CFPB Director Richard Cordray's term, which ends in July 2018.[8]

   The fact that both the Report and the CHOICE Act leave the CFPB intact indicates recognition that removing an agency designed to protect consumers from unfair financial practices would be politically unpopular. Even so, any moves to limit the CFPB will not make it through Congress as long as Democratic support is needed in the Senate. Therefore, although only Congress could remove the CFPB's authority to conduct examinations (as recommended in both the CHOICE Act and Treasury Report), we believe simply waiting Cordray out would give the new director broad discretion to reduce CFPB examinations and modify enforcement practices.

6. **You say you want a resolution.** Many of the recommended changes to the resolution planning process are already underway,[9] and as such we expect a number of the recommendations made in the Report to be adopted. Both the Report and the CHOICE Act call for biennial submissions, a six month deadline for feedback, and more specific guidance that is subject to a public notice and comment period. Although the Fed and FDIC (collectively, Agencies) have consistently taken longer than six months to provide feedback, they have provided several extensions over the last year and have recently endorsed a change to less frequent submissions. The Agencies have also already responded to calls for greater transparency by publicizing a framework and specific guidance for the largest banks' resolution plans.[10] Further, the Report contains a recommendation that the Agencies

have already enacted for mid-sized and regional banks – the institutions only need to submit material changes to their resolution plans rather than entirely new plans each year.[11] The only recommendation that is unlikely to be implemented is the removal of the FDIC from the resolution plan process, which would take Congressional action. Also, even if the FDIC were removed from the process, the FDIC has its own bank level resolution planning rule under Dodd-Frank that would remain unaffected.

7. **Echoes of Tarullo.** On the topic of capital stress testing, the Report largely reflects recommendations that former Fed Governor Daniel Tarullo made during his farewell speech in April.[12] The Report's suggestions for increasing transparency exceed what Tarullo proposed by calling for a notice and comment period for models and scenarios, which Tarullo and other Fed Governors have argued would reduce the Fed's flexibility when designing its annual stress test and could lead banks to "game" the tests. The Report further recommends removing the countercyclical capital conservation buffer and integrating CCAR with the risk-based capital regime without increasing post-stress capital requirements. Notably, these goals could be accomplished by implementing the stress capital buffer (SCB) that Tarullo introduced in September 2016 and reemphasized in his farewell speech.[13] Fed Chair Janet Yellen has stated to Congress that the Fed is continuing to pursue the SCB, and the Report could offer Fed officials political cover to do so.

   The Report also recommends eliminating mid-cycle stress testing and the Fed's adverse scenario. These changes would require Congressional action, which makes it unlikely to happen in the near-term. Many of the Report's other recommendations can be implemented by the Fed, but any amendments to the Capital Plan and Stress Test Rules would require a notice and comment period. Because we expect major changes to also wait for the Vice Chair for Supervision to be appointed, any significant changes to stress testing will likely not take effect until at least the 2019 cycle.

8. **Getting in line with Basel.** Consistent with the Administration's principle to enable American companies to be competitive with foreign firms in domestic and foreign markets, the Report proposes scaling back some of the "gold plated" provisions that US regulators have added to Basel Committee standards. For larger banks, such provisions include a short-term wholesale funding factor in the US G-SIB risk-based surcharge's calculation;[14] the minimum debt requirement included in the Total Loss Absorbing Capacity (TLAC) ratio;[15] and the Enhanced Supplementary Leverage Ratio (eSLR).[16] The TLAC and eSLR rules were recently finalized, and therefore will take a long time to modify. However, recommended changes for smaller institutions, such as amending the Collins Amendment[17] and exempting community banks from most of the Basel III standards, could be adopted more readily. All of these changes apart from the Collins Amendment can be made without legislation, but would have to go through the regulatory agencies' review and comment process. More generally, the Report supports finalizing the Basel Committee's effort to establish a global risk-based capital floor, especially as such a floor is perceived to bring foreign banks closer to parity with the leverage requirements for US firms.[18]

9. **Cybersecurity harmonization**. The Report calls for greater coordination between federal and state agencies on cybersecurity regulation and specifically recommends that the Financial and Banking Information Infrastructure Committee (FBIIC), a public sector body consisting of 18 federal and state regulators, lead efforts to reduce cybersecurity regulatory overlap by harmonizing requirements and examinations.[19]

   The call for regulatory harmonization is welcome news to the industry, who have had to deal with a rapidly growing amount of cybersecurity regulations containing at times uneven or vague requirements.[20] Having the 18 regulators that make up the FBIIC sit down together is a good first step, and we expect to see some coordination of examinations and harmonization of governance and controls requirements. However, some state regulators are unlikely to relax existing requirements that are more onerous than federal regulation.[21]

10. **What's next?** The three remaining reports will be released after Labor Day. Additionally, Treasury will release reports (in response to other EOs) on the Orderly Liquidation Authority and the FSOC designation process after October.

    In the meantime, we expect the regulatory agencies to move forward with their review of Treasury's recommendations while Congress remains focused on debates over healthcare, tax reform, and the debt ceiling. Before the agencies can make significant changes, however, the Administration will need to move more quickly to fill the numerous remaining vacancies in leadership positions.

