How The Federal Reserve Might Approach Regulatory Reform

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For the better part of a decade, the Federal Reserve has worked with other regulators to build out the post-crisis regulatory framework. This framework, centered on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, was designed to address the causes of the financial crisis. Some observers have said that certain Dodd-Frank reforms made banks and the financial system more resilient than they were pre-crisis. Others have argued that parts of Dodd-Frank have created burdens for financial institutions, without creating equally valuable benefits for the strength of those institutions or the broader financial system. Now, with a change in presidential administration, as well as new personnel at the financial regulatory agencies, regulators have an opportunity to tailor and recalibrate the post-crisis framework, and address any unintended consequences of legislation enacted in the heat of the crisis. With the relatively recent confirmations of Randal K. Quarles to the board of governors of the Federal Reserve System as vice chairman for supervision, and of Jerome H. Powell as the chairman of the board of governors, it is a good time to consider how the Federal Reserve might approach some key proposals for regulatory reform.

Regulatory reform can occur either through legislative change or the rulemaking process (or both). The Federal Reserve's regulatory objectives, of course, are constrained by the applicable statutes. Moreover, the Trump administration's views influence both parts of that process. An executive order from February 2017 directed the U.S. Department of the Treasury to determine which existing policies should be retained, reformed or eliminated based on certain listed principles for regulatory reform. The Treasury Department has published a series of reports, beginning in June of 2017, that serve as the most detailed articulation of this administration's positions on regulatory reform.

The first report, titled "A Financial System That Creates Economic Opportunities: Banks and Credit Unions," contains the core banking-related proposals. Subsequent reports deal with capital markets, asset management and insurance, designations of systemic importance by the Financial Stability Oversight Council, and, most recently, Dodd-Frank's orderly liquidation authority, or OLA. The banking report proposes a combination of changes, some of which would require legislation, while others could be made through regulation. In contrast, the changes proposed in the OLA report, which proposes creating a new system for resolving insolvent systemically important financial institutions, would generally require legislation.

There are two competing regulatory reform bills in Congress. The Financial Choice Act in the House is a comprehensive rewrite of the financial regulatory framework that could be characterized as "repealing and replacing" major parts of Dodd-Frank. It does not have sufficient support in the Senate, and thus is unlikely to be enacted in its current form. In contrast, the Senate bill, known as the Economic Growth, Regulatory Relief, and Consumer Protection Act, represents a bipartisan compromise capable of passing the Senate. However, it lacks support from House leadership. Thus, the Senate bill may form the basis for any regulatory reform legislation that reaches the president's desk, but is unlikely to be enacted without significant changes. As drafted, the Senate bill incorporates several proposals from the Treasury report, but largely preserves the core of Dodd-Frank. This article is based upon the amendment to the bill offered by Sen. Mike Crapo, R-Idaho, on March 7, 2018. However, as with all pending legislation, the text of the final bill is key.

During the past year, President Donald Trump has reshaped the leadership of many of the banking regulators, including the Federal Reserve. Randal Quarles was confirmed by the Senate in mid-2017 as vice chairman for supervision, a position created by Dodd-Frank, but which had never previously been filled.[1] The new chairman, Jerome Powell, was a governor on the Federal Reserve Board appointed by President Barack Obama. He now replaces former chairwoman Janet Yellen. Furthermore, the previous general counsel of the Federal Reserve, Scott Alvarez, recently retired, and was replaced by Mark Van Der Weide. Van Der Weide is a long-time veteran of the Federal Reserve, and played a central role in helping to draft and implement Dodd-Frank.

The Federal Reserve's leadership has made clear that, while it supports certain changes to Dodd-Frank and the related regulations, it broadly supports the post-crisis regulatory framework. Testifying before the House Financial Services Committee on Feb. 27, Powell indicated that there are several "primary pillars of post-crisis financial regulation that [the Federal Reserve wants] to strengthen and protect ... high-risk based capital, high liquidity, stress testing and resolution." Quarles offered a similar sentiment in a Jan. 19 speech to the American Bar Association Banking Law Committee Annual Meeting. While supporting the Federal Reserve working to "improve the efficiency, transparency, and simplicity of regulation," he noted that the United States "undoubtedly [has] a stronger and more resilient financial system due in significant part to the gains from [the] core [post-crisis] reforms." Accordingly, the most likely path for the Federal Reserve is to support incremental reforms and tailoring of the post-crisis regulatory structure: attempting to decrease burdens on banks, where possible, but while still maintaining the core benefits of Dodd-Frank to the economy and financial system.

With that background, we have chosen to focus on the Federal Reserve's anticipated views of five areas where reform is possible, although there may be others. These are: (1) simplification of the Volcker Rule, (2) revision and simplification of the capital rules, (3) reducing the burden associated with the application of enhanced prudential standards to financial institutions and the "living will" requirements, (4) reducing the burden associated with stress testing, and (5) changes to OLA. The extent of likely reform in these areas varies, with some proposals requiring changes to both legislation and regulations.

Both Powell and Quarles have proposed clarification and simplification of the Volcker Rule. In a March 5 speech to the Institute of International Bankers Annual Washington Conference, Quarles indicated that the regulators collectively responsible for implementing the Volcker Rule have begun preparing revisions to the rule. There are three parts of the Volcker Rule to which changes seem especially likely, although additional changes may also result from the interagency process.

