US financial regulation

From words to action: Recent regulatory reforms in the U.S.

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Regulation

June 2018

Since Trump's arrival to the White House, the U.S. started a path to relax its financial regulation framework. The process so far has led to an important legislative change that eases regulation mainly for smaller and regional banks, but also implies some relief for the industry in general. Furthermore, regulators have embarked in a process of recalibration to simplify some important rules. Overall, these revisions seek to improve the framework and make it more efficient and proportional, but in the end global standards must be respected to preserve financial stability and a level playing field, not just globally but also in terms of not making the framework stricter for foreign banks.

The starting point: Core Principles and Treasury's recommendations

Shortly after taking office, President Donald Trump signed an Executive Order with a set of core principles for regulating the financial system. These principles were based on the idea that financial regulation was limiting banks' loans and access to savings, thus hampering the economy. Some of these principles were: prevent bailouts, foster economic growth and make regulation more efficient and tailored. The Executive Order clearly set the tone for the process that was to follow.

As a consequence, in June 2017, the U.S. Treasury published its first report, that sought to review the financial regulatory framework for depository institutions. It was prepared based on a consultation process with different stakeholders, and included over 100 recommendations. Among the issues covered, it recommended: i) to improve the coordination among regulators, ii) to revise prudential requirements and raise the threshold that triggers enhanced supervision, iii) to raise the threshold for stress testing, and iv) to simplify the complexity of the Volcker Rule (exempting smaller institutions). In general terms the report showed a shift in the U.S. policy towards a recalibration and simplification of financial regulation.

In October 2017, the Treasury released two additional reports based on the core principles for financial regulation. They focused on the reduction the regulatory burdens in capital markets, and on asset management and insurance industries.

Last February 2018, the Treasury released a report on the review of the Orderly Liquidation Authority (OLA) recommending some enhancements to the current framework. Additionally, the OLA report recommends the creation of a new bankruptcy regime that applies only to financial institutions (the "Chapter 14").

Finally, in April 2018, the Treasury issued a Memorandum for the supervisory agencies with a series of recommendations to improve the functioning of the Community Reinvestment Act (CRA)[1]. The recommendations are focused on four major topics: i) update the definition of geographical assessment areas, ii) enhance the clarity and flexibility of the assessment process, iii) improve the timeliness of the examination process, and iv) review penalties for non-performers to provide better incentives.

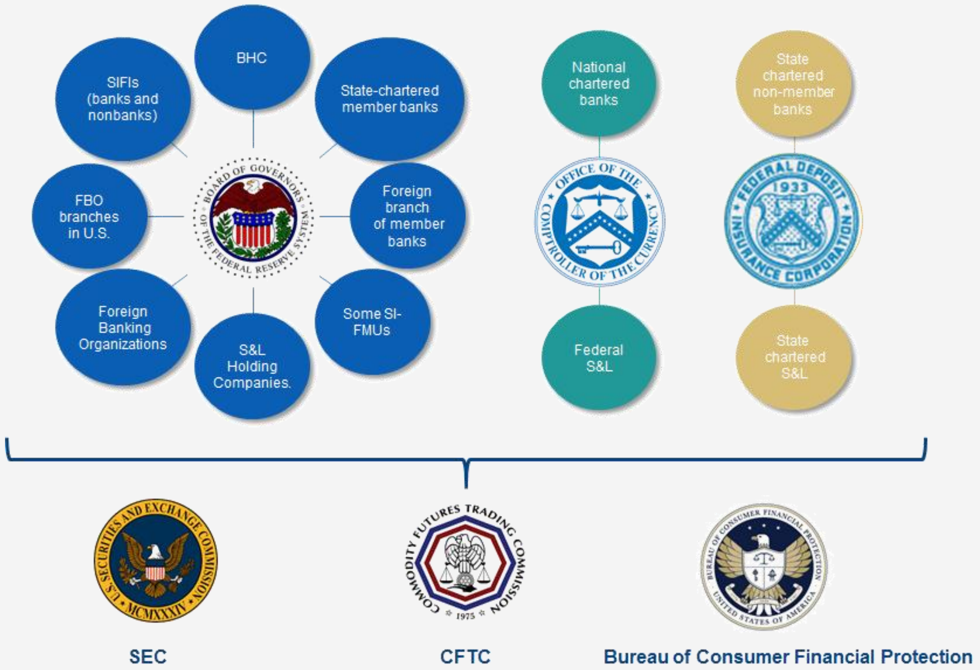
1: CRA is a federal law that seeks to encourage banks to take care of the credit needs of the communities in which they operate. The corresponding federal supervisor evaluates whether these actions are appropriate. The CRA performance is considered when the bank applies for deposit facilities.

