Regulatory Reform for Mid-Sized and Regional Banks: Where Are We at Mid-Year?

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There has been a slow start to financial regulatory reform under the Trump Administration, but the conversation is now changing in ways that are serious and thoughtful. This note highlights the key themes that we believe are important for mid-sized and regional banks in light of recent personnel announcements, the Treasury Report and responses to the Report by key regulatory principals. It also describes what we believe will happen next.

Personnel is Policy. The leadership vacuum at the top of the financial regulatory agencies has begun to be filled. Jay Clayton is now at the helm of the SEC and Christopher Giancarlo, the Acting Chair of the CFTC, will soon be confirmed as CFTC Chair. Nominations for vacant commissioner positions are expected shortly. Keith Noreika, the Acting Comptroller, has already started to make significant changes. He will be replaced by Joseph Otting once confirmed, and Jim Clinger is on track to become the FDIC Chair, replacing Martin Gruenberg by the end of 2017. We expect that Randal Quarles and Marvin Goodfriend will soon be nominated as Vice Chair for Supervision and Governor, respectively, at the Fed. As is usual with a new administration, a number of senior staff members have retired. As an example, Scott Alvarez, the long-time general counsel of the Fed, has announced his retirement and we expect that his replacement will be announced soon. See our visual resource (here) for the full suite of nominations, resignations and existing and expiring terms of principals as well as notes on changes in senior staff at the agencies. Overall, there is movement at all of these agencies, and we are no longer at stage zero. By fall, there ought to be, if not a full complement, then a working core.

Treasury Report and Regulator Principal Testimony Skews Towards Agency Action. Filling the leadership vacuum is key, since we believe that the next steps will be heavily skewed towards agency action. Treasury officials are making the point that the recommendations in the Treasury Report are weighted two to one in favor of agency action rather than statutory amendments. This weighting towards agency action is a recognition that the CHOICE Act in its current form is unlikely to be able to attract the necessary 60 votes in the Senate. While certain elements of either the CHOICE Act or other regulatory reform priorities may be enacted between now and the congressional mid-term elections, we believe they are likely to be one-off elements rather than a package reform.

The Treasury Report and the public statements of regulator principals reinforce the message that the core elements of the Dodd-Frank Act and the other post financial crisis regulatory reforms are likely to remain largely in place. Federal Reserve Chair Yellen has stated that the Treasury Report "underscores the importance of capital, liquidity, stress testing and resolution planning and having a safe and sound banking system, which are views that I and my colleagues have long espoused" and that "Treasury has set out a list of objectives for regulation

that I'm sympathetic to and endorse." Recent testimony by Governor Powell, current FDIC Chair Gruenberg and Acting Comptroller Noreika contain this same message.

There is less consensus, not surprisingly, on exactly what should be changed and how. We, however, are as far away from "doing a big number on Dodd-Frank"[1] as we are from any "Wall Street wish list." Instead, the mindset is for a recalibration of the financial regulatory framework to be more consistent with economic growth, jobs creation, reduced complexity, increased transparency and fewer regulatory overlaps.[2]

Next Steps by Regulators. Among the 97 recommendations in the Treasury Report, the regulatory priorities are not entirely clear. For the moment, the most talked about recommendations from the Treasury Report, in addition to the all-important capital and liquidity rules, are the Volcker Rule, living wills, size or risk-based tailoring, CFPB reform, improving the supervisory engagement, Community Reinvestment Act changes and examination reform. The most important next steps that could be taken by the regulators include changes to capital and liquidity rules, with a focus on the CCAR and DFAST requirements. Stay tuned for our upcoming visual memo that will examine the Treasury Report's recommendations with respect to capital, liquidity and stress testing. Treasury has already started to work with regulators, including through the FSOC, to discuss implementing the suggestions of the Treasury Report, beginning with ways to refocus the regulations implementing the Volcker Rule on the statute's core purposes. We also think that changes in BSA and AML, which are not in the Treasury Report but which both Governor Powell and Acting Comptroller Noreika mentioned in their recent Senate testimony, are an important area where new leadership at the regulators could reduce unnecessary and ineffective burdens.

Needs Congressional Action. Some key changes, however, will require or be better implemented by congressional action. These include changes to the FSOC and the CFPB, the $10 billion company-run DFAST threshold, the Durbin Amendment and the CRA. Secretary Mnuchin has made revising the CRA a high priority for Treasury.

Tailoring of Risk. There has been a deep consensus for at least the last two years that the hard-coded asset-based thresholds in the Dodd-Frank Act are not appropriate for regional, mid-sized and community banks. The challenge has been getting either Congress or the regulators to agree on how the thresholds might be changed. And, as Acting Comptroller Noreika acknowledged, difficulty also exists where a statute does not provide the agencies with "sufficient flexibility to tailor their regulations to the risk profiles of different institutions."

