Implementation of Financial Services Regulatory Reform Legislation

Financial Regulators Discuss Implementation of the “Economic Growth, Regulatory Relief, and Consumer Protection Act”

SUMMARY

On October 2, the Senate Banking Committee held a hearing on the implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Act”), which was enacted earlier this year. The hearing featured testimony by FDIC Chairman Jelena McWilliams, Federal Reserve Board Vice Chairman for Supervision Randy Quarles, National Credit Union Administration Chairman Mark McWatters, and Comptroller of the Currency Joseph Otting.

At the hearing, the regulators discussed their progress and priorities in implementing several modifications that the Act made to the post-crisis regulatory framework. These modifications, some of which are already in effect and others of which remain to be completed, should provide meaningful regulatory relief for smaller and certain regional banking organizations. A number of other regulatory and supervisory issues were also discussed, including proposed reforms to the regulations implementing the Community Reinvestment Act (“CRA”), the use and role of supervisory guidance, the Congressional Review Act, the pending interagency proposal to modify the regulations implementing the Volcker Rule, and the negotiation of international insurance standards.

Vice Chairman Quarles focused his testimony on risk-based tailoring by the Federal Reserve of the supervision and regulation of bank holding companies (“BHCs”) with greater than $100 billion in total consolidated assets. We discuss this aspect of the hearing—which related primarily to the Act’s increase in the statutory asset threshold (often referred to as the “SIFI” threshold) above which the Federal Reserve is required to apply the “enhanced prudential standards” in Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)—in a separate Memorandum to Clients that
was also published today. That Memorandum is available on our website or by following the instructions at the end of this document.

BACKGROUND

The Act, originally introduced by Senate Banking Committee Chairman Mike Crapo (R-ID) and cosponsored by a bipartisan group of Senators, was approved by the Senate and the House of Representatives earlier this year and signed into law on May 24. As discussed in our Memorandum to Clients published on that date, the Act generally preserves the fundamental elements of the regulatory framework established after the 2010 enactment of Dodd-Frank, but includes a variety of measures that should result in meaningful regulatory relief for smaller and certain regional banking organizations.

Although the Act directly affects various regulations promulgated by the Federal banking agencies, it does not itself amend those regulations. Accordingly, the agencies must amend their existing regulations to account for certain changes made by the Act. The Federal banking agencies must also promulgate new regulations to implement certain other provisions of the Act.

In July, the FDIC, Federal Reserve, and OCC took initial steps to implement certain modifications made by the Act. On July 6, these agencies released an interagency statement (the “Interagency Statement”), and the Federal Reserve released a separate statement (the “Federal Reserve Statement”). As described in our Memorandum to Clients, dated July 12, 2018, these statements outline positions that the agencies intend to take, until the underlying regulations are amended, to implement modifications that became effective upon, or shortly after, enactment of the Act.

TESTIMONY

FDIC Chairman McWilliams, Federal Reserve Vice Chairman Quarles, NCUA Chairman McWatters, and Comptroller of the Currency Otting spoke about the progress their respective agencies have made in implementing the Act. They also described priorities and other actions their agencies intend to take in connection with the implementation of the Act. The provisions of the Act about which these regulators testified included the following:

- **Adjustments to the Supplementary Leverage Ratio for “Custodial Banks.”** The Act requires the Federal banking agencies to amend their rules implementing the supplementary leverage ratio (“SLR”), which became effective on January 1, 2018, to specify that funds of a “custodial bank” that are deposited with a central bank, such as the Federal Reserve or European Central Bank, will not be taken into account when calculating the measure of total leverage exposure (i.e., the SLR denominator), but that any amount that exceeds the total value of deposits of the custodial bank that are linked to fiduciary or custodial and safekeeping accounts will be taken into account when calculating the SLR denominator. Because of the bill’s narrow definition of “custodial bank,” these SLR amendments would appear to apply only to a small number of banking organizations. Vice Chairman Quarles and Comptroller Otting both noted that their agencies are working to address this provision, with Comptroller Otting adding that the Federal banking agencies “are determining how best to implement these changes, particularly in the context of other, proposed changes to the leverage ratio calculations.”
• **Adjustments to the LCR for Certain Municipal Securities.** The Act directs the Federal banking agencies to amend their liquidity coverage ratio (“LCR”) rules within 90 days after the date of enactment to classify “investment-grade” and “liquid and readily-marketable” municipal securities as “level 2B” liquid assets under their LCR rules and “any other regulation that incorporates a definition of the term ‘high-quality liquid asset’ or another substantially similar term.” The FDIC, Federal Reserve, and OCC issued an interim final rule on August 22, 2018, to implement this required amendment to their LCR rules.