Box 1 Who supervises who in the U.S. financial system

The US supervisory framework is arguably a complex one. Not only there are multiple supervisors, with seemingly overlapping responsibilities, but to some extent financial institutions are able to “choose” their supervisors. Financial oversight is shared among many different regulators, so it is important to identify the primary supervisor for each institution within this complex network.

In general, the supervisor that corresponds to each institution depends on a series of factors such as the charter of the institution (e.g. national vs state), the type of market (e.g. securities or retail banking), or the particular activity in which the institution engages (e.g. derivatives).

Figure 1 U.S. Financial Supervisors in the banking industry



Source: BBVA Research
BHC: Bank Holding Company, SIFI: Systemically Important Financial Institution, FBO: Foreign Banking Organization, S&L: Savings and Loans companies.

For banking activities, the Office of the Comptroller of the Currency (OCC) is the main regulator for banks with national charter (i.e. National Banks). If the bank has a state charter, the Federal Reserve Board (FRB) is the main regulator if the bank is a member of the Federal Reserve System. Otherwise, the main regulator is the Federal Deposit Insurance Corporation (FDIC) if the bank offers insured deposits or the corresponding state authority otherwise. Additionally, the FRB is the primary regulator for Bank Holding Companies (BHC), Financial Holding Companies (FHC), firms designated as systemically significant by the Financial Stability Oversight Council (FSOC), and U.S. branches of foreign banks.

The Securities Exchange Commission (SEC) deals with brokers, securities exchanges or investment advisers (investment banks were under the scope of the SEC during the last financial crisis). Regarding future exchanges, or swap dealers, it is the Commodity Futures Trading Commission (CFTC) that has regulatory power. Finally, the Consumer Financial Protection Bureau (CFPB)[2] supervises the conduct of financial institutions (with some exceptions).

2: Technically, Title X from the Dodd-Frank Act creates a Bureau of Consumer Financial Protection (BCFP). Now, the CFPB current acting director (Mick Mulvaney) is seeking to rebrand the agency as the BCFP.

Legislative proposals in the Congress

There are several proposals in the Congress dealing with financial regulation[3]. In the House of Representatives, the Republicans have an ample majority (241 out of 435 representatives). But in the Senate this majority is negligible (51 out of 100). While technically a simple majority is enough to pass a law, the Senate's internal rules and procedures make it difficult to pass laws without major hurdles with less than 60 senators, thus requiring some degree of coordination between the majority and minority leaders.

A. House of Representatives

In April 2017 the House presented a legislative proposal, the Financial CHOICE Act (H.R.10), to significantly overhaul the Dodd-Frank Act (DFA). This is an extensive proposal that repeals many aspects introduced by DFA. Some of the proposals are: i) repeal of the OLA, ii) repeal the authority of the FSOC to designate Financial Market Utilities (such as CCPs) and other non-bank financial institutions as systemically important (which would make them subject to supervision by the FRB, with potentially larger safety requirements), iii) the need for congressional approval of any "major rule" issued by federal regulators, iv) a regulatory relief for strongly capitalized banks[4], v) a significant reduction in powers to the CFPB, and vi) repeal the Volcker Rule and other related provisions. The bill was passed in the House given the ample majority the Republicans hold (233 Yeas, 186 Nays). Nevertheless, it is not likely that, considering the range and depth of the proposed reforms, it will pass in the Senate.

After this, in April 2018 the House passed a different proposal (300 Yeas, 104 Nays), the Volcker Rule Regulatory Harmonization Act (H.R.4790). This is a much less ambitious bill that seeks to grant the FRB exclusive rulemaking authority (currently shared with the OCC, FDIC, SEC and CFTC). Additionally, the bill would exempt from the Rule small banks (those with total assets $10 billion or less, and with 5% or less of trading assets and liabilities with respect to total consolidated assets). While this proposal would not imply a major overhaul of the DFA, it will be hard to pass in the Senate, as it has its own legislative proposal, with some proposed changes to the Volcker Rule as well[5].

