

A Financial System
That Creates Economic Opportunities
Banks and Credit Unions



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A Financial System That Creates Economic Opportunities **Banks and Credit Unions**

Report to President Donald J. Trump

Executive Order 13772 on Core Principles
for Regulating the United States Financial System

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Acronyms and Abbreviations

Acronym/Abbreviation	Term
ACICS	Accrediting Council for Independent Colleges and Schools
ALJ	Administrative Law Judge
AOCI	Accumulated Other Comprehensive Income
ATR	Ability-to-Repay
Basel	Basel Committee on Banking Supervision
Basel Committee	Basel Committee on Banking Supervision
BEA	Bureau of Economic Analysis
BHC	Bank Holding Company
Board	Board of Directors
C&I	Commercial & Industrial
CCAR	Comprehensive Capital Analysis and Review
CCyB	Countercyclical Capital Buffer
CDFI	Community Development Financial Institution
CECL	Current Expected Credit Losses
CET1	Common Equity Tier 1 Capital
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
CLAR	Comprehensive Liquidity Assessment and Review
CID	Civil Investigative Demand
CO	Consent Order
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
CRT	Credit Risk Transfer
CSBS	Conference State Bank Supervisors
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
DFAST	Dodd-Frank Act Stress Test
DTI	Debt-to-Income
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization
eSLR	Enhanced Supplementary Leverage Ratio

Executive Order	Executive Order 13772 on Core Principles for Regulating the United States Financial System
Fannie Mae	Federal National Mortgage Association
FASB	Financial Accounting Standards Board
FBIIC	Financial and Banking Information Infrastructure Committee
FBO	Foreign Banking Organization
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FFIEC	Federal Financial Institutions Examination Council
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FINRA	Financial Industry Regulatory Authority
FRB	Board of Governors of the Federal Reserve System
Freddie Mac	Federal Home Loan Mortgage Corporation
FRTB	Fundamental Review of the Trading Book
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FTC	Federal Trade Commission
G-20	Group of 20
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
Ginnie Mae	Government National Mortgage Association
GSE	Government-Sponsored Enterprise, here refers to Fannie Mae and Freddie Mac
G-SIB	Global Systemically Important Bank
HAMP	Home Affordable Modification Program
HCAI	Housing Credit Availability Index
HCR	Horizontal Capital Review
HMDA	Home Mortgage Disclosure Act
HQLA	High-Quality Liquid Assets
HUD	U.S. Department of Housing and Urban Development
HVCRE	High Volatility Commercial Real Estate

IAIS	International Association of Insurance Supervisors
IHC	Intermediate Holding Company
IOSCO	International Organization of Securities Commissions
LCR	Liquidity Coverage Ratio
LISCC	Large Institution Supervision Coordinating Committee
MBA	Mortgage Bankers Association
MBS	Mortgage-Backed Security
MDI	Minority Depository Institution
MOU	Memorandum of Understanding
MRA	Matters Requiring Attention
MRIA	Matters Requiring Immediate Attention
MSA	Mortgage Servicing Assets
MSRB	Municipal Securities Rulemaking Board
NCUA	National Credit Union Administration
NFA	National Futures Association
NSFR	Net Stable Funding Ratio
OCC	Office of the Comptroller of the Currency
OLA	Orderly Liquidation Authority
OMB	Office of Management and Budget
Policy Statement	Federal Reserve Small Bank Holding Company and Savings and Loan Holding Company Policy Statement
PLS	Private Label Mortgage-Backed Securities
PRI	Program-Related Investment
QM	Qualified Mortgage
QRM	Qualified Residential Mortgage
Reg AB II	Asset-Backed Securities Disclosure and Registration Final Rule
REIT	Real Estate Investment Trust
RENTD	Reasonably Expected Near Term Demand
Repo	Repurchase Agreement
RESPA	Real Estate Settlement Procedures Act
RLAP	Resolution Liquidity Adequacy and Positioning

RLEN	Resolution Liquidity Execution Need
RMBS	Residential Mortgage-Backed Securities
RWA	Risk-Weighted Assets
SBA	Small Business Administration
SCAP	Supervisory Capital Assessment Program
SCCL	Single-Counterparty Credit Limit
SEC	U.S. Securities and Exchange Commission
Secretary	Steven T. Mnuchin, Secretary of the Treasury
SLR	Supplementary Leverage Ratio
SSB	Standard-Setting Bodies
TARP	Troubled Asset Relief Program
TILA	Truth in Lending Act
TLAC	Total Loss-Absorbing Capacity
Treasury	U.S. Department of the Treasury
TRID	TILA-RESPA Integrated Disclosure
UDAAP	Unfair, Deceptive, or Abusive Acts and Practices
VA	U.S. Department of Veterans Affairs



Executive Summary



Introduction

President Donald J. Trump established the policy of his Administration to regulate the United States financial system in a manner consistent with a set of Core Principles. These principles were set forth in Executive Order 13772 on February 3, 2017. This Report is prepared by the U.S. Department of the Treasury, under the direction of Secretary Steven T. Mnuchin, in response to the Executive Order. This Report, and subsequent Reports, will identify any laws, treaties, regulations, guidance, reporting and record keeping requirements, and other Government policies that inhibit Federal regulation of the U.S. financial system in a manner consistent with the Core Principles.

