May 22, 2018

Financial Regulatory Reform Legislation Proceeds through Congress

On May 22, 2018, the U.S. House of Representatives ("House") passed S. 2155, the "Economic Growth, Regulatory Relief, and Consumer Protection Act." The bill was passed on a bipartisan basis with a vote of 258-159. The bill was previously passed by the U.S. Senate ("Senate") on March 14, 2018.[1] Now that identical legislation has passed both houses of Congress, the bill will go to President Trump for his signature, which is expected in the coming days. Once effective, the new law will provide modest regulatory relief to regional and community banks.

The House had sought to incorporate additional financial regulatory reforms into the Senate bill. However, proponents of the Senate bill were concerned that any changes to the language would upset a carefully assembled, filibuster-proof Senate coalition. News reports indicate that, in exchange for agreeing that the House would vote on S. 2155 without amendments, House Financial Services Committee Chairman Jeb Hensarling (R-TX) was assured that the Senate will consider additional financial regulatory reform measures which passed the House earlier this Congress. Despite the bicameral compromise, it is unclear whether there is enough time in the legislative calendar to bring up additional financial regulatory reform legislation. Nevertheless, the enactment of S. 2155 represents a significant victory for financial regulatory reform advocates.

Perhaps the most significant aspect of the new law is the relaxation of thresholds for the application of certain regulatory requirements. Under the new law, institutions with total consolidated assets of less than $250 billion may no longer be subject to some of the more onerous requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), as discussed below. In addition, even in cases where the new law does not explicitly apply a higher threshold for a particular regulatory requirement, this legislative change could encourage federal banking agencies to reconsider other thresholds across the bank regulatory framework. These reforms may ease the pathway for the further growth and consolidation of regional banks, which previously may have strategically limited their growth to avoid triggering enhanced regulatory requirements.

The following is a summary of some of the principal components of the new law.

- **Enhanced Prudential Standards.** Section 165 of the Dodd-Frank Act imposed various enhanced prudential standards (EPS) on bank holding companies[2] with $50 billion or more in total consolidated assets, including, among other things, resolution planning requirements, short term debt limits, and contingent capital requirements. Under the new law, the Board of Governors of the Federal Reserve System ("Federal Reserve") will be required to apply certain EPS only to bank holding companies with $250 billion in total consolidated assets, and to any bank holding companies, regardless of asset size, that have been identified as global systemically important bank holding companies. In addition, if the Federal Reserve makes a

[1] The text of the bill is available here.

[2] For purposes of Title I of the Dodd-Frank Act, the term "bank holding company" includes foreign banks or companies that are treated as bank holding companies for purposes of the Bank Holding Company Act of 1956 ("BHC Act"), pursuant to Section 8(a) of the International Banking Act of 1978, as amended.

determination that application of such EPS is appropriate to prevent or mitigate risks to the financial stability of the United States or to promote the safety and soundness of the institution, the Federal Reserve will also be authorized (though not required) to apply such EPS to bank holding companies with total consolidated assets of $100 billion or more.[3] In addition to relaxing the threshold for application of EPS, the new law will require the Federal Reserve to tailor EPS on an individual basis or by category. Such tailoring was previously optional.[4]

  - **Clarification for Foreign Banks.** A provision in the new law clarifies that the relaxation of the thresholds for the application of EPS does not affect the legal effect of the Federal Reserve's current EPS rules as applied to foreign banking organizations with total consolidated assets of $100 billion or more. As a result, the Federal Reserve need not make a financial stability or safety and soundness determination in order for the current EPS rules to continue to apply to foreign banking organizations. In addition, the new law clarifies that nothing contained therein limits the Federal Reserve's authority to (a) require the establishment of an intermediate holding company by such foreign banking organizations; (b) implement enhanced prudential standards with respect to such foreign banking organizations; or (c) tailor the regulation of such foreign banking organizations.

- **Stress Testing.** The new law will modify the Dodd-Frank Act stress testing requirements. First, the threshold for bank holding companies to become subject to an annual supervisory stress test conducted by the Federal Reserve will be raised to $250 billion, and such stress tests will only be conducted under two scenarios (baseline and severely adverse) rather than the previous three (baseline, adverse, and severely adverse). Bank holding companies with total consolidated assets of $100 billion or more, but less than $250 billion, will be subject to supervisory stress tests conducted by the Federal Reserve on a periodic basis. Second, the new law will set the threshold for requiring financial companies and bank holding companies to conduct company-run stress tests at $250 billion, and will only require such company-run stress tests to be conducted on a periodic basis (rather than semi-annually or annually, as applicable). Finally, such company-run stress tests will need to be conducted only under two scenarios (baseline and severely adverse) rather than the previous three (baseline, adverse, and severely adverse).

- **Small Bank Holding Companies.** Under the Federal Reserve's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement ("Policy Statement"), certain small bank holding companies and savings and loan holding companies are permitted to operate with higher levels of debt than are generally permitted for larger institutions. The new law will raise the threshold of the applicability of the Policy Statement, from bank holding companies and savings and loan holding companies with consolidated assets of less than $1 billion, to such institutions that have consolidated assets of less than $3 billion.

