Tinkering, tailoring and drama

The Trump administration has been working through its plan to reduce regulatory burdens for financial institutions – with various consequences

The new administration began with a roar of regulatory rollback enthusiasm amidst calls for the repeal of the Dodd-Frank Act. This early zeal for regulatory overhaul was fed by the issuance of several executive orders; however, the first year of the Trump administration has been marked by incremental, rather than radical, change. Most of the change has been brought about by the banking agencies rather than through congressional action. The modest tweaks to and tinkering with regulations adopted as a reaction to the financial crisis that have been proposed by the banking agencies should be viewed as an inevitable and natural return to a more balanced regulatory approach, which would not have been possible in the immediate aftermath of the crisis.

As discussed below, continued change is anticipated over the next several years as regulation is rationalised. But incremental change may be augmented by more dramatic developments as congressional deals are reached and the agencies, under new leadership, have time to develop more significant changes.

Executive orders

Some executive orders focused on relatively simplistic regulatory reduction measures, such as announcing that departments and agencies would be required to issue two deregulatory actions for each new regulatory action that imposes costs (the so-called two-fer order). Another order required each agency to identify a regulatory reform officer whose mission would be to identify outdated, unnecessary or ineffective regulations for elimination. More substantively, the guiding principles for regulatory policy were included in an executive order titled Core Principles for Regulating the United States Financial System. This order required the US Treasury Department to identify regulations inconsistent with the principles. To do so, to date, the Treasury has released three reports recommending changes with respect to the regulation of depository system, the capital markets, including the commodities and derivatives markets, and the asset management and insurance industries. A fourth report regarding recommendations

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Early calls for the repeal of the Dodd-Frank Act and a comprehensive regulatory rollback have given way to a measured approach to regulatory burden relief. In the absence of legislation, the regulatory agencies have advanced various proposals focused on scaling rules based on the size and complexity of institutions, relieving institutions of duplicative and outdated requirements, and providing guidance to bank boards of directors and senior management on key matters. These incremental changes over time are likely to have a significant cumulative effect and relieve the compliance burdens for many financial institutions, especially smaller banks.

for the regulation of non-bank financial institutions, financial technology and financial innovation is expected this year. The reports reflect discussions with many stakeholders, including the regulatory agencies, and include actions that already were underway at the banking agencies, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission.

Treasury report on depository institutions

With respect to depository institutions, the first report suggests that Congress take steps to reduce duplication and overlap in regulation. Consistent with many proposed legislative measures, the report recommends tailoring of bank capital and liquidity requirements based on the size and complexity of depository institutions. This would include, for example, modifying the threshold at which banks become subject to the enhanced prudential standards mandated by the Dodd-Frank Act, the systemic importance threshold, and the threshold for resolution plan requirements. The report also addresses changes to various Basel requirements, including the liquidity coverage ratio (LCR) and the supplementary leverage ratio (SLR). The report recommends significant changes to the comprehensive capital analysis and review (CCAR) and Dodd-Frank Act stress tests (DFAST) process. The report also suggests modifications to, but not the elimination of, the Volcker Rule.

Banking agency proposals

The Volcker Rule

The banking agencies, having undergone leadership transitions, and also having the benefit of some distance from the financial crisis, already were proposing changes in these areas. For example, the Federal Reserve provided temporary relief for foreign banking organisations (FBOs) with respect to investments in certain foreign private funds, as well as guidance regarding applications for extensions of the seeding period when a banking entity organises a covered fund. In August 2017, the Office of the Comptroller of the Currency (OCC) released a notice and request for comment on Volcker Rule modifications that sought views on narrowing the types of banking entities subject to the rule based on the scope of their activities as well as their size. Comment was requested on the rule's application to foreign funds and on ways to simplify the covered fund definition. Comment also was requested regarding the ways in which exclusions and exemptions related to the proprietary trading ban could be simplified. While Volcker Rule modifications, which must be coordinated among the five agencies tasked with oversight and enforcement of the rule, may come slowly, the changes addressed by both the OCC request for comment and the Treasury report would significantly reduce compliance burdens for financial institutions.

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Stress testing

The Fed also has taken actions to relieve the burdens associated with CCAR, DFAST and other stress testing requirements. In January 2017, the Fed adopted a rule tailoring the capital plan requirements for large and noncomplex firms. In December 2017, it adopted revisions to certain aspects of CCAR and DFAST. Also in December, the agency articulated seven principles for stress testing and, consistent with these principles, sought comments on proposals to increase modelling transparency and to modify its framework on economic scenarios. Most recently, the Fed requested comment on call report requirements to reduce data collection burdens and reporting frequency and to eliminate outdated and repetitive requirements.

Bank boards and supervisory guidance

The Fed also has issued various proposals clarifying governance and supervisory expectations, as well as risk management expectations for bank holding companies (BHCs). An August 2017 proposal outlines the attributes for an effective board of directors of a BHC and attempts to reallocate responsibilities as between a bank's board of directors and its management. The proposed guidance, which is applicable to domestic bank and savings and loan holding companies with total consolidated assets in excess of $50 billion, would make clear that a board's principal responsibilities are to set a direction regarding strategy and risk tolerance, effectively reversing a trend toward requiring greater board attention to specific management issues. For example, matters requiring immediate attention and matters requiring attention would principally be directed to bank management and would be addressed to boards of directors only to the extent that there are significant identified governance failings. In January 2018, the Fed proposed guidance for comment that would clarify risk management supervisory expectations for the same large financial institutions as the boards of director proposal mentioned above and for the US operations of large FBOs. The proposal outlines guidelines applicable to, and responsibilities of, bank senior management and business line heads, as well as guidelines for independent risk management and controls.