First, the Senate bill proposes an exemption from the Volcker Rule for community banks — any institution that neither has nor is controlled by a company that has more than $10 billion in total consolidated assets, and meets certain other criteria. This is what Treasury requested in its banking report, and we believe this proposal has Federal Reserve support. Second, Federal Reserve leadership has discussed making the definitions of key Volcker Rule terms more clear and transparent. This includes how the core activities covered by the Volcker Rule are defined, as well as the applicable exceptions. For example, the Federal Reserve has specifically noted the need for greater clarity regarding how a banking entity should measure the reasonably expected near-term demands of clients, customers or counterparties (RENT'D). This is important for banking entities that engage in exempted market-making activities under the Volcker Rule's proprietary trading restrictions. Third, Federal Reserve leadership has discussed the need to refine how the Volcker Rule applies to trading and investment activities of foreign banking organizations occurring outside the United States. There is widespread agreement that the Volcker Rule has, perhaps unintentionally, had a significant extraterritorial effect.

Powell and Quarles similarly agree that the capital rules, while effective in ensuring the strength of banking institutions, could stand to be simplified. In particular, regulators are concerned that the capital rules excessively burden community and regional banks. The Senate bill provides relief from certain aspects of the capital rules for banks and holding companies with less than $10 billion in total consolidated assets, and which meet certain other regulatory criteria. This generally conforms with what Treasury recommended. Second, the Federal Reserve, in conjunction with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp., has put a number of revisions to the capital rules out for comment.[2] These proposed revisions simplify how certain types of assets are treated. The proposed rule is expected to be finalized in the relatively near future.

There is also support for reducing the burdens imposed by prudential requirements under Dodd-Frank. Prudential requirements include the enhanced prudential standards, as well as resolution planning, more commonly known as "living wills." The enhanced prudential standards currently apply to large and mid-sized banks — those with $50 billion or more in total assets. The Senate bill raises the threshold over which banks become subject to the enhanced prudential standards from $50 billion to $250 billion, while permitting the Federal Reserve to apply the standards to banks with $100 billion or more in assets, when required by either safety and soundness or systemic concerns. The bill also leaves the existing rules intact for foreign banking organizations with assets of $100 billion or more, but permits the Federal Reserve to tailor or supplement the rules. This conforms with the Treasury report as to U.S. banks, but falls short of the relief suggested for foreign banking organizations. Further, under current law and regulation, banks are required to submit a new living will every year. Recently, though, the Federal Reserve has granted one-year extensions to certain domestic firms and foreign banks with limited U.S. operations. The Federal Reserve is likely to support a more permanent two-year planning cycle as a way of reducing the burden associated with resolution planning, as highlighted by Quarles in his speech to the ABA Banking Law Committee.

Similarly, there is broad support for reducing the burdens associated with a third prudential requirement — stress testing. Both Powell and Quarles have emphasized that the stress testing regime should be simplified and made more transparent. As part of this initiative, the Federal Reserve has invited public comment on enhanced disclosure of the models used in stress testing.[3] This will likely be followed by changes to the rules implementing the stress testing requirements. The Senate bill formally eliminates the Dodd-Frank Act stress tests (company-run stress tests, also known as DFAST), as well as the comprehensive capital analysis and review (Federal Reserve-run stress tests, also known as CCAR) for institutions with less than $250 billion in total assets. It creates a separate requirement that the Federal Reserve perform "supervisory" stress testing on institutions with total assets between $100 billion and $250 billion (likely similar to CCAR), and grants the Federal Reserve the discretion to impose prudential standards on those same institutions. The bill also grants greater discretion regarding the frequency of testing, and reduces the number of required stress testing scenarios from three to two. This exceeds the Treasury's recommendations as to DFAST, but is consistent with what the Treasury suggested for CCAR.

Lastly, there has been some public discussion concerning replacement of OLA with a new chapter of the Bankruptcy Code. This would eliminate the burden placed on the government to provide bridge financing in the event that a SIFI were to fail (although OLA does contain mechanisms to recover that cost from the private sector). However, this reform, unlike the others discussed, is less likely to be implemented. First, replacing OLA with a chapter of the Bankruptcy Code would require an act of Congress, and there does not appear to be support for this outside of the House. Equally important, regulators are broadly in favor of OLA, which would have been a helpful tool in the midst of the financial crisis, although they recognize that there is potential room for improvement. As such, we do not believe this reform is likely to be enacted.

Reforms to Dodd-Frank are likely, though the final nature of such reforms will not be clear until the House and Senate reach a compromise. Nonetheless, banks and holding companies should be aware that there is currently momentum favoring regulatory reform, and that the Federal Reserve has, even absent legislation, shown interest in making incremental changes within the limits of their powers.

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[1] Former Gov. Daniel Tarullo acted as the board's point person for supervision, though he never received Senate confirmation to formally serve as vice chairman for supervision.

[2] 82 Fed. Reg. 49984 (Oct. 27, 2017).

[3] 82 Fed. Reg. 59547 (Dec. 15, 2017).