It seems most likely that a mix of higher asset thresholds and a new framework of risk profile evaluations will be the end result. Some changes, like raising the $10 billion company-run DFAST threshold to $50 billion, will require congressional action. Interestingly, the threshold could be raised for Title I living wills via an FSOC recommendation that would have to be accepted by the Federal Reserve and FDIC.[3] A number of other changes could be made by

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[1] *See* President Trump's comments from a January 2017 event with small business leaders at the White House, discussed in a Jan. 30, 2017 Bloomberg article (**here**).

[2] For a discussion of the future of U.S. financial regulatory reform under the Trump Administration and the need for rebalancing, see the Randy Guynn and Meg Tahyar January 2017 Oxford University Press article (**here**).

[3] *See* Dodd Frank Act § 115(a)(2).

regulations alone, such as increasing the enhanced prudential standards $50 billion threshold—an increase supported by the Treasury Report, Powell, Noreika and Gruenberg—revising the existing CCAR threshold to match the revised EPS threshold and limiting the full LCR to the U.S. G-SIBs. Limiting the applicability of the Volcker Rule may be best achieved by a mix and match approach between legislative and regulatory reform. Tailoring regulations based on an increased benchmark, either based on specified assets or more risk-based evaluations, is further supported by Powell, Gruenberg and Noreika, as evidenced from their recent Senate testimony.

CFPB Reform. A common theme from the Treasury Report, recent Senate testimony and the current version of the CHOICE Act is the need for CFPB reform. Discourse from several years ago about eliminating the CFPB has disappeared so that the range of proposals today is between those that would downgrade the CFPB so that it has no real supervisory or enforcement authority to those that would keep its powers mostly intact but require more budget control, governance accountability and transparency. Where and how this will play out involves not only Congress but the courts. In the meantime, as Representative Luetkemeyer recently noted, "CFPB Director [Cordray] and President [Trump] are kind of in a standoff, from the standpoint that neither one can really accomplish what they want to get accomplished because of the way the [CFPB] is structured and the way the law is right now. . . . What [Congress] would like to accomplish is to change the dynamic of [the CFPB] completely."

Changing the Engagement with Regulators. One of the deeper but critically important themes in the Treasury Report and the recent congressional testimony is the call to change how the regulators engage with the banking sector in the supervisory context. The Report notes that there must be "mutual accountability" and a "common understanding of responsibility" at both the regulators and banking organizations to successfully remediate any identified regulatory issues. Acting Comptroller Noreika and Chair Gruenberg also made similar points consistent with the Treasury Report's recommendation that regulators rationalize examination procedures and expand coordination efforts. As part of the recently completed EGRPRA process, they specifically noted that the agencies are "jointly reviewing the examination process, examination report format, and examination report preparation process to identify further opportunities to minimize burden, principally by rethinking traditional processes" and technology use. These agencies also plan to "review interagency guidance, such as policy statements, to update and streamline guidance."

For us, this theme is also connected to the Report's call for a re-assessment of how a bank's board of directors and supervisors interact. The Treasury Report specifically advocates for greater engagement between a board and the regulators when reviewing significant regulatory actions and complaints, and recommends that "regulators and banking organizations develop an improved approach to addressing and clearing regulatory actions." The Report also cites the dramatic increase in MRAs and MRIAs, including many that seem trivial as a matter of actual risk to safety and soundness or financial stability, the sheer number of which is overwhelming management and boards' ability to oversee management and is strangling mid-sized and regional banks' ability to grow as a result of focusing on remediation processes for an excessive number of largely trivial compliance issues.

These themes are nicely laid out in recent testimony by Greg Baer, The Clearing House Association President, in congressional testimony on how the CAMELS system, which is derived from supervisory practice and not through statute or regulation, is "hopelessly out of date" and is "punitive and arbitrary in practice." Baer specifically cited the increased consent orders and actions such as MRAs and MRIAs that result from a poor CAMELS rating also result

in an unfair blocking of M&A activity for regional and mid-size banks. Baer further noted that a board's time becomes quickly diverted from strategy or risk management to "remediating frequently immaterial compliance concerns, and engaging in frequent meetings with examiners."

Encouraging Investment in the Banking Sector. One of the hidden themes in the Treasury Report involves encouraging more investment in the banking sector, which could lead to the de-blocking of M&A activity for mid-sized and regional banks. A comprehensive assessment of the CRA and regulatory engagement-related issues such as a review of the CAMELS ratings system could eliminate the penalty box for compliance foot faults that stop M&A activity by mid-sized and regional banks for years at a time for no sound policy reason. Acting Comptroller Noreika's call to streamline the *de novo* bank chartering process by allowing deposit-taking banks to automatically obtain FDIC insurance after obtaining OCC certification could also help to unblock M&A activity among mid-sized and regional banks.

Conclusion. We remain hopeful that, even before the congressional mid-term elections, there will be some recalibration of the post financial crisis regulatory framework for mid-sized and regional banks at the regulatory level. We hope there might be some changes at the congressional level, but that is more doubtful. In either case, the extent of such relief will likely depend on a banking organization's size, complexity and risk profile. We will continue to carefully monitor this crucial topic.

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