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Leaked HFSC Memo Reveals Various Capital-Related Changes Expected in CHOICE Act 2.0

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A newly leaked memo outlines the changes to be made in the next version of Rep. Jeb Hensarling's CHOICE Act, including changes to the core regulatory off-ramp provision and to stress testing and capital planning requirements. The February 6 memo from Rep. Hensarling to the House Financial Services Committee leadership, which we believe comments on an interim nonpublic version of the CHOICE Act, outlines how CHOICE Act 2.0 will differ from **CHOICE Act 1.0**
. Among other changes, CHOICE Act 2.0 will make capital-related changes to CHOICE Act 1.0 by adjusting the regulatory off-ramp available for qualifying banking organizations ("QBOs") and by introducing additional changes to stress testing and capital planning requirements. (We assume that by referring to "changes," the memo intends to list additional provisions beyond those already included in CHOICE Act 1.0.) Many of these changes would impact a broad group of banking organizations, whether or not they avail themselves of the off-ramp by electing QBO treatment.

The memo indicates that, among other changes, CHOICE Act 2.0 would:

- **Eliminate the CAMELS supervisory rating-based requirement as a condition to the regulatory off-ramp.** CHOICE Act 2.0 would condition the off-ramp for QBOs solely on a 10% or higher leverage ratio requirement. CHOICE Act 2.0 does not appear to make any significant changes to the calibration of this leverage ratio requirement.
- **Change the "Capital Election Leverage Ratio Effective Date."** The memo indicates that CHOICE Act 2.0 will change the "SLR effective date" to the date of enactment of the CHOICE Act. The Federal Reserve's final rule on the supplementary leverage ratio is currently scheduled to go into effect on January 1, 2018. Although unclear, we believe that this provision refers only to the timing of when the SLR would be incorporated in the QBO election process, and not the timing of the effectiveness of the SLR rule itself.
- **Exempt QBOs from stress testing.** Under CHOICE Act 1.0, QBOs would have been exempted from CCAR and DFAST, but would have faced the possibility of discretionary supervisory stress tests. The memo states that QBOs would be exempt from "the stress tests," which must mean all stress tests, whether under CCAR or DFAST or on the basis of general supervisory authority.
- **Exempt non-QBOs from qualitative CCAR review.** The Federal Reserve recently adopted a **final rule** exempting "large and non-complex" CCAR firms from qualitative review of their capital plans. CHOICE Act 2.0 would exempt the remaining CCAR firms (i.e., those that would not otherwise qualify for exemption from stress testing altogether by virtue of being QBOs) from qualitative CCAR review. Thus, all firms remaining subject to CCAR would face only a quantitative review of their capital plans.
- **Prevent non-QBOs' stress test results from being "used to impose new regulations that have not been the subject of a public notice and comment period."** We believe this provision relates to the Stress Capital Buffer approach that Federal Reserve Governor Tarullo previewed in a **speech** last September. It is unclear if this provision is intended to prevent the Federal Reserve from even proposing the Stress Capital Buffer, or if it is intended merely to ensure that the Federal Reserve does not impose this new buffer requirement (or any other new requirement based on stress test results) using any of its powers other than the public notice-and-comment rulemaking process—for example, by imposing such requirements as a general supervisory matter or as an interim final rule, either of which

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would bypass a public notice and comment period.

- **Eliminate the mid-year company-run DFAST requirement.** DFAST would be limited to the annual supervisory stress test conducted by the Federal Reserve.
- **Change CCAR to a two-year cycle.** Currently, firms subject to CCAR are required to submit capital plans to the Federal Reserve on an annual basis, each spanning a nine-quarter planning horizon.
- **Codify the GAO's recommendations for stress test improvements.** Among other actions already addressed elsewhere in Rep. Hensarling's memo, the GAO recommended in its **November 2016 report** on the Federal Reserve's stress testing regime that the Federal Reserve:
  - work together with the FDIC and OCC to harmonize the agencies' approaches to granting extensions and exemptions from stress test requirements;
  - establish procedures for notifying companies about time frames relating to its responses to company inquiries;
  - assess—and adjust as necessary—the overall level of severity of its severely adverse scenario;
  - assess whether a single severe supervisory scenario is sufficient to inform CCAR decisions and promote the resilience of the banking system;
  - develop a process to test its proposed severely adverse scenario for procyclicality annually before finalizing and publicly releasing the supervisory scenarios; and
  - take actions to improve its ability to manage model risk and ensure that decisions based on supervisory stress test results are informed by an understanding of model risk.
- **?Direct the Federal Reserve to rely on a banking organization's planned capital distributions for purposes of both CCAR and DFAST.** Although unclear, we believe that this provision is intended to be a corollary to CHOICE Act 2.0's proposed elimination of qualitative reviews under CCAR.
- **Specify that operational risk capital charges only apply to business lines and products a banking organization continues to offer.** It is unclear what the real impact of this change would be, since when banking organizations sell assets the acquiror often assumes any related liabilities as well. However, to the extent that banking organizations continued to be required to recognize operational risk capital charges against discontinued business lines or assets, this seems a substantively logical provision. Even more notable than the substance, however, is the fact that Congress would consider legislating a specific substantive provision of the banking agencies' capital rules. This implies a potentially greater degree of Congressional involvement in the details of regulatory capital rules than ever before.

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