Trump Treasury's Blueprint for Financial Regulation in the Banking World

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New leadership creates new opportunities. And this Fall, after more than seven years of criticism, Republicans look poised to begin revising some of the financial rules imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Sen. Mike Crapo, the new chairman of the Senate Banking Committee, has said that reducing federal financial regulations is his committee's top priority and that the U.S. Treasury Department's review of financial rules, a directive from President Trump, gives the issue momentum. His committee is set to confirm nominees who will have the opportunity to implement these changes.

In June, the Treasury Department issued a report, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions," that serves as the most detailed roadmap yet on how Congress and the federal financial regulators might revisit the post-financial crisis regulatory framework. It is a blueprint primarily for loosening regulation of the U.S. banking sector. The recommendations in the Treasury report represent a wide-ranging rethinking of the rules governing banks and credit unions. If the recommendations were implemented in full or in large part, they would meaningfully reduce costs and other burdens for many institutions. Critics say they would negatively impact the financial system.

The Treasury report is the first in a series of four that are being issued pursuant to Executive Order 13772 on Core Principles for Regulating the U.S. Financial System. The other three will address capital markets, the asset management and insurance industries, and non-bank financial institutions and financial technology and innovation. Separately, the Treasury Department intends to issue recommendations regarding "orderly liquidation authority" established under Title II of Dodd-Frank as well as recommendations regarding the process by which the Financial Stability Oversight Council (FSOC) of financial regulators designates non-bank financial institutions and financial market utilities for heightened supervision. In addition to reviewing published data and other materials, the Treasury Department consulted with a range of stakeholders in preparing its report, including all of the major federal financial regulators and a large number of industry participants, trade groups, consumer advocacy groups, academics and others. However, a clear majority of those stakeholders were industry participants and the trade groups representing them.

It is appropriate to reconsider and adjust regulations enacted in the midst of a crisis. If history is any guide, that is a normal and healthy process. It occurred, for example, after the Great Depression and after the savings and loan crisis of the 1980s. Regulatory frameworks adopted shortly after a crisis tend to be overly inclusive, reactionary, and draconian. Dodd-Frank was adopted in 2010—many would say that it was not even clear at that time whether the financial crisis had ended. Banking regulators and the industry now have more and better data to use in evaluating the effectiveness of financial reforms implemented after the crisis. Even though

Dodd-Frank has helped stabilize the financial system in many ways, it is no surprise that it has also led to unintended consequences.

Importantly, the Treasury report seems to acknowledge this nuance. It does not fundamentally reject the overall Dodd-Frank framework. It calls for broad regulatory relief but does not "repeal and replace" Dodd-Frank as the most recent version of the bill known as the Financial CHOICE Act that passed the U.S. House of Representatives would do. For example, while the Financial CHOICE Act would repeal the Volcker Rule, which generally prohibits banks and their affiliates from engaging in proprietary trading or investing in hedge funds or private equity funds, the Treasury report recommends a series of specific improvements that would address industry concerns while preserving the basic goal of the Volcker Rule to protect deposit-taking and loan-making functions that banks serve by segregating them from other financial activities.

Of course, a repeal of the Volcker Rule, which was created by §619 of Dodd-Frank, would require legislative action. It could not be accomplished solely by changes to the final regulations that implemented it. This raises the question of just how many of the more than 100 recommendations in the Treasury report can be adopted without both houses of Congress passing a statute. Secretary Mnuchin has estimated that about 70-80 percent of the recommendations could be adopted through a combination of rulemaking and guidance from the regulators together with executive actions. The remainder would appear to require Congress to act. Sen. Crapo has said that he wants to pass financial reform legislation no later than early next year.

Some of the most significant recommendations appear to fall into the category of requiring legislative action. Examples of these include:

• broadening FSOC's mandate to address areas where regulators have conflicting or overlapping jurisdiction;

• making the currently semi-independent Office of Financial Research a part of the Treasury Department, with the Treasury Department controlling its budget and the tenure of its director;

• raising the $50 billion asset threshold for application of enhanced prudential standards and certain stress testing requirements to bank holding companies;

• raising the $10 billion asset threshold mandating company-run stress tests for bank holding companies to $50 billion;

• removing the Federal Deposit Insurance Corporation (FDIC) from the resolution planning (so-called "living will") process;

• creating a regulatory "off-ramp" from all capital and liquidity requirements and many other aspects of Dodd-Frank for depository institutions and their holding companies that maintain a sufficiently high level of capital, such as a 10 percent non-risk-weighted leverage ratio;

• exempting from the Volcker Rule those banking entities with fewer than $10 billion in total assets and banking entities with more than $10 billion in total assets that also have a limited amount of trading assets;

• potentially removing from the definition of proprietary trading in the Volcker Rule the "purpose test," which requires a subjective judgment about the intent of a trade; and

• most of the fundamental structural changes to the Consumer Financial Protection Bureau (CFPB) recommended in the Treasury report, such as making the director removable at will by the President, funding the CFPB through the Congressional appropriations process, and repealing the CFPB's supervisory authority.