The Core Principles are:

- A. Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
- B. Prevent taxpayer-funded bailouts;
- C. Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;
- D. Enable American companies to be competitive with foreign firms in domestic and foreign markets;
- E. Advance American interests in international financial regulatory negotiations and meetings;
- F. Make regulation efficient, effective, and appropriately tailored; and
- G. Restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

Review of the Process for This Report

As directed by the Executive Order, Treasury consulted with the member agencies of the Financial Stability Oversight Council (FSOC), including the Board of Governors of the Federal Reserve System (Federal Reserve or FRB), the Office of the Comptroller of the Currency (OCC), the Consumer Financial Protection Bureau (CFPB), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), the Federal Housing Finance Agency (FHFA), and the National Credit Union Administration (NCUA). These consultations with FSOC members included holding a series of bilateral meetings and evaluation of written submissions. Treasury also consulted with FSOC's independent member with insurance expertise and nonvoting members of FSOC.

Treasury consulted extensively with a wide range of stakeholders, including trade groups, financial services firms, consumer and other advocacy groups, academics, experts, financial markets utilities, rating agencies, investors and investment strategists, and others with relevant knowledge. Treasury also reviewed a wide range of data, research, and published material from both public and private sector sources.

Treasury incorporated the widest possible range of perspectives in evaluating approaches to the regulation of the U.S. financial system according to the Core Principles. A list of organizations and individuals who provided input to Treasury in connection with the preparation of this report is set forth as Appendix A.

Scope of This Report and Subsequent Reports

The U.S. financial system is a vast network of various types of institutions that offer services to consumers and businesses. It comprises domestic organizations, U.S.-based organizations that operate globally, and foreign-owned institutions that have a presence in the United States. Financial services are offered across a wide range of categories of institutions, including banks and credit unions, asset managers, insurance companies; non-bank financial companies, and various market utilities, including exchanges and clearing houses. Markets for liquid financial products include a wide range of listed and over-the-counter markets, exchanges and other market utilities that provide liquidity for equity, fixed income, financial derivatives, and other financial products. In short, the financial system encompasses a wide variety of institutions and services.

Given the breadth of the financial system and the unique regulatory regime governing each segment, Treasury will divide its review of the financial system into a series of reports:

- The depository system, covering banks, savings associations, and credit unions of all sizes, types and regulatory charters;
- Capital markets: debt, equity, commodities and derivatives markets, central clearing and other operational functions;
- The asset management and insurance industries, and retail and institutional investment products and vehicles; and
- Non-bank financial institutions, financial technology, and financial innovation.

This report covers the depository system. Subsequent reports will cover the other topics listed above. This report does not cover comprehensive housing reform and the future state of the government-sponsored enterprises, Fannie Mae and Freddie Mac. However, reference is made to numerous elements of regulations pertaining to mortgage loan origination, servicing and capital markets treatment.

On April 21, 2017, President Trump issued two Presidential Memoranda to the Secretary of the Treasury. One calls for Treasury to review the Orderly Liquidation Authority (OLA) established in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The other calls for Treasury to review the process by which the FSOC determines that a nonbank financial company could pose a threat to the financial stability of the United States, subjecting such an entity to supervision by the Federal Reserve and enhanced prudential standards, as well as the process by which the FSOC designates financial market utilities as systemically important. Treasury will conduct a review and submit separate reports to the President in response to each Memorandum within 180 days of the issuance thereof. Accordingly, this report will not cover OLA or the FSOC designation process.

The U.S. Depository Sector

The U.S. banking system is the strongest in the world and is critical in supporting the U.S. economy. There are over 5,900 banks and 5,800 credit unions operating in the United States. Regulated depositories reported total assets of \$21.4 trillion as of December 31, 2016, or 115% of U.S. GDP. Depositories operated by foreign banking organizations play a meaningful role in the U.S. banking system, in part by helping connect consumers and businesses to global economic opportunities.

The depository system can be stratified by size and type of organization, with each playing a unique role serving its target client base. Key segments include the eight firms designated as U.S. global systemically important banks (G-SIBs), regional banks, mid-sized banks, community banks, and credit unions.

The eight U.S. G-SIBs currently have \$10.7 trillion of assets, or approximately 50% of total U.S. depository assets, down from 58% in 2008. Regional and mid-sized banks, often operating across multiple states, have in the aggregate \$6.7 trillion of assets, or approximately 31% of total U.S. depository assets. They typically have balance sheets and business models geared toward deposit-taking and lending to consumers and businesses, without extensive capital markets activities.

Community banks and credit unions have total assets of \$2.7 trillion and \$1.3 trillion, respectively. Together, these entities represent over 19% of total U.S. depository assets and play an important role in the communities that they serve. They have relatively simple business models, with capital ratios generally equal to or higher than their larger counterparts. Community banks and credit unions serve the needs of the nation's small businesses and rural communities, and they play a key role in agricultural lending.