• **Capital Treatment of Certain Commercial Real Estate Loans.** Prior to the enactment of the Act, all high-volatility commercial real estate (“HVCRE”) exposures were assigned a 150 percent risk-weight, instead of the 100 percent risk-weight that would otherwise typically apply if the exposures were not classified as HVCRE exposures. As required by the Act, the agencies may now only require that the heightened risk-weight apply to HVCRE exposures that meet a new definition of “HVCRE ADC loan,” which applies to a narrower scope of exposures than the existing definition of HVCRE exposures. According to the Interagency Statement, in making risk-based capital calculations, depository institutions may now either (1) “use available information to reasonably estimate and report only HVCRE ADC Loans” as subject to the higher, 150 percent risk-weight, with such institutions permitted to “refine these estimates in good faith as they obtain additional information” (no amendments to previously filed regulatory reports are required for institutions that refine previous estimates); or (2) “until the agencies take further action,” continue to report and risk-weight HVCRE exposures without application of the new definition of HVCRE ADC loan. Although the relevant provision of the Act does not, by its terms, apply to bank holding companies (“BHCs”) or savings and loan holding companies (“SLHCs”), the Interagency Statement and the Federal Reserve Statement permit BHCs, SLHCs, and intermediate holding companies of foreign banking organizations to estimate and report HVCRE exposures using whichever methodology is consistent with the approach taken by their subsidiary depository institutions. On September 18, 2018, the FDIC, Federal Reserve, and OCC released a notice of proposed rulemaking that seeks comments on potential changes to the agencies’ capital rules for HVCRE that would implement the modifications made by the Act.

• **Volcker Rule.** The Act makes two amendments to Section 13 of the Bank Holding Company Act (commonly referred to as the Volcker Rule). First, it exempts certain smaller institutions from the Volcker Rule that have (1) less than $10 billion in total consolidated assets and (2) total trading assets and trading liabilities representing less than 5% of its total consolidated assets. Second, the legislation amends the Volcker Rule’s restriction on sponsoring hedge funds and private equity funds to permit such funds to share the name or a variation of the same name of the banking entity that is an investment adviser to the fund so long as (1) the investment adviser is not, and does not share the name or a variation of the same name as, an insured depository institution, a company that controls an insured depository institution, or an FBO and (2) the name does not contain the word “bank.” According to the Interagency Statement, the agencies will not enforce the final rule implementing the Volcker Rule in a manner inconsistent with these amendments. Vice Chairman Quarles noted in his testimony that the Federal Reserve and the other responsible agencies intend to incorporate the Act’s amendments in the final rule through a separate rulemaking process. In his concluding remarks at the hearing, Chairman Crapo encouraged the agencies to “use [their] discretion to address the overly broad application” of the covered funds provisions in the final Volcker Rule “to venture capital, other long-term investments, and loan creation.”

• **Community Bank Leverage Ratio.** The Act requires the Federal banking agencies to promulgate a rule establishing a new “Community Bank Leverage Ratio” of 8%-10% for qualifying depository institutions and depository institution holding companies with less than $10 billion in total consolidated assets. If such a depository institution or holding company maintains tangible equity in excess of this newly defined leverage ratio, it will be deemed to be in compliance with (1) the leverage and risk-based capital requirements promulgated by the Federal banking agencies; (2) in the case of a depository institution, the capital ratio requirements to be considered “well capitalized” under the Federal banking agencies’ “prompt corrective action” regime; and (3) “any other capital or leverage ratio requirements” to which the depository institution or holding company is subject, in each case unless the appropriate Federal banking agency determines otherwise based on the particular institution’s risk profile. In carrying out these requirements, the Federal banking agencies are
required to consult with State banking regulators and notify the applicable State banking regulator of any relevant depository institution or holding company that exceeds or no longer exceeds the Community Bank Leverage Ratio. FDIC Chairman McWilliams predicted that the FDIC will issue a proposed rule to implement the Community Bank Leverage Ratio “certainly before the year end, if not much sooner.” Vice Chairman Quarles described implementation of this provision as one of the Federal Reserve’s “top priorities,” adding that he expects a regulatory proposal on this topic to be issued “in the very near future.”

- **Relief for Appraisals in Rural Areas.** The Act provides that an appraisal is, in certain circumstances in which a mortgage originator subject to Federal oversight has had difficulty obtaining an appraisal, no longer required for a transaction valued at less than $400,000 involving real property or an interest in property located in a rural area. The Interagency Statement notes that this relief was effective upon enactment of the Act. At the hearing, FDIC Chairman McWilliams and Comptroller Otting noted that there are interagency discussions to change existing regulations to implement this relief. In response to a question, Chairman McWilliams predicted that the FDIC will issue a proposed rule or some other form of guidance on this topic “in the next month or so.”