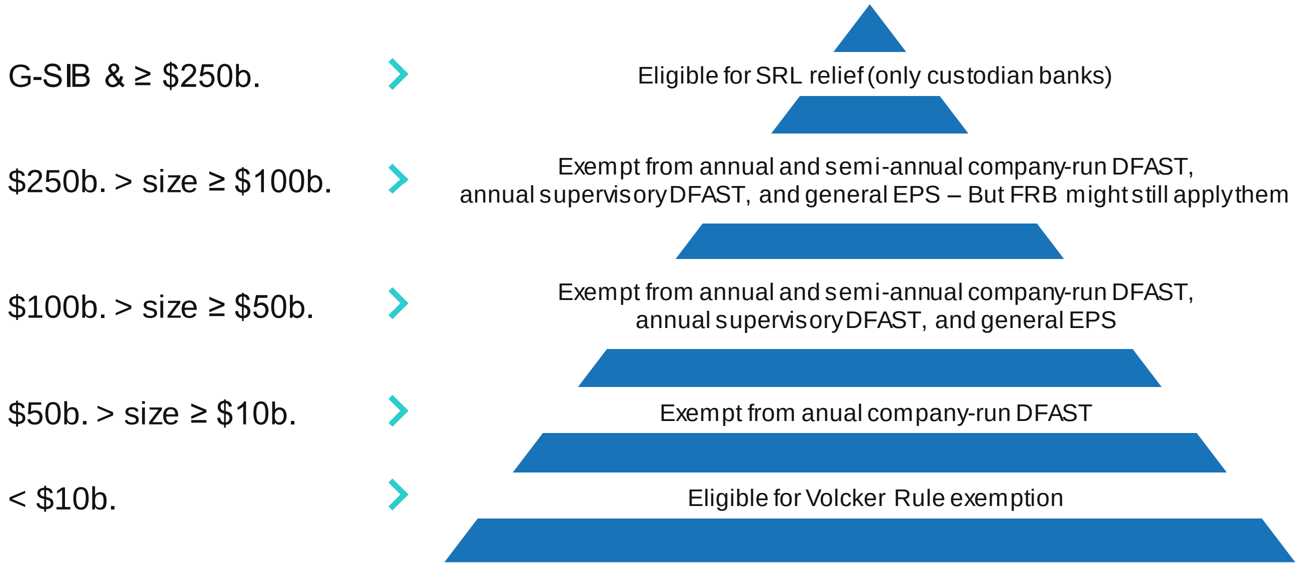
B. Senate

In March 2018 the Senate reached a major bipartisan agreement and passed (67 Yeas, 31 Nays) the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155). Recently, in May, the House voted and passed the Bill (258 Yeas, 159 Nays) converting it into Law, after president Trump signed it.

Among other changes, it includes some provisions regarding enhanced supervision. It increases the threshold of assets that determines enhanced prudential standards from $50 billion to $250 billion[6]. Banks subject to this enhanced framework are subject contingent capital requirements and resolution plans, limits to credit granted to a single counterparty, or the need to set up risk committees. Additionally, the proposal increases the threshold for mandatory company-run and supervisory stress tests (DFAST) while reducing the number of economic scenarios to only two. The extent to which these changes affect foreign banks will depend on the interpretation that the regulators make, i.e. measure total assets on a global consolidated basis or only U.S. assets.

3: The regulation making process differs significantly from the EU process. In the US, regulations are not embedded into laws, but rather the law sets a relatively vague framework for regulators to draft the actual rules afterwards.
4: Those banks with leverage greater or equal to 10% are no longer subject to: i) laws and regulation for capital or liquidity requirements; ii) law, or regulation under which federal financial agencies can object capital distributions; iii) considerations as to whether the bank poses a risk to the U.S. financial system.
5: The main difference between the Senate Bill and the House Bill, in terms of the Volcker Rule, is that the first one does not contemplate granting exclusive powers to the FRB. This is no minor issue, as it will allow the FED to modify the rule without the need to compromise with other agencies. Currently any change in the rule is hard to enforce since it would require the agreement among five different agencies.
6: Nevertheless, it includes a provision to allow the FRB to apply these standards to bank holding companies with total consolidated assets of at least $100 billion.