The U.S. operations of foreign banking organizations have total assets that exceed \$4.5 trillion, which includes the assets of commercial banks, branches, agencies, and non-bank affiliates, representing approximately 20% of our banking system.¹ This segment plays a large role in providing business loans and infrastructure finance. They also provide significant capital markets services, comprising more than half of the 23 primary dealers of the Federal Reserve Bank of New York.

Despite a relatively weak economic recovery since the financial crisis, the banking system has demonstrated resilience, increasing capital, improving liquidity standards, improving loan portfolio quality, and implementing better risk management practices. When the housing bubble burst over 10 years ago, gaps were revealed in financial regulation that resulted in significant shortcomings in both the financial strength and risk-management activities of banking organizations.

The financial characteristics and operation of the U.S. depository system were transformed as a consequence of the July 21, 2010 enactment of Dodd-Frank. Dodd-Frank made sweeping changes to regulatory requirements and the powers of independent regulatory agencies. In parallel, the banking agencies also imposed major changes in the operating expectations and capital and liquidity requirements of regulated institutions.

1. Foreign banking organizations are a subset of the other depository sector segments, and market share is measured here against U.S. commercial bank assets, including U.S. branches and agencies. Federal Reserve Board, Share Data for the U.S. Offices of Foreign Banking Organizations (Sep. 30, 2016), available at: <https://www.federalreserve.gov/releases/iba/ffbosh.htm>.

As banking regulators are approaching the full implementation of Dodd-Frank, nearly seven years after its passage, regulation has proven to be insufficiently tailored to depository institutions based on the size and complexity of their business models. Requirements in Dodd-Frank are overseen by multiple regulatory agencies with shared or joint rule-making responsibilities and overlapping mandates. This complicated oversight structure has raised the cost of compliance for the depository sector, particularly for mid-sized and community financial institutions. Moreover, the regulatory agencies often do not engage in sufficient coordination, so financial institutions often face duplication of efforts.

A sensible rebalancing of regulatory principles is warranted in light of the significant improvement in the strength of the financial system and the economy, as well as the benefit of perspective since the Great Recession. Treasury has identified recommendations that can better align the financial system to serve consumers and businesses in order to support their economic objectives and drive economic growth. Through thoughtful reform, the soundness of the financial system can be further strengthened.

Why Alignment of Regulation with the Core Principles is of Critical Importance

Breaking the Cycle of Low Economic Growth

The U.S. economy has experienced the slowest economic recovery of the post-war period. Real gross domestic product is only 13% higher than in 2007. Since 2010, total employment has risen 12%, while wages have risen only a little more than 4%. The implementation of Dodd-Frank during this period created a new set of obstacles to the recovery by imposing a series of costly regulatory requirements on banks and credit unions, most of which were either unrelated to addressing problems leading up to the financial crisis or applied in an overly prescriptive or broad manner.

At the same time as regulatory burdens were increasing, financial institutions faced a prolonged period of low interest rates. While the accommodative conditions have lowered consumer, business, and government borrowing costs, they have also reduced the return on household savings and made achieving adequate return on the capital of financial institutions more difficult.

The Administration is pursuing a wide range of coordinated strategies to stimulate growth, including tax reform, a new approach to managing international trade, and improvements to government accountability, including shrinking, where appropriate, the size and role of government. A more efficient system of financial regulation is a critical pillar of policies to stimulate economic growth. Two of the most fundamental requirements for economic expansion are the presence of liquid and robust financial markets and the availability of credit. American banks and credit unions are integral to fulfilling both of these needs.

The sweeping scope of and excess costs imposed by Dodd-Frank, however, have resulted in a slow rate of bank asset and loan growth. At the same time, banking system resources dedicated to markets and market liquidity have declined, in large part due to regulatory changes. Finding the

correct regulatory balance impacting market liquidity and the extension of credit to consumers and businesses is required to fuel economic growth.

Better Fulfilling the Credit Needs of Consumers and Businesses

A healthier and more dynamic banking sector that provides improved access to credit for U.S. consumers and businesses is essential to supporting more robust GDP growth. Improperly tailored capital, liquidity, and leverage requirements, as well as a tremendous increase in activities-based regulation, including regulatory parameters that guide loan underwriting, have undermined the ability of banks to deliver attractively priced credit in sufficient quantity to meet the needs of the economy.

Loan growth has been quite slow compared to prior recoveries, up only 25% in the current recovery, compared with increases of 64%, 30%, and 87% for the 2001, 1990-91, and 1981-82 recessions, respectively (all at the same period of time since the beginning of each recovery). Cumulative asset and loan growth at FDIC-insured institutions is 26% since 2010, approximately equal to nominal GDP growth. Breaking the cycle of the low rate of GDP growth requires increased access to credit for U.S. consumers and businesses, particularly small businesses.

The largest stalled asset class is residential mortgage lending, showing only 5% growth since 2010, with credit cards and commercial real estate (excluding multifamily lending) showing growth rates of 14% and 24%, respectively. Credit availability in residential mortgages remains tight. The Housing Credit Availability Index (HCAI) reported by the Urban Institute is at approximately half the level of the 2001-2003 period.² This tightness has resulted in several trends, including a concentration of the mortgage market in government-supported mortgage programs, which funded nearly 70% of 2016 origination volume.