Many other important recommendations—the majority of the proposals in the report—could be implemented without legislative action once like-minded regulators are in place. Examples of these include:

• narrowing the scope of the liquidity coverage ratio to apply only to internationally active banks, with the most stringent requirements applying only to U.S. global systemically important banks, and expanding the types of assets that would qualify as high-quality liquid assets;

• implementing certain reforms to the regulatory capital rules, such as reducing reliance on the advanced approaches for calculating overall risk-based capital requirements, considering whether certain types of exposures should benefit from more appropriate risk weighting, and increasing transparency regarding operational risk capital requirements under advanced approaches;

• adjusting the calculation of the supplementary leverage ratio denominator to exclude cash on deposit with central banks, U.S. Treasury securities, and initial margin for centrally cleared derivatives, which could result in more highly leveraged banks;

• reducing some of the burdens of the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR), for example by eliminating the qualitative assessment of the capital plans for large and complex firms, reassessing some of the assumptions and models used by the Federal Reserve, and increasing transparency in the process by subjecting its stress-testing and capital planning review to public notice and comment;

• making the living will process a two-year cycle and providing clearer and more specific living will guidance;

• limiting the scope of single-counterparty credit limits to apply to institutions subject to the revised threshold for enhanced prudential standards;

• several of the recommendations for improving the regulatory engagement model, such as an interagency review of the requirements imposed on the boards of directors of financial institutions, and an assessment of the volume and nature of enforcement actions and supervisory matters requiring attention; and

• making certain changes to the Volcker Rule, such as increasing flexibility for permitted market-making activities and hedging and reducing the burdens of the compliance regime.

Statutory reform will be quite difficult; regulatory change seems more likely. Even though Sen. Crapo has said that he is committed to working with Democrats and though he has positioned himself as a possible dealmaker among senators, House conservatives, and the White House, he has yet to introduce a reform bill. And finding (any) Democrats to support some of the most ambitious reform plans will probably prove illusory. Bipartisanship seems more likely if Congress limits reforms proposals to those that benefit community banks and other small institutions—such as Volcker Rule relief for institutions below the $10 billion threshold, or raising the Federal Reserve's Small Bank Holding Company Policy Statement to $2 billion. We expect it will be more difficult to secure Democratic support for the recommendations requiring legislative action that would benefit the largest institutions or make structural changes to the CFPB, whether through the budget reconciliation process or otherwise.

The recommendations that could be implemented by the regulators alone are more likely to materialize. There have been generally positive reactions from top decision-makers at the regulators, such as Chair Janet Yellen at the Federal Reserve (who has been measured in also recognizing the benefits to the financial system from many post-crisis reforms), Vice Chairman Thomas Hoenig at the FDIC, and Acting Comptroller Keith Noreika at the Office of the Comptroller of the Currency (there has, however, been some dissent from Chairman Martin Gruenberg at the FDIC and more recently from Vice Chair Stanley Fischer at the Federal Reserve). The testimony of the President's nominees to key regulatory posts, such as Joseph Otting and Randal Quarles, also has been generally consistent with the report's recommendations. Confirmation of these nominees may accelerate implementation of the regulatory recommendations. Moreover, the regulators are already moving forward on some recommendations. For example, the OCC issued a notice soliciting comments on improving the Volcker Rule, which agreed with many of the Treasury report's recommendations. The Federal Reserve recently proposed an extension of the transitional capital treatment for certain regulatory capital deductions and risk weights in anticipation of a proposal to simplify the capital rules to reduce regulatory burden, especially for community banks. The Federal Reserve also issued a notice of proposed rulemaking that would more clearly articulate expectations for boards of directors—the Treasury report referenced in passing that boards have been weighed down by a complex and increasing set of requirements imposed following the financial crisis.

Notably missing from the report are any recommendations to improve bank culture, which some have viewed as a precipitating cause of the financial crisis. In fact, the word "culture" does not appear in the nearly 150-page report. It is astonishing that after several years of the banking regulators expressing concerns about setting the right tone—and following enforcement actions allegedly arising from problems with bank culture—the Treasury report does not address it. In the process of pursuing the administration's deregulatory agenda, perhaps this is one area that would allow for some compromise.

A well-functioning financial system is not a Republican or Democratic issue. Financial regulation should not be partisan. Meaningful compromise on these issues is possible (just look at the final vote tallies for the Gramm-Leach-Bliley Act or the Sarbanes-Oxley Act—laws enacted with virtually unanimous support). If policymakers prioritize practical solutions over partisanship this Fall, they can address the perceived errors of Dodd-Frank without undoing its sensible reforms.