Figure 2 Senate Bill: How will these changes affect banks?



Note: the list of changes is not comprehensive, but rather to illustrate how these changes will affect banks depending on their size. There many measures not considered here that will likely affect the majority of the banking sector.
Source: BBVA Research

There are also changes on the leverage ratio (e.g. funds deposited in a central bank are excluded from the computation for the purpose of the supplementary leverage ratio *for custodial banks*) and on the use of municipal bonds for the purpose of the liquidity coverage ratio (LCR). Additionally, it exempts banks with less than $10 billion in assets from the Volcker Rule (but, as opposed to the H.R.4790 it does not alter rulemaking power over the rule). There are some provisions regarding mortgage loans: it allows institutions with less than $10 billion to waive the “ability-to-repay” requirements for some residential-mortgage loans.

While this Bill is not as comprehensive as the CHOICE Act, it certainly implies a major step towards easing some of the strict rules imposed after the last financial crisis. It clearly represents an effort to recalibrate the regulatory burden in order to foster economic growth. Given the numbers in the House, the Republicans should not have any problem to pass this Bill.

Recent proposals presented by U.S. regulators

Regulatory agencies in the U.S. have been actively promoting proposing a set of measures to simplify regulation for the banking industry. The FRB in its banking supervisor role, under the command of Randal Quarles (vice chair for supervision) proposed a series of changes to better tailor regulation, making it more efficient. The OCC has joined some of these proposals as well. Similarly, the CFPB’s acting director Mick Mulvaney, pledged to reduce the power of its agency in its mid-term report. Finally, there are also other lines of work undergoing in different agencies seeking to reduce the burden of financial regulation.

A. FRB proposal on stress buffer requirements

In early April, the FRB presented a proposal to simplify and integrate capital rules and stress tests. Currently, larger banks subject to the Comprehensive Capital Analysis Review (CCAR)[7] face to two different triggers that restrict capital distribution measures. First, the capital rule, under which the bank must hold at least a CET1 buffer of 2.5% of Risk

7: Bank Holding Companies with $50 billion or more in total consolidated assets are subject to CCAR.

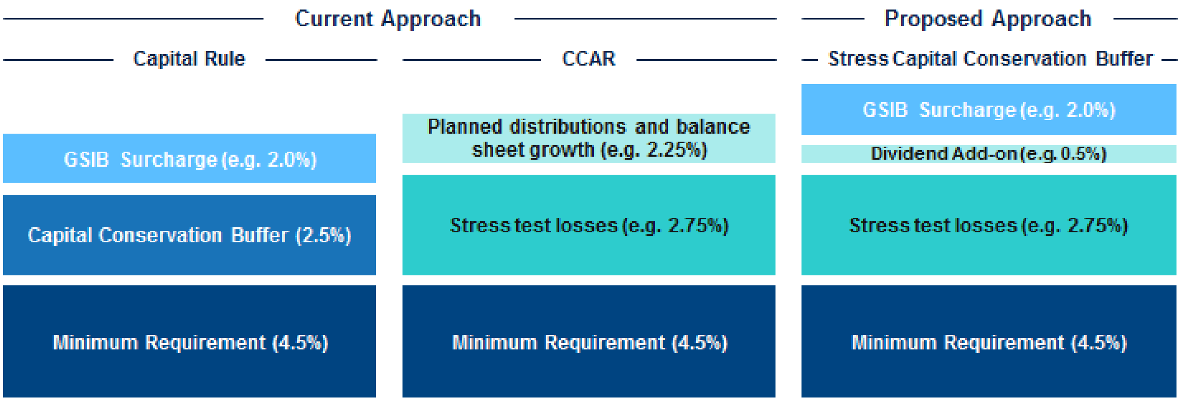
Weighted Assets (RWA) above the minimum risk-based capital (4.5% of RWA) plus the GSIB surcharge and the countercyclical buffer. Second, the CCAR's objection: the bank must keep a sufficient amount of capital above the minimum regulatory under a stress scenario.

Under these new proposed rules, these approaches will be integrated. The FRB would introduce a new risk sensitive firm-specific "Stress Capital Buffer" (SCB) requirement that would replace the fixed capital conservation buffer of 2.5% of standardised RWA, and would be recalibrated on an annual basis. The results provided by the CCAR will determine the SCB. It will be composed by the sum of two elements: i) the reduction in CET1 from the peak (starting level) to the lowest projected level in the nine quarters period analysed under the severely adverse scenario of the stress test, plus ii) four quarters (from the fourth to the seventh) of planned common stock dividends. The SCB will have a floor of 2.5% of RWA[8].

Then, the new standardized approach capital conservation buffer requirement will be composed by the SCB, the Global Systemically Important Bank (GSIB) surcharge, and the countercyclical buffer (if activated). Failure to meet this single requirement will trigger increasingly stricter limitations on capital distribution and bonus payments. The quantitative objection of the CCAR would be eliminated.

Additionally, the FRB proposes a series of changes on its CCAR stress test. As commented before, capital plans would no longer be subject to the quantitative objection. The stress test would not limit capital distribution directly, but instead indirectly through the SCB. Nevertheless, larger banks would still be subject to the qualitative objection. Additionally, the FRB would relax the assumption that implicitly leads to an expansion in banks' balance sheets, replacing it for the assumption that balance sheets remain constant during the stress period. Furthermore, the proposal relaxes the assumption that banks need to comply with all of their planned capital actions throughout the nine quarter of stress period under analysis. Instead banks need to carry out only four quarters of planned stock dividends. This last measure reduces both, the period of time in which the bank needs to comply with planned capital actions, and the depth of such actions (it considers only stock dividends, leaving out other measures such as stock repurchases). All these changes on stress tests will have an effect on the projected impact on CET1, and subsequently on the SCB.

Figure 3 The new Stress Capital Buffer



Source: BBVA Research based on the FRB illustration

The FRB has estimated the impact of these proposed changes in capital rules. It recognizes that for many banks, the required capital could be lower, but for GSIBs the requirements would remain similar, or slightly higher.

8 The proposal also envisages the creation of a new Stress Leverage Buffer that would be estimated similarly to the SCB, but it will not have a floor. This SLB will be computed considering total assets, rather than RWA, and failure to have sufficient capital to meet the minimum leverage ratio (4%) plus the SLB would trigger similar limitations on capital distribution.

Box 2 Stress Testing in the U.S.

In the USA there are currently two different but supplementary stress tests. The first one is the supervisory Dodd-Frank Act Stress Test (DFAST). The other one is the Comprehensive Capital Analysis Review (CCAR) prepared by the FRB. Both project capital ratios under stress conditions for each quarter of a nine-quarter horizon.

DFAST: Before the recent passage of the Senate Bill discussed above, DFA required all federally supervised financial companies with at least $10 billion in consolidated assets to conduct an annual company-run stress tests. Additionally, BHC, U.S. Intermediate Holding Companies (IHCs) and nonbank financial companies, with $50 billion or more in consolidated assets, are also subject to a mid-cycle test, and a supervisory-run stress test. The company-run tests used three scenarios provided by the FRB: baseline, adverse and severely adverse.

After the new law introduced by the Senate, BHC with more than $250 billion and GSIBs will be subject to annual supervisory run stress tests and periodic (instead of annual or semi-annual) company-run stress tests. BHC with at least $100 billion (and less than $250 billion), may be subject to these tests depending on the FRB's decision. In all cases the scenarios considered will be only two: baseline and severely adverse.

CCAR: this sort of stress test is not mandated by the DFA, but rather a FRB's requirement. It requires BHC with consolidated assets over $50 billion (and IHCs) to submit a capital plan annually. The capital plan requires banks to use three scenarios provided by the FRB (same as DFAST), plus two internally developed scenarios: baseline and stress. The recent legislative change does not have a direct effect on CCAR (but the FRB could adjust the test to match DFAST).

Differences:

- DFAST is mandatory under DFA and all federal regulators must enforce it. CCAR on the other hand is run only by the FRB, and does not stem from a legislative requirement.
- While they use the same supervisory-scenarios, the underlying assumptions regarding capital actions are different. In DFAST, the supervisor uses a set of standardized assumptions on capital actions (e.g. dividend payments set to the same level as in the previous year). In CCAR, the FRB uses the firms' planned capital actions for the period under consideration.
- DFAST consist only on a quantitative assessment of the capital needs of the bank in a stress scenario. CCAR contains a quantitative assessment as well as a qualitative assessment. In this second part, the FRB evaluates the model governance, risk management, internal controls and other related issues of the capital planning process. This qualitative analysis is held only for BHCs that are LISCC and for other complex and large firms: those with at least $250 billion in consolidated assets, non-bank assets of $75 billion or more, or banks designated as GSIBs.

B. FRB & OCC proposal on enhanced supplementary leverage ratio

A different proposal issued jointly by the FRB and the OCC deals with the leverage ratio requirements for GSIBs and their regulated subsidiaries (known as Insured Depository Institutions - IDI). The proposal seeks to recalibrate some supplementary buffers so that the leverage buffer requirements act as backstop to risk weighted capital instead of a binding constraint.

Currently U.S. banks are subject to a minimum leverage requirement of 4% Tier 1 capital to total consolidated assets. But those bank regarded as "Advanced approach"[9], must also comply with an additional not additive requirement: a Supplementary Leverage Ratio (SLR) of 3% Tier 1 capital measured with respect to their total leverage exposure (including on-balance and off-balance sheet exposures). Finally, GSIB banks (which are all advanced approach) are subject to an enhanced Supplementary Leverage Ratio (eSLR) of 2% that serves as a buffer for the SRL (making a total 5% ratio for GSIBs).

Under the proposed changes, the uniform eSLR for GSIB would be replaced for a leverage buffer that will depend on the GSIB surcharge which is specific for each bank. Particularly, the new buffer would be set at 50% of the corresponding GSIB risk-based capital surcharge. For instance, a bank with a GSIB surcharge of 1% of RWA would have an eSLR of 0.5% of total assets (instead of a 2%). Given the current surcharges, the CET1 requirements for GSIBs would be reduced.

Similarly, some rules under the Prompt Corrective Action (PCA) framework[10] (that applies to IDIs that are covered by the FDIC) will be modified. Currently, covered institutions which are subsidiaries of a GSIB are subject to a 6% threshold for the leverage ratio in order to be considered "well capitalized". The proposal would set a new threshold to 3% plus 50% of the corresponding GSIB surcharge. Then, a covered institution which is a subsidiary of a GISB with a surcharge of 2% of RWA will need to have a leverage ratio of 4% to be considered "well capitalized" under the PCA framework[11].

The agencies estimated that the impact of these measures would reduce the amount of required Tier 1 capital by nearly 0.04%. As stated by the FRB, the current effect of these measures in terms of capital will be very limited.

C. FRB proposal on the Volcker Rule

In late May, the Federal Reserve issued a proposal to review one the most significant rules created after the financial crisis: the Volcker Rule. While any review needs the backing of 5 different regulatory agencies, this is the first attempt to amend this rule[12]. As argued by the regulators themselves, the changes do not imply a repeal of the rule, nor they allow banks to trade as in the pre-crisis era (speculative proprietary trading is still banned), but rather they seek to simplify the rule and make it more efficient and tailored.

Among many other changes, the FRB proposes to create three different categories of banks based on the size of their trading desks in order to better tailor the requirements. Banks with significant trading activities (at least $10 billion of trading assets and liabilities) will have a comprehensive six-pillar compliance program[13] (among other requirements such as CEO attestation). According to Governor Brainard (an Obama appointee), banks under this category represent nearly 98% of total U.S. trading activities. Meanwhile, banks with moderate trading activities (less than $10 billion and at least $1 billion) will have simplified compliance requirements, and banks with limited activities (less than $1 billion) will be subject to a rebuttable presumption of compliance exempting them from any compliance program.

Additionally, the FRB proposes to eliminate the 60-day rebuttable presumption (rule that classifies by default as "*trading accounts*" those used for instruments held for less than 60 days[14]). Instead it proposes an accounting

9 Advanced approach banks are those required to use internal ratings-based approach to calculate risk-based capital requirements. These are typically banks with at least $250 billion in total consolidated assets, or at least $10 billion in total on-balance sheet foreign exposure, or subsidiaries of advanced approach banks. These banks are subject to the stricter of the capital requirement arising from either the standardized or advanced approaches.
10 PCA is a framework created to stop FDIC's losses. Under this regime, regulators classify banks as "well capitalized", "adequately capitalized", "undercapitalized", "significantly undercapitalized" and "critically undercapitalized" depending on different measures of regulatory capital (RWA and leverage measures).
11 The proposal also contemplates amendments to the TLAC rule for GSIBs, by replacing the current additional 2% external TLAC leverage buffer, with a buffer that is 50% of the corresponding GSIB surcharge.
12 In the opening statement after the proposed changes were presented, Quarles argued that this is the "best ***first*** effort at simplifying and tailoring the Volcker rule". Arguably, we should expect more proposals in the future regarding the Volcker Rule.
13 This includes written requirements on policies and procedures, internal controls, a management framework, independent testing and audit, training for relevant personnel, and recordkeeping.
14 The ban on proprietary trading applies to positions taken as principal for the "trading account" of the entity. This account is defined as that used for "*acquiring or taking positions in financial instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)*".

approach: trading accounts are those used to purchase/sell instruments recorded at fair value on a recurring basis (generally derivatives, available-for-sale securities, etc.).

Finally, it is worth mentioning that foreign banks will have fewer requirements to qualify for permitted trading activities outside the U.S. The proposal focuses on where the principal risk and actions of the transaction take place.

D. Other proposals and recommendations

The three federal regulators (FRB, OCC and FDIC), issued a joint proposal regarding the application of of the Current Expected Credit Losses (CECL) methodology (similar to the IFRS 9 in the EU). Particularly, they proposed to phase-in the negative impact on regulatory capital arising from the new accounting standard. Additionally, the agencies present some changes on the eligibility of certain allowances for the purpose of Tier 2 capital: Particularly, only “Allowances for Credit Losses” would count for regulatory capital purposes (up to 1.25% of total RWA).

On a different scenario the CFPB acting director, published a series of recommendations in order to increase the accountability of the Bureau, and reduce its powers. In its semi-annual report, Mick Mulvaney (a longtime critic to the agency) pledged to keep the Bureau’s actions within its statutory mandate, arguing that so far the agency has been too powerful and worked with little oversight. For this, he requests four legislative changes to the Congress: i) to fund the agency with Congressional appropriations, ii) legislative approval should be needed to pass major rules, iii) guarantee that the Bureau’s director answers directly to the President, and iv) create an Inspector General for the Bureau which is independent.

Finally, the regulatory agencies are conducting some work to revise other regulatory rules. For instance, in a recent speech FED’s vice chair of supervision Randal Quarles mentioned that U.S. regulators should reconsider how the internal TLAC calibration for Intermediate Holding Companies could be adjusted, given that currently it is at the top of the FSB scale (90%).

Final remarks

Under Trump’s presidency, the U.S. has embarked in a process to relax their supervisory and regulatory landscape. While it seems unlikely that the government will be able to carry out a major overhaul of the financial regulation structure, it has certainly tweaked some rules to ease the burden.

All in all, the reform will make the framework more proportional by easing the burden for smaller and regional banks. But it also contemplates many adjustments that will affect mid-size and larger banks as well. The revision seems affect the overall banking system, without focusing on a specific subgroup. Furthermore, these changes are, in principle, neutral with respect to the ownership of the banks (i.e. foreign or locally owned).

Improving the efficiency of the regulatory framework and making it more proportional is a worthy objective in itself. Based on thorough impact assessments, rules imposed in the past should be recalibrated when there are unintended consequences, inefficiencies, or when facing different threats. Nevertheless, high standards should prevail, and global rules must be respected in order to preserve financial stability and a level playing field (so far the reform does not seem to imply a departure of global standards).

Finally, it is should be noted that even though the EU is still going through an implementation phase, it could benefit from a comprehensive revision of its regulatory setting, to improve it and make it more efficient, closing potential loopholes, and addressing unintended consequences.

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