Small business lending has been one of the most anemic sectors, barely recovering to 2008 levels. By comparison, origination rates for large business loans are at record levels. The Federal Reserve offered further evidence of the challenges of small business credit conditions in its nationwide survey published in April 2017.

The lack of tailoring and imprecise calibration in both capital and liquidity standards have diminished the flow of credit to fulfill loan demand. Numerous aspects of risk-based capital standards discourage lending in key asset classes. Further, activities-based regulation restricts the flow of consumer lending, particularly in small dollar loans, residential mortgage loans, credit cards, and indirect auto lending.

Maintaining Liquid Markets

It is critical that the United States maintain a leadership position in the vitality of its financial markets for financial products, which have long been the envy of the world. Robust markets support capital formation, expand economic activity, and attract foreign capital. Equity capital and debt capital allow our small and large businesses to expand and drive job and wage growth. Banks

2. Urban Institute, *Housing Credit Availability Index* (April 14, 2017), available at: www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-credit-availability-index.

play a significant role in providing market liquidity, serving as the primary market intermediaries, as both principal and agent.

Factors that contribute to declining market liquidity include an increase in the quantity and quality of liquid assets on bank balance sheets, which has resulted in a decline in the percentage of bank balance sheets available to support market-making activities. Implementation of a wide range of capital and liquidity rules, and the manner in which these rules interact, may be limiting resources for market liquidity, including low-margin products that do not produce sufficient returns, and short-term, secured financing.

The Volcker Rule requires substantial amendment. Its implementation has hindered market-making functions necessary to ensure a healthy level of market liquidity. Combined with high liquid asset buffers, and limited time to restore buffers during periods of stress, the Volcker Rule could result in pro-cyclical behavior and reinforce market volatility during periods of stress.

Conforming the regulatory environment to promote liquid and vibrant markets is an important element of the Core Principles.

Assessing Regulatory Impact and Burden

The financial crisis of 2008 revealed longstanding flaws in the structure of both global and American financial regulation. Widespread and extensive government guarantees undermined market discipline, resulting in moral hazard on the part of investors, lenders and borrowers. Reform was desperately needed if future financial crises were to be avoided. In response to the financial crisis, Congress enacted Dodd-Frank, a dense 2,319-page piece of legislation that is sweeping in its scope and mandates. The length of Dodd-Frank fails to reflect fully its expansive scope as the legislation delegated unprecedented authority to financial regulators and mandated hundreds of new regulations. In total, implementing Dodd-Frank required approximately 390 regulations, implemented by more than a dozen different regulatory agencies. Dodd-Frank failed to address many drivers of the financial crisis, while adding new regulatory burdens.

Nearly seven years following Dodd-Frank's enactment, it is important to reexamine these rules, both individually and in concert, guided by free-market principles and with an eye towards maximizing economic growth consistent with taxpayer protection. Doing so will help to unleash the potential of consumers and businesses, which has been restrained in one of the weakest economic recoveries in U.S. economic history. Immediate changes, at both the regulatory and legislative level, are needed both to increase economic growth and financial stability. These goals need not be in conflict. Greater certainty about the rules, for instance, would allow for more informed choices on the part of lenders, investors, and consumers.

During this period, as part of the international response to the global financial crisis, the United States has played a leading role in the G-20's financial regulatory reform agenda and the development of international financial regulatory standards by standard-setting bodies (SSBs), such as the Basel Committee on Banking Supervision (Basel Committee) and the Financial Stability Board (FSB). The impact of international standards on the global competitiveness of U.S. financial institutions requires thoughtful review.

Banks and credit unions are confronted with a vast array of regulatory requirements, putting a substantial burden on financial and human capital. Most critically, regulatory burdens must be appropriately tailored based on the size and complexity of a financial organization's business model and take into account risk and impact. In particular, the use of arbitrary asset thresholds to apply regulation has resulted in a "one-size-fits-all" approach that has prevented regulators from focusing on a banking organization's most serious risks. Such asset thresholds also create competitive advantages for the largest institutions, which can more easily absorb regulatory costs, and deter mid-sized banks from growing. Regulatory overlap and duplication must be addressed to reduce conflicting requirements and inadequately coordinated examinations across the various regulatory bodies.

It is critical that Congress and the regulatory agencies undertake a holistic analysis of the cumulative impact of the regulatory environment. It is also important to modernize and conform outdated statutes and regulations to the realities of the current financial system and better target the statutory and regulatory response to the real risks that American consumers and the American economy face. This should include statutes of critical importance to the banking sector, such as the Community Reinvestment Act (CRA).

The CRA statute is in need of modernization, regulatory oversight must be harmonized, and greater clarity in remediating deficiencies is called for. It is very important to better align the benefits arising from banks' CRA investments with the interest and needs of the communities that they serve and to improve the current supervisory and regulatory framework for CRA. Treasury expects to comprehensively assess how the CRA could be improved to achieve these goals, which will include soliciting input from individual consumer advocates and other stakeholders. Aligning the regulatory oversight of CRA activities with a heightened focus on community investments is a high priority for the Secretary.