- **Small Holding Company Regulatory Relief.** The Act requires the Federal Reserve, within 180 days of the date of enactment, to revise its Small Bank Holding Company and Savings and Loan Holding Company Policy Statement to apply to certain BHCs and SLHCs with pro forma consolidated assets of less than $3 billion—an increase from the current $1 billion threshold. The Federal Reserve retains the authority to exclude any BHC or SLHC from the policy if such action is warranted for supervisory purposes. The Federal Reserve issued an interim final rule on August 28, 2018 to implement the revisions required by the Act.

- **Small Institution Examination Relief.** The Act increases the asset threshold for institutions qualifying for an 18-month on-site examination cycle from $1 billion to $3 billion. The FDIC, Federal Reserve, and OCC issued an interim final rule on August 23, 2018 to implement this increased asset threshold.

- **Short Form Call Report.** The Act requires the Federal banking agencies to promulgate regulations allowing an insured depository institution with less than $5 billion in total consolidated assets (and that satisfies such other criteria as determined to be appropriate by the agencies) to submit a short-form call report for its first and third quarters. Each of Chairman McWilliams, Vice Chairman Quarles, and Comptroller Otting said that their agencies are working together to implement this requirement. Chairman McWilliams noted that the agencies intended to issue a proposed rule for public comment “in the very near term.” Vice Chairman Quarles noted that the Federal Reserve, together with the other Federal banking agencies, intends to provide relief in the short term to qualifying institutions, “with additional simplifying changes to follow at a later date.”

- **Thrift Conversion Exception.** The Act permits a Federal savings association with $20 billion or less in total consolidated assets as of December 31, 2017, to elect to operate as a “covered savings association,” which would have the same powers as a national bank, subject to the same duties, restrictions, and limitations as a national bank, without having to convert to a national bank charter. A covered savings association is required to conform its activities to those permissible for a national bank (subject to OCC rulemaking) and could continue to operate as a covered savings association even if its total assets were to exceed $20 billion after the date on which it made its election. The OCC issued a notice of proposed rulemaking on September 10, 2018 that solicited public comment on a new regulation that would implement this provision.

- **International Insurance Standards.** The Act requires the Secretary of the Treasury, the Federal Reserve, and the Federal Insurance Office (“FIO”) to “support increasing transparency at any global insurance or international standard-setting regulatory or supervisory forum in which they participate,” such as meetings of the International Association of Insurance Supervisors (“IAIS”) and the Financial Stability Board. Among other requirements, the Treasury Secretary and Federal Reserve Chairman are required to submit a report to and testify before Congress within 180 days of the date of enactment of the Act regarding their efforts to increase transparency at meetings of the IAIS, and to testify annually through 2024 on the status of and their involvement in discussions at international
insurance standard-setting fora. The Act also requires the Treasury, Federal Reserve, and FIO to “achieve consensus positions” with State insurance regulators through the National Association of Insurance Commissioners (“NAIC”) before “take[ing] a position or reasonably intend[ing] to take a position” with respect to international insurance proposals negotiated at such global fora. Further, before supporting or consenting to the adoption of any “final international insurance capital standard,” the Treasury Secretary, Federal Reserve Chairman, and FIO Director, in consultation with the NAIC, are required to conduct a study, subject to notice and comment, on the effects of such proposal or standard on U.S. markets and consumers. In addition, the Act requires the establishment of an “Insurance Policy Advisory Committee on International Capital Standards and Other Insurance Issues” at the Federal Reserve, comprised of up to 21 members representing a “diverse set of expert perspectives from the various sectors of the United States insurance industry.”

Vice Chairman Quarles noted that, although the advisory committee has not yet been established, the Federal Reserve is “working to increase the transparency” of the process of setting international insurance standards and that it is “very much in our national interest” to ensure that U.S. “views are made known” in this process.

The regulators also provided testimony on other efforts by their respective agencies to revise the post-crisis regulatory framework. The topics addressed included the following:

- **Modifications to Community Reinvestment Act Regulations.** Comptroller Otting discussed the OCC’s recent advance notice of proposed rulemaking (“ANPR”) soliciting public comment on ways to “modernize the implementation of the CRA.” He noted that the ANPR is intended, among other goals, to “provid[e] greater clarity regarding CRA-qualifying activities” and “establish[] clear and objective measures to assess CRA performance.” Asked whether physical branches remain relevant to defining CRA assessment areas, Chairman McWilliams replied that they are “still important” and that the FDIC would “certainly want to make sure that emphasis remains” to the “extent that . . . consumers rely on those branches more so than they rely on digital devices.” Similarly, Vice Chairman Quarles stressed the importance of physical bank branches in rural communities and said that regulators “need to think creatively, while not ignoring place as an issue with respect to” CRA enforcement.