Endnotes

1. The report issued on June 12 was the first of four reports Treasury will issue in response to the EO. The remaining reports will cover capital markets, the asset management and insurance industries, and non-bank financial institutions.
2. The Core Principles from the EO are: 1. Empower independent financial decisions; 2. Prevent taxpayer-funded bailouts; 3. Foster economic growth through rigorous impact analysis; 4. Enable American companies to compete with foreign firms; 5. Advance American interests in international meetings; 6. Efficient, effective, tailored regulation; and 7. Publicly accountable and rationalized regulation.
3. See PwC's *First takes, Ten key points from Donald Trump's victory* (November 2016) and *Ten key points from Trump's first 100 days* (April 2017).
4. The Report defines community banks as having less than $10 billion in assets, mid-sized banks as having $10-50 billion in assets, and regional banks as non-Global Systemically Important Banks (G-SIBs) with greater than $50 billion in assets.
5. The streamlined option allows regional banks to submit only content that has changed from their previous filings and to incorporate their 2015 plans to reference material that has not changed for their December 2017 filing. See PwC's *First take, Ten key points from regional bank resolution feedback and FBO guidance* (March 2017).
6. The Report does not clarify if the FSOC would hold a vote to determine the lead regulator or if the Treasury Secretary, as Chair, would be able to make the appointment on his own.
7. Last year, a federal court ruled the CFPB's governance structure unconstitutional because its single director can only be removed "for cause" from his five-year term, but that ruling was vacated when the full court agreed to hear the case on appeal. Oral arguments for the appeal were heard on May 24th.
8. There is speculation that Cordray will leave his position early in order to run for Governor in Ohio in 2018.
9. Last April, the Agencies provided some relief by delaying the largest US banks next filing date by one year to July 2017. Then in June, the Agencies issued guidance allowing 84 December-filing banks with limited US operations to file "reduced content" plans for the next three years, beginning on December 31, 2016. See PwC's *First take: Five key points from the Agencies' FBO resolution plan announcements* (June 2016). In August 2016, the Agencies delayed the filing date for the remaining 38 December-filing institutions (36 banks and two insurance companies) to December 2017. Finally, this March, the Agencies delayed the four large FBOs' next resolution plan deadline to July 2018 (their last plans were filed in 2015).
10. Guidance was released along with the Agencies' feedback to the largest US banks' 2015 resolution plans. See PwC's *First take, Agencies' resolution plan feedback* (April 2016).
11. See note 5.
12. See PwC's *First take, Ten key points from Governor Tarullo's farewell speech* (April 2017).
13. See PwC's *First take, Ten key points from Governor Tarullo's speech on stress testing and the Fed's NPR* (October 2016).
14. Under the US rule, G-SIBs must calculate their capital charge under the Basel methodology and the US-specific methodology and are subject to the higher of the two. The US methodology incorporates a charge against a G-SIB's reliance on short-term wholesale funding.
15. See PwC's *First take, Ten key points from the Fed's final rule on TLAC* (December 2016).
16. The eSLR is not a Basel standard and goes beyond Basel's 3% Tier 1 leverage ratio, disadvantaging the largest US banks versus their foreign peers. See PwC's *First take, Ten key points about the new US supplementary leverage ratio* (April 2014).
17. The Collins Amendment requires that "generally applicable" risk-based capital requirements serve as a floor for banking institutions' regulatory capital.
18. Discussion between the US and EU on an output floor fell through last week. The US pushed for a 75% output floor while the EU requested a 70% limit.
19. The FBIIC is chaired by Treasury and consists of the Commodity Futures Trading Commission (CFTC), Conference of State Bank Supervisors, CFPB, FDIC, Fed, National Association of Insurance Commissioners, OCC, and SEC, among other federal and state regulators.
20. Last December, the New York Department of Financial Services (DFS) released the most in-depth cybersecurity regulation to date, and other states, such as California and Colorado, have followed with their own cyber regulations. Federal regulators, including the OCC, Fed, and FDIC, the CFTC, and FinCEN have all released or proposed cyber regulations within the past year. For additional information, see PwC's Financial crimes observer, Cyber: New approach from New York regulator (January 2017), PwC's *Financial crimes observer, Cyber: Banking regulators weigh in* (November 2016), PwC's *Financial crimes observer, Cyber: Regulators putting market infrastructure to the test* (September 2016), and the New York Law Journal's *A Meeting of the Minds: Emerging Regulation and the Convergence of Cyber and Fraud* (March 2017).
21. Because these requirements do not contradict existing federal regulation, they are not subject to preemption. An example of such requirements include the New York Department of Financial Services annual certification and incident reporting requirements.

Additional information

For additional information about PwC's Financial Services Regulatory Practice
and how we can help you, please contact:

Dan Ryan
Financial Services Advisory Leader
646 471 8488
daniel.ryan@pwc.com
@DanRyanWallSt

Mike Alix
Financial Services Advisory Risk Leader
646 471 3724
michael.alix@pwc.com

Adam Gilbert
Financial Services Advisory Regulatory Leader
646 471 5806
adam.gilbert@pwc.com

Roberto Rodriguez
Financial Services Advisory Director
646 471 2604
roberto.j.rodriguez@pwc.com

Contributing authors: Lance Auer, Josh Horowitz, Adam Weisz, Sharon Haas,
Jason Ashenfelter, and Doug Bloom.

To learn more about financial services regulation from
your iPad or iPhone, click here to download PwC's Regulatory Navigator App
from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs