How Is Regulatory Reform Likely to Proceed?

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Proposed massive legislative change is unlikely; more moderate reforms floated by Treasury are better bets.

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By George Madison, Michael Borden, Michael Lewis and Cameron Gibbs, Contributors

Editor's note: Co-author George Madison served as general counsel of the U.S. Treasury Department from 2009-2012. Co-author Michael Borden was senior counsel to the House Financial Services Committee from 2007 to 2012.

The great debate over the shape of post-crisis financial regulation is in full swing, with the House of Representatives, federal financial regulators, and the Trump administration all having staked out their positions on reforming the financial services industry.

Their positions include:

House Republicans' plan to repeal the Dodd-Frank Act and replace it with the Financial Choice Act.
The U.S. Treasury's June 2017 report, "A Financial System that Creates Economic Opportunities: Banks and Credit Unions," which provides a detailed roadmap for broad regulatory relief using the Dodd-Frank framework.

"Modest" changes to Dodd-Frank recommended by Federal Reserve Chair Janet Yellen in a speech last month. CFOs should pay close attention to these developments.

After seven years of Dodd-Frank, some reform to the regulatory framework established during the crisis is appropriate. It is normal to revisit legislation enacted following major upheavals in the financial system; this occurred after the Great Depression and the savings-and-loan crisis of the 1980s.

While the Treasury report and Chair Yellen's remarks offer many possibilities for legislative and regulatory reform, legislative change resembling the Choice Act or the Treasury report is unlikely. More likely are some regulatory reforms advocated in the Treasury report that reduce burdens but preserve U.S. financial regulators' focus on safety and soundness. The likelihood of regulatory relief rises as the Senate confirms President Trump's nominees to head each federal financial agency.

This article briefly contrasts the Federal Reserve's appetite for regulatory change (as expressed by Yellen) with the Treasury report's ambitious agenda, before closing with our view on the likelihood of legislative and regulatory change.

Yellen: Adjustments to a Functioning Framework

Yellen's recent speech, at the Kansas City Federal Reserve's Jackson Hole Economic Policy Symposium, was called "Financial Stability a Decade after the Onset of the Crisis." It revealed a modest view toward reform compared with the Treasury report, which is the best available proxy for the Trump administration's current views. But while President Trump has vowed to "do a big number on Dodd-Frank," the Treasury report does not go as far.

The basis for Yellen advocating modest change is the success of post-crisis reforms still in place. She spent considerable time reviewing the benefits, including large banks' stronger capital positions, reduced dependencies on short-term funding, and enhanced resolvability. She stated that the problem of too-big-to-fail is now "significantly reduce[d]" thanks to annual stress testing, greater leverage requirements, and other enhanced regulations for large firms.

Yellen also addressed concerns of overregulation and recognized the need for reflection. She instructed policymakers to monitor "areas for improvement and unexpected side effects." Without committing the Federal Reserve to specific reform, she suggested that the Volcker Rule could be simplified, and that access to mortgages and small business loans could improve.

These suggestions should not be considered endorsements of major reform. Rather, Yellen emphasized that any change must be modest while preserving large banks' safety and resilience. As long as she serves as chair, CFOs should expect the Fed to focus on targeted regulatory reforms that reduce burdens for small and medium-sized institutions and community banks, rather than systemically important financial institutions (SIFIs).

Even with Yellen's term expiring next February, institutions hoping for significant relief from the Fed should temper short-term expectations.

Treasury: Practical Recommendations or Wish List?

The Treasury Department's June 2017 report is a detailed set of recommendations to reduce the burdens of many post-crisis reforms lauded by Yellen. Though less ambitious than the Choice Act, which would repeal Dodd-Frank, the report principally examines how financial regulation can be simplified.

Many Treasury recommendations seem inconsistent with Yellen's vision. Critics call the recommendations an industry "wish list" that ignores lessons learned from the 2007-2009 crisis. They include:

- Granting the Financial Stability Oversight Council (FSOC) authority to coordinate and appoint a lead regulator when multiple agencies have overlapping jurisdiction over an institution.
- Raising the current $50 billion asset threshold for applying enhanced prudential standards and stress testing requirements to bank holding companies.
- Creating a "regulatory off-ramp" from Dodd-Frank's capital, liquidity, and other requirements for depository institutions and their holding companies that maintain adequate levels of capital. Treasury suggested a 10% non-risk-weighted leverage ratio.