Preventing Taxpayer-Funded Bailouts and Maintaining the Safety and Soundness of the Financial System

The taxpayer-funded bailouts that occurred during the financial crisis were not only unfair to taxpayers and businesses that did not receive a bailout, but also created serious moral hazard risk in U.S. financial markets by signaling to market participants that certain investors will not bear the consequences of poor investments. Over the long run, this moral hazard threatens to undermine market discipline, create too-big-to-fail institutions, and set the stage for future financial crises and taxpayer-funded bailouts. Accordingly, one of the Core Principles is to prevent taxpayer-funded bailouts.

To satisfy this Core Principle, two key policies are required. First, there needs to be an effective mechanism for resolving the largest and most complex financial institutions. The Treasury Secretary is currently reviewing the OLA established under Title II of Dodd-Frank pursuant to the Presidential Memorandum dated April 21, 2017. Thus, this report will defer comment on the effectiveness of our current resolution mechanisms.

The second policy needed to prevent taxpayer-funded bailouts is eliminating regulation that fosters the creation or cements the market position of too-big-to-fail institutions. Excessive regulation imposes costs on institutions that can create incentives for institutions to grow larger than market

conditions would otherwise require. To the extent regulatory costs can be spread over a large number of customers, regulation can create a barrier to entry for smaller firms and confer competitive advantages on the largest institutions. Tailoring regulation therefore is essential to ensure that regulation does not play a role in fostering too-big-to-fail institutions.

Beside the need to prevent taxpayer-funded bailouts, the financial sector must be well regulated to ensure the safety and soundness of the financial system. Treasury's recommendations seek to right-size financial regulation and remove unnecessary regulatory duplication and overlap. The key elements of the regulatory framework that should be retained through any reform include:

- Explicit, appropriately risk-sensitive capital standards;
- Supervised stress-testing appropriately tailored based on banking organizations' complexity;
- Explicit, measurable and transparent liquidity requirements;
- Actionable living wills for the largest systemically-important banks; and
- Enhanced prudential standards, based on the size and complexity of financial institutions.

Treasury believes that the recommendations identified in this report would further enhance the stability of the financial system by improving the effectiveness of regulation and creating more robust and resilient financial institutions.

Summary of Recommendations for Regulatory Reform

Treasury's review of the regulatory framework for the depository sector has identified significant areas for reform in order to conform to the Core Principles. The review has identified a wide range of changes that could meaningfully simplify and reduce regulatory costs and burdens, while maintaining high standards of safety and soundness and ensuring the accountability of the financial system to the American public.

Treasury's recommendations relating to the reform of the banking sector regulatory framework, as set forth within this Report, can be summarized as follows:

- Improving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap, and duplication across regulatory agencies;
- Aligning the financial system to help support the U.S. economy;
- Reducing regulatory burden by decreasing unnecessary complexity;
- Tailoring the regulatory approach based on size and complexity of regulated firms and requiring greater regulatory cooperation and coordination among financial regulators; and
- Aligning regulations to support market liquidity, investment, and lending in the U.S. economy.

Treasury's recommendations to the President are focused on identifying laws, regulations, and other government policies that inhibit regulation of the financial system according to the Core Principles. In developing the recommendations, several common themes have emerged. First, there is a need for enhanced policy coordination among federal financial regulatory agencies. Second, supervisory and enforcement policies and practices should be better coordinated for purposes of promoting both safety and soundness and financial stability. Increased coordination on the part of the regulators will identify problem areas and help financial regulators prioritize enforcement actions. Third, financial laws, regulations, and supervisory practices must be harmonized and modernized for consistency.

A list of all of Treasury's recommendations within this report is set forth as *Appendix B*, including the recommended action, method of implementation (Congressional and/or regulatory action), and which Core Principles are addressed.

Following is a summary of the recommendations set forth in the report.

Addressing the U.S. Regulatory Structure

Both Congress and the financial regulatory agencies have roles to play in reducing overlap and increasing coordination within the U.S. financial regulatory framework.

Treasury recommends that Congress take action to reduce fragmentation, overlap, and duplication in the U.S. regulatory structure. This could include consolidating regulators with similar missions and more clearly defining regulatory mandates. Increased accountability for all regulators can be achieved through oversight by an appointed board or commission or, in the case of a director-led agency, appropriate control and oversight by the Executive Branch, including the right of removal at will by the President.

Treasury recommends that Congress expand FSOC's authority to play a larger role in the coordination and direction of regulatory and supervisory policies. This can include giving it the authority to appoint a lead regulator on any issue on which multiple agencies may have conflicting and overlapping regulatory jurisdiction.

Treasury recommends that Congress reform the structure and mission of the Office of Financial Research to improve its effectiveness and to ensure greater accountability. Treasury recommends that the OFR become a functional part of Treasury, with its Director appointed by the Secretary, without a fixed term and subject to removal at will, and that the budget of OFR come under the control of the Treasury appropriation and budget process.

Finally, the agencies should work together to increase coordination of supervision and examination activities. The agencies should also consider coordinating enforcement actions such that only one regulator leads enforcement related to a single incident or set of facts.