Legislative initiatives

Even in the absence of regulatory burden relief legislation, it is reasonable to anticipate that the banking agencies will continue to focus on completing their work in the areas identified above, including amending the Volcker Rule, simplifying stress tests, ensuring greater transparency regarding supervisory expectations and relieving bank boards of some burdens. Agency heads also have discussed the need for recalibration of the leverage ratio, adjustment of the LCR, and simplification of the loss absorbency requirements. Although legislative efforts have thus far failed to advance as a result of the highly partisan congressional environment, there now appears to be some bipartisan consensus forming for a Senate measure called

the Economic Growth, Regulatory Relief and Consumer Protection Act. The Senate bill addresses many of the issues discussed above with a focus on tailoring, rather than rolling back, regulation. For example, the bill would:

- modify the threshold for enhanced prudential standards and set the standard at $250 billion in total consolidated assets, with the ability for the Fed to impose modified standards on institutions between $100 billion and $250 billion in assets;
- raise the threshold to $50 billion in assets for BHCs to maintain risk committees;
- simplify further stress test requirements;
- modify the SLR calculation for custodial banks;
- include municipal securities as high-quality liquid assets for LCR purposes;
- modify the threshold for prior notice of larger acquisitions to BHCs with $250 billion or more in assets;
- provide significant relief for community banks; and
- exempt banking entities with less than $10 billion in total assets and total trading assets and liabilities that comprise no more than five percent of total assets from the application of the Volcker Rule.

Drama at the CFPB

In contrast to the incremental changes in other areas, changes in the consumer area, and particularly at the Consumer Financial Protection Bureau (CFPB), have been more dramatic. Congress overturned a CFPB rule that would have limited the use of arbitration as an alternative to class action litigation. The subsequent resignation by CFPB director Cordray to pursue political ambitions in his home state of Ohio set off a court battle as to his legitimate successor, his hand-picked replacement or President Trump's interim appointee, Mick Mulvaney. So far, the courts have sided with Mulvaney and he has set about a process of reviewing CFPB policies and practices from the ground up, including abandoning a number of initiatives, revisiting others and requesting public comment on what is likely to turn out to be virtually all aspects of the CFPB's operations. This change is not surprising considering the CFPB's single director structure, but it appears likely that going forward the consumer activist zeal exhibited by the original CFPB may be a thing of the past.

The fiduciary standard

In other areas, the same dynamic of scaling back regulation rather than repealing Dodd-Frank Act mandated rules can be observed. The Dodd-Frank Act called for the SEC to study the need for, and to propose, a heightened standard of care for broker-dealers advising retail accounts. The SEC completed its study, but did not propose a rule. The Department of Labor (DoL) proposed and adopted in April 2016 a highly controversial fiduciary standard for broker-dealers providing investment advice to retail retirement accounts. This rule has been the subject of intense debate and litigation challenges. While many suspected that the new administration would repeal the DoL fiduciary rule, instead a presidential directive required that the DoL consider the potential disruptions caused by the rule within the retirement services industry and the potential harm to investors arising from a reduction of access to varied retirement products. The rule, which had been scheduled to become effective in April 2017 was delayed and become partially applicable in June 2017. In the meantime, the SEC appears to be working on a best interest standard that would be applicable to retail, not just retirement, accounts.

Other Dodd-Frank Act related measures

Legislative proposals, like the Financial CHOICE Act, which would have repealed various Dodd-Frank Act related regulations, including those requiring risk retention in securitisation transactions, the rules prohibiting certain incentive-based compensation measures, the pay ratio disclosures rules, and the conflicts minerals and resource extraction issuer rules, have not garnered sufficient bipartisan support to advance. The SEC led by a new chair has noted that it does not intend to focus resources on addressing Dodd-Frank Act rulemaking mandates other than those related to security-based swaps and a handful of executive compensation related measures. Instead, the SEC will focus on measures designed to promote capital formation, including reducing the burdens associated with becoming a US public company. From an enforcement perspective, the SEC has recommitted itself to its mission of protecting individual investors. To that end, the SEC intends to focus on micro-cap fraud, the sale of unsuitable or complex products to retail investors, fee disclosures and related matters. The SEC also announced the creation of a cyber unit to combat cyber-related threats, including schemes involving cryptocurrencies.

Conclusion

While incremental change may not be as exciting as a regulatory overhaul, all of the tinkering with and tailoring of regulations that has emerged following the financial crisis will reduce regulatory burdens for financial institutions without destabilising the financial sector. Most commentators and regulators agree that some of the regulatory framework that resulted from the Dodd-Frank Act and Basel III, while imperfect, has led to greater stability and reduced systemic risk, albeit at a cost.

Similarly, most financial institutions, which spent the immediate years following the financial crisis and the enactment of the Dodd-Frank Act restructuring their businesses and operations, eliminating certain business lines, and implementing costly compliance policies and procedures and the accompanying technology systems to allow for reporting and supervision, may be reluctant to advocate wholesale repeal of many Dodd-Frank era rules. Tinkering and tailoring may, then, continue to be the guiding principles for the next few years.

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