- **The De Novo Application Process.** Chairman McWilliams testified that the FDIC is “currently looking at how [it] can further improve the application process to encourage more de novo activity.” She expressed concern that, since 2010, the number of insured depository institutions has declined by nearly 2,500—driven in large part by consolidation and bank failures—during which time only 11 new charters have been approved and opened. Chairman McWilliams clarified that the FDIC does not have a standard initial capital figure for de novo banks, but instead requires that a prospective bank propose initial capital that is sufficient to support its business model.

- **Approvals of Industrial Loan Company Deposit Insurance Applications.** Chairman McWilliams also testified that the FDIC is reviewing the deposit insurance application process for industrial loan companies (“ILCs”). She noted that Congress has authorized the FDIC to act on applications for deposit insurance by ILCs, and that the FDIC “stands ready” to review and, provided it meets statutory requirements, approve any such ILC application.

- **Brokered Deposits.** Chairman McWilliams noted that the FDIC will “revisit[] those regulations that have not received recent or comprehensive public input,” specifically noting that the agency intends to take a “comprehensive look at the regulatory approach to brokered deposits and national rate caps.” She added that the FDIC will seek public comment on this issue “later this year” in light of the significant changes to the banking industry since the brokered deposit regulations were adopted and “the impact of changes in technology, business models, and products.”

- **Cybersecurity.** Asked about current systemic risks facing the U.S. financial system, Chairman McWilliams emphasized the importance of recognizing “potential exposures . . . to cybersecurity and cyber breaches.” Both Vice Chairman Quarles and Comptroller Otting agreed with the importance of
considering and addressing cybersecurity, with Vice Chairman Quarles describing cybersecurity risk as “the issue that we should be focusing on that we have not.”

Chairman Crapo and Senator Pat Toomey (R-PA) stressed the applicability of the Congressional Review Act and Administrative Procedure Act to the regulators’ actions to implement the Act and to otherwise modify the post-crisis regulatory framework.

- **Congressional Review Act.** In his opening statement, Chairman Crapo stressed that all actions taken by the agencies to implement the Act—whether pursued through notice-and-comment rulemaking or informal guidance—must comply with the Congressional Review Act. He encouraged the regulators to submit to Congress any release that might fall within that statute’s broad definition of “rule,” which has been interpreted to include both rules that are subject to public notice and comment and those that are not. Chairman Crapo argued that such submissions will ensure Congress can engage in proper oversight and “that future Congresses do not overturn the agency’s policy statements” in connection with implementation of the Act.

- **Administrative Procedure Act.** Senator Toomey stressed the importance of observing the distinction between agency issuances that are legally binding (e.g., rules promulgated through notice-and-comment rulemaking) and those that are not (e.g., informal guidance). Each of the Federal banking agencies and the NCUA has recently confirmed this distinction, and Senator Toomey emphasized that bank examiners be aware of, and observe, this distinction.

* * *
ENDNOTES


2 The legislation defines “custodial bank” for these purposes as “any depository institution holding company predominantly engaged in custody, safekeeping, and asset servicing activities, including any insured depository institution subsidiary of such a holding company.”


6 EGRRCPA, § 403.


8 EGRRCPA, § 214.


10 EGRRCPA, § 203.

11 EGRRCPA, § 204.

12 EGRRCPA, § 201.
ENDNOTES (CONTINUED)

13 Statement by Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, at 1-2, 4 (Oct. 2, 2018) [hereinafter Quarles Statement].

14 EGRRCPA, § 103.

15 See 12 C.F.R. Appendix C to Part 225.

16 EGRRCPA, § 207.


18 EGRRCPA, § 210.


20 EGRRCPA, § 205.

21 Statement of Jelena McWilliams, Chairman, Federal Deposit Insurance Corporation, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, at 5 (Oct. 2, 2018) [hereinafter McWilliams Statement].

22 Quarles Statement, at 10.

23 EGRRCPA, § 206.


25 EGRRCPA, § 211.


27 Otting Statement, at 10.

28 McWilliams Statement, at 9 & n.1. The 11 de novo banks formed since 2010 do not include new banks formed to acquire a failed bank or another bank, new banks formed as conversions from credit unions or spin-offs of existing banks, or new subsidiaries of a banking organization that already has an affiliated bank.

29 Id. at 9-10.

30 For further discussion of the Congressional Review Act, see our Memorandum to Clients, Congressional Review Act: GAO Determines That Banking Agencies’ Leveraged Lending Guidance is a “Rule” and Therefore Subject to the Requirements of the Congressional Review Act, dated October 20, 2017, available at https://www.sullcrom.com/congressional-review-act-10-20-17.

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