Refining Capital, Liquidity, and Leverage Standards

Treasury offers a number of recommendations aimed at both decreasing the burden of statutory stress testing and improving its effectiveness by tailoring the stress-testing requirements based on the size and complexity of banks. For the statutory, company-led annual Dodd-Frank Act stress

test (DFAST), Treasury recommends raising the dollar threshold of participation to \$50 billion from the current threshold of \$10 billion in total assets. Treasury also supports giving the banking regulators the flexibility to implement a threshold for mandatory stress-testing that is tailored to business model, balance sheet, and organizational complexity such that institutions with assets greater than \$50 billion could be exempt from stress-testing requirements.

Treasury recommends eliminating the mid-year DFAST cycle and reducing the number of supervisory scenarios from three to two – the baseline and severely adverse scenario. For the company-run stress tests, banks should be permitted to determine the appropriate number of models that are required to develop sufficient output results, based on the complexity of the banking organization and the nature of its assets.

Treasury recommends that Congress amend the \$50 billion threshold under Section 165 of Dodd-Frank for the application of enhanced prudential standards to more appropriately tailor these standards to the risk profile of bank holding companies. The Federal Reserve should also revise the threshold for application of Comprehensive Capital Analysis and Review (CCAR) to match the revised threshold for application of the enhanced prudential standards. The CCAR process should be adjusted to a two-year cycle, which will not compromise quality in that stress-testing results are forecast over a nine quarter cycle. Provision could be made for off-cycle submission if a revised capital plan is required due to extraordinary events or in the case of financial distress.

Treasury supports an off-ramp exemption for DFAST, CCAR, and certain other prudential standards for any bank that elects to maintain a sufficiently high level of capital, such as the 10% leverage ratio proposed by H.R. 10, the Financial CHOICE Act of 2017.

In order to provide for more transparent and accountable regulatory processes, the Federal Reserve should subject its stress-testing and capital planning review frameworks to public notice and comment. Treasury makes further recommendations concerning the CCAR process and the process of setting economic assumptions and modelling parameters, in both the quantitative and qualitative assessments, that may result in estimates of excessive capital requirements in the severely adverse scenario.

The CCAR qualitative assessment is too subjective and non-transparent, and hence should be eliminated as a sole objection to a capital plan. The qualitative assessment should be adjusted for all banking organizations to conform to the horizontal capital review (as the Federal Reserve has already done for non-complex banking groups with assets less than \$250 billion, to decrease the regulatory burden).

Additionally, further emphasis should be given to the use of standardized approaches over advanced approaches for risk-weighting assets to simplify the capital regime. Also, a more transparent, rules-based approach should be used in the calculation of operational risk capital.

The scope of application of the liquidity coverage ratio (LCR) should be considerably narrowed to include only internationally active banks. The single-counterparty credit limit (SCCL) also should only apply to banks that are subject to the revised threshold for the application of the enhanced prudential standards. The degree of conservatism in the cash flow calculations methodologies and other aspects of the LCR process should be adjusted, including greater reliance on a banking organization's historical experience.

Treasury recommends delaying the domestic implementation of the Net Stable Funding Ratio (NSFR) and Fundamental Review of the Trading Book (FRTB) rules until they can be appropriately calibrated and assessed. Both of these standards represent additional regulatory burden and would introduce potentially unnecessary capital and liquidity requirements on top of existing capital and liquidity requirements. U.S. regulators should also rationalize and improve the risk-based capital regime over time through, for example, reducing redundant calculation approaches and improving risk sensitivity in the measurement of derivative and securities lending exposures.

Treasury recommends that the potential impact of the FASB Current Expected Credit Losses (CECL) standard on banks' capital levels be carefully reviewed by U.S. prudential regulators with a view towards harmonizing the application of the standard with regulators' supervisory efforts.

Treasury recommends that the living will process be made a two year cycle rather than the current annual process, which is not required by Dodd-Frank. Treasury also recommends that the threshold for participation in the living will process be revised to match the revised threshold for application of the enhanced prudential standards. This change would only include those banks that have a sufficient level of complexity as to justify the living will requirement. Other changes Treasury recommends include improving the quality and transparency of guidance and promoting better regulatory harmonization and timely response following submission of living wills.

Treasury recommends that living wills guidance be subject to notice and comment before becoming final. While the Federal Reserve and the FDIC have increased their coordination and responsiveness to companies seeking guidance on the preparation of their living wills, ongoing discrepancies in guidance remain. Treasury recommends that section 165(d) of Dodd-Frank be amended to remove the FDIC from the living wills process. The Federal Reserve should be required to complete its review and give feedback to firms on their living wills within six months.

Providing Credit to Fund Consumers and Businesses to Drive Economic Growth

Treasury has identified numerous regulatory factors that are unnecessarily limiting the flow of credit to consumers and businesses and thereby constraining economic growth and vitality. Some of these regulatory factors also unnecessarily restrict the range of choices and options for borrowers, particularly consumers, through undue restrictions on banks' ability to design and deliver responsible lending products.

Treasury's recommendations for revising capital and liquidity regulatory regimes are aimed at increasing banks' lending capacity while maintaining safety and soundness standards. Treasury recommends recalibrating capital requirements that place an undue burden on individual loan asset classes, particularly for mid-sized and community financial institutions.