[3] Under the Dodd-Frank Act, the Federal Reserve was also required to issue regulations that require bank holding companies that are publicly traded and have total consolidated assets of $10 billion or more to establish a risk committee of the board of directors that has certain attributes. The new law raises the threshold for this requirement to publicly traded bank holding companies with $50 billion or more. Under the new law, the Federal Reserve will be permitted, but not required, to establish a risk committee requirement for publicly traded bank holding companies with less than $50 billion in total consolidated assets.

[4] Upon enactment of the new law, bank holding companies and foreign banking organizations with less than $100 billion in total consolidated assets will be immediately exempt from certain EPS requirements. While the language of the new law technically only provides this immediate relief to bank holding companies, we believe it should be interpreted to also apply with respect to foreign banking organizations. For bank holding companies and foreign banking organizations with total consolidated assets of $100 billion or more but less than $250 billion, the effective date of the new law with respect to application of EPS is 18 months after the date of enactment of the new law. During the interim period between enactment of the new law and the effective date of the EPS provisions, the Federal Reserve is authorized to exempt any bank holding company with total consolidated assets of less than $250 billion from application of EPS.

- **Custodial Banks.** The new law will provide relief from capital regulations for large custodial banks. The new law will require capital regulations to specify that funds of a custodial bank deposited with a central bank will not be taken into account when such custodial bank calculates the supplementary leverage ratio. A "custodial bank" is any depository institution holding company predominately engaged in custody, safekeeping, and asset-servicing activities, including any insured depository institution subsidiary of such holding company.

- **Treatment of Municipal Obligations under LCR Final Rule.** For purposes of the Liquidity Coverage Ratio (LCR) final rule,[5] the new law will direct the federal banking agencies to treat municipal obligations as level 2B liquid assets if they are (a) liquid and readily-marketable; and (b) investment grade.

- **Volcker Rule.** The new law will make two changes to Section 13 of the BHC Act (*i.e.*, the "Volcker Rule"). First, the new law exempts from the Volcker Rule insured depository institutions that (i) have $10 billion or less in total consolidated assets; and (ii) have total trading assets and trading liabilities that are less than 5% of total consolidated assets. Second, the new law will amend the asset management exemption. Previously, one of the conditions for reliance on the asset management exemption was that the banking entity does not share the same name as the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes. Under the new law, a banking entity that is not an insured depository institution, a company that controls an insured depository institution, or a company that is treated as a bank holding company and is an investment adviser to a hedge fund or private equity fund can have the same name as the hedge fund or private equity fund (subject to certain conditions) and still rely on the asset management exemption.

- **High Volatility Commercial Real Estate Exposures.** The new law will provide clarity to the capital treatment of acquisition, development, and construction (ADC) loans characterized as high volatility commercial real estate (HVCRE) exposures. This section of the new law will address concerns expressed by banks and industry groups regarding the complexity of the current HVCRE exposure rule and its uncertain application.[6]

- **Community Bank Leverage Ratio.** The new law will require the federal banking agencies to simplify the capital requirements for qualifying community banks (*i.e.*, insured depository institutions with total consolidated assets of less than $10 billion and the requisite risk profile). Specifically, qualifying community banks that exceed a leverage ratio set by the federal banking agencies (required to be set between 8% and 10%) will be deemed to be in compliance with all other generally applicable leverage capital and risk-based capital requirements.

- **Mortgage Lending.** Several provisions are included in the new law which would provide regulatory relief for certain aspects of mortgage lending. These revisions to the Dodd-Frank Act and other laws are centered on smaller banks and credit unions. Taken together, the changes are modest and will not have a wide-ranging impact on the mortgage industry. For example, the new law will provide a safe harbor from ability-to-repay (ATR) requirements for residential mortgage loans to consumers that are originated and retained in portfolio by an insured depository institution or insured credit union that has, together with its affiliates, less than $10 billion in total consolidated assets. The new law also changes Home Mortgage Disclosure Act (HMDA) reporting requirements by relieving small banks and credit unions from reporting loan-level data if such

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[5] See 79 Fed. Reg. 61439 (October 10, 2014).

[6] In November 2017, the House passed H.R. 2148, which included nearly identical language. For more information on H.R. 2148, please see our client alert.

institutions make fewer than 500 open-end mortgage loans or 500 closed-end mortgage loans in a previous year. Transitional loan officer licensing, an issue that the mortgage industry has been advocating on for years, is codified in the new law. Moreover, there are certain amendments regarding the TILA-RESPA Integrated Disclosure (TRID) rule that will benefit consumers. Also, consumers stand to benefit from the restatement of the Protecting Tenants in Foreclosure Act.

- **Expanded Examination Cycle.** The new law will extend the examination cycle to 18 months for banks that are well managed and well capitalized, and have total assets of less than $3 billion. The previous threshold for the expanded examination cycle was set at less than $1 billion.
- **Treatment of Small Federal Savings Associations.** The new law will permit federal savings associations with total consolidated assets of $20 billion or less to have the same rights and privileges as national banks, without converting to a national bank charter.

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