Yet some Treasury recommendations are consistent with Yellen's recommendations. Both suggest modifying the Volcker Rule rather than repealing it outright, which the Choice Act would do. Both also discuss simplifying regulation of small, non-systemic financial institutions, while the Choice Act focuses on broad-based deregulation.

Notably absent from the 149-page report are recommendations on reforming bank culture, a factor some consider a significant cause of the last financial crisis. Given the enormous bank fines post-crisis, one would expect the report to recommend changes to improve bank culture. Yet the word "culture" is unmentioned, suggesting that it is not a priority for the Trump administration.

Likelihood of Regulatory and Legislative Reform

Treasury Secretary Mnuchin estimates that 70% to 80% of Treasury's recommendations are achievable through independent regulatory reform, with the remainder requiring legislative action. The odds of regulatory reform increase as President Trump continues appointing new players to key positions at the federal financial agencies.

Earlier this month, the Senate Banking Committee advanced the nominations of Randal Quarles and Joseph Otting to fill key posts at the Federal Reserve and Office of the Comptroller of the Currency, respectively. Testimony from each during a July 2017 Senate Banking Committee hearing, including Quarles' suggestion to simplify the Volcker Rule, was consistent with Treasury recommendations.

Quarles' position accords with that of acting Comptroller Keith Noreika, who in August began soliciting public comment for rewriting the Volcker Rule. And while FDIC Chairman Martin Gruenberg and Federal Reserve Vice Chair Stanley Fischer criticized the report, Gruenberg's term ends this November and Fischer will step down in October. Both departures allow President Trump to fill important positions with individuals committed to financial reform.

Simplifying the Volcker Rule therefore appears likely. But doing so requires coordination among the Federal Reserve, OCC, FDIC, SEC, and CFTC — a challenging task given that each agency is in transition.

Otting, who could replace Noreika within weeks, may opt for a slower timeline than Noreika if confirmed. While Gruenberg and Yellen both support simplification, the FDIC and Federal Reserve may be hesitant given Gruenberg's upcoming departure and Yellen's uncertain future. It could thus take time before the industry sees formal change.

Other regulatory reform through the agencies is also possible. This may include simplified capital requirements, such as an emphasis on standardized rather than advanced approaches to calculating risk-weighted assets. The Treasury also recommends narrowing the liquidity coverage ratio to apply only to internationally active — a change that is possible through coordinated rulemaking among the OCC, Federal Reserve, and FDIC.

And while removing the FDIC from the annual living will process requires amending Dodd-Frank, changing the process to a two-year cycle only requires coordinated action between the FDIC and Federal Reserve.

Legislative reform has less momentum. Many Treasury recommendations requiring legislative action may be too bold in their current form, including broad application of the regulatory off-ramp and the increased asset thresholds mentioned above. Successful reform, if any, is likely to be bipartisan. If the two parties can come together, the greatest beneficiaries will likely be smaller firms. Volcker Rule relief for institutions falling below a $10 billion asset threshold would be a priority.

Forthcoming Treasury Reports

The June 2017 Treasury report is the first of four reports, with the next three slated to address asset management, capital markets, and non-bank financial institutions (including financial technology and innovation). Press reports suggest these will be released sometime after the Federal Housing Finance Agency's 2017 Annual Housing Report examining the performance of Fannie Mae and Freddie Mac, and FSOC's 2017 Annual Report addressing SIFI designations, among other matters.

Given the volume of Treasury recommendations in its first report — and thus the potential volume forthcoming — the financial industry may be entering a lengthy period of deregulation. The changes could significantly affect the capital markets, both for financial institutions and for other companies seeking to fulfill capital and liquidity needs.

George Madison and Michael Borden are partners at Sidley Austin LLP. Michael Lewis and Cameron Gibbs, who also contributed to this article, are associates at the firm. During the financial crisis, Madison served as general counsel of the U.S. Treasury Department (2009-2012), and Borden served as senior counsel to the U.S. House Financial Services Committee (2007-2012).

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