A significant restructuring in the authority and execution of regulatory responsibilities by the CFPB is necessary. The CFPB was created to pursue an important mission, but its unaccountable structure and unduly broad regulatory powers have led to predictable regulatory abuses and excesses. The CFPB's approach to rulemaking and enforcement has hindered consumer access to credit, limited innovation, and imposed unduly high compliance burdens, particularly on small institutions. Treasury's recommendations include: making the Director of the CFPB removable at will by the President or, alternatively, restructuring the CFPB as an independent multi-member

commission or board; funding the CFPB through the annual appropriations process; adopting reforms to ensure that regulated entities have adequate notice of CFPB interpretations of law before subjecting them to enforcement actions; and curbing abuses in investigations and enforcement actions.

The regulatory environment should protect consumers' interests and allow banks adequate leeway to exercise reasonably constructed consumer lending regimes, giving consumers the broadest array of choices, supported by appropriately designed and implemented compliance regimes. The regulatory environment should also promote financial inclusion, bringing more consumers into the banking system and out of less regulated markets.

Treasury has reviewed and made recommendations to improve, and reduce the costs of, lending flows from the banking system across a range of product types, including residential mortgages, leveraged lending, and small business lending. A significant amount of regulatory overlap of activities-based regulation exists across consumer and commercial lending that should be addressed through inter-agency review and coordination. This overlap puts a particularly high burden on mid-sized and community banking organizations.

Improving Market Liquidity

The cumulative effect of a number of bank regulations implementing Dodd-Frank may be limiting market liquidity. Maintaining strong, vibrant markets at all times, particularly during periods of market stress, is aligned with the Core Principles and is necessary to support economic growth, avoid systemic risk, and therefore minimize the risk of a taxpayer-funded bailout.

Consideration of adjustments to the Supplementary Leverage Ratio (SLR) and enhanced Supplementary Leverage Ratio (eSLR) is important to address unfavorable impacts these requirements may have on market liquidity and low-risk assets. Specifically, adjustments should be made to the calibration of the eSLR buffer and the leverage exposure calculation. Exceptions from the denominator of total exposure should include: (1) cash on deposit with central banks; (2) U.S. Treasury securities; and (3) initial margin for centrally cleared derivatives.

Treasury recommends significant changes to the Volcker Rule, including changes to the statute, regulations and supervision. Undue compliance burdens must be eliminated in order to eliminate unnecessary impact on market liquidity. Treasury supports in principle the Volcker Rule's limitations on proprietary trading and does not recommend its repeal.

Banks with \$10 billion or less in assets should not be subject to the Volcker Rule. Treasury also recommends that the proprietary trading restrictions of the rule not apply to banks with greater than \$10 billion in assets unless they exceed a threshold amount of trading assets and liabilities. In addition, Treasury has identified various ways of reducing the complexity of the Volcker Rule to decrease regulatory compliance burdens. Treasury advocates simplifying the definition of proprietary trading and allowing banks to more easily hedge their risks and conduct market-making activities. Treasury's recommendations respond to the concern that undue constraints on market making present risks to market liquidity, particularly during times of stress. Treasury also recommends changes to the compliance program requirements of the rule in order to decrease regulatory burden.

Similarly, the covered funds provisions of the rule require modification to decrease unnecessary burdens, including by refining the definition of a covered fund. This change can greatly assist in the formation of venture and other capital that is critical to fund economic growth opportunities. Finally, given the fragmentation of responsibility for implementing the Volcker Rule across five agencies, these agencies should ensure that their guidance and enforcement of the rule is consistent and coordinated.

Allowing Community Banks and Credit Unions to Thrive

In order to promote the orderly operation and expansion of the community banking and credit union sector, Treasury recommends that the overall regulatory burden be significantly adjusted. This is appropriate in light of the complexity and lack of systemic risk of such financial institutions.

The capital regime for community banks having total assets less than \$10 billion should be simplified, which can be achieved by providing for an exemption from the U.S. Basel III risk-based capital regime and, if required, an exemption from Dodd-Frank's Collins Amendment. This change could address the treatment of select asset classes that are integral to banking models, such as mortgage servicing assets and certain types of commercial real estate loans. In addition, Treasury recommends raising the Small Bank Holding Company Policy Statement asset threshold from \$1 billion to \$2 billion.

Treasury recommends that regulators undertake additional efforts to streamline regulatory supervisory burden and reporting requirements for all community financial institutions, including the scale of Call Reports (i.e., each bank's consolidated reports of condition and income).³ Regulators should undertake a critical review of their coordination procedures and consider forming a consolidated examination force. Further, greater accountability and clarity should be incorporated into the examination procedures and data collection requirements.

Treasury recommends changes to the CFPB's ATR/QM rule and raising the total asset threshold for making Small Creditor QM loans from the current \$2 billion to a higher asset threshold of between \$5 and \$10 billion to accommodate loans made and retained by a larger set of community financial institutions.

For credit unions, Treasury recommends raising the scope of application for stress-testing requirements for federally-insured credit unions to \$50 billion in assets (from \$10 billion in assets currently). The final rule requiring credit unions with assets greater than \$100 million to satisfy a risk-weighted capital framework should also be repealed. Instead, credit unions of all sizes should have a simple leverage test, with consideration as to whether the current capital requirement should be revised in order to promote greater equality with equivalent commercial bank capital requirements.

As with banks, credit unions should be granted relief from the current level, design, and lack of notice and transparency of the supervision and examination processes. Examination should be more tailored and cost efficient to avoid burdensome and unnecessary procedures. This would require coordination between NCUA, CFPB, and state regulators. Procedures that are redundant between regulators should be streamlined.

3. To access call reports see FFIEC, Central Data Repository's Public Data Distribution, available at cdr.ffiec.gov/public.

Advancing American Interests and Global Competitiveness

Treasury recommends increased transparency and accountability in international financial regulatory standard-setting bodies. Improved inter-agency coordination should be adopted to ensure the best harmonization of U.S. participation in applicable international forums. International regulatory standards should only be implemented through consideration of their alignment with domestic objectives and should be carefully and appropriately tailored to meet the needs of the U.S. financial services industry and the American people.

Treasury recommends additional study of the recalibration of standards for capital and liquidity that have been imposed on U.S. G-SIBs. These regulations add significant complexity to capital and liquidity requirements and may have adverse economic consequences that can be addressed without impacting safety and soundness. The elements of U.S. regulations that should be reevaluated include: the U.S. G-SIB surcharge, the mandatory minimum debt ratio included in the Federal Reserve's total loss absorbing capacity (TLAC) and minimum debt rule, and the calibration of the eSLR.

Treasury generally supports efforts to finalize remaining elements of the international reforms at the Basel Committee including establishing a global risk-based capital floor in order to promote a more level playing field for U.S. firms and to strengthen the capital adequacy of global banks, especially non-U.S. institutions that, in some cases, have significantly lower capital requirements.

Treasury recommends that banking agencies carefully consider the implications for U.S. credit intermediation and systemic risk from the implementation in the United States of a revised standardized approach for credit risk under the Basel III capital framework. U.S. regulators should provide clarity on how the U.S.-specific adoption of any new Basel standards will affect capital requirements and risk-weighted asset calculations for U.S. firms.

Improving the Regulatory Engagement Model

In conducting its review of the depository sector and the regulatory engagement model, Treasury has identified areas for review and further evaluation to improve the effectiveness of regulation. The role of the boards of directors (Boards) of banking organizations can be improved to enhance accountability by appropriately defining the Board's role and responsibilities for regulatory oversight and governance. A greater degree of inter-agency cooperation and coordination pertaining to regulatory actions and consent orders should be encouraged, in order to improve the transparency and timely resolution of such actions.

Boards of banking organizations provide oversight that is critical to the successful and sound operation of these enterprises. The failure of Board governance and oversight of banking organizations was a major contributor to the financial crisis. The ability to attract and retain high-quality talent on Boards, as well as consistent principles that promote discipline and accountability, are important components of a successful governance model for banking organizations.

Treasury has identified several areas in which regulators' expectations of Boards should be reformed. Regulatory expectations of Boards suffer from a number of limitations, including the following: they may, in some instances, crowd out critical functions that Boards and Board Committees should play; blur the responsibilities between the Board and management; and impose a "one-size-fits-all" approach, which places a particular burden on mid-sized and community financial institutions.

Boards should be held to the highest standards when developing and implementing comprehensive regulatory compliance procedures and should in turn hold management to the same standards. This would, of course, involve Boards engaging with regulators and reviewing significant regulatory actions and complaints. At the same time, Treasury recommends an inter-agency review of the collective requirements imposed on Boards in order to reassess and better tailor these aggregate expectations and restore balance in the relationship between regulators, Boards, and bank management.

Treasury endorses rigorous regulatory procedures and accountability in the regulation of depository institutions. However, some rebalancing of the volume of regulatory actions based on materiality and the nature of required remediation may be warranted. A modified regulatory approach could restore more accountability on the part of Boards and management teams. This modified approach might focus more on regulatory coordination, along with supervisory guidance and recommendations, in lieu of overly prescriptive actions requiring specific remediation, such as matters requiring immediate attention. Regulators and banking organizations should develop an improved approach to addressing and clearing regulatory actions in order to limit the sustained and unnecessary restriction of banking activities and services provided to customers.

Enhancing Use of Regulatory Cost-Benefit Analysis

While Congress has imposed discrete cost-benefit analysis requirements on independent financial regulatory agencies – including the CFTC, SEC, FDIC, Federal Reserve, OCC, and CFPB – these agencies have long been exempt from Executive Order 12866 (discussed below). As a result, the financial regulators have not adopted uniform and consistent methods to analyze costs and benefits, and their cost-benefit analyses have sometimes lacked analytical rigor. Federal financial regulatory agencies should follow the principles of transparency and public accountability by conducting rigorous cost-benefit analyses and making greater use of notices of proposed rulemakings to solicit public comment. In particular, Treasury recommends that financial regulatory agencies perform and make available for public comment a cost-benefit analysis with respect to at least all “economically significant” proposed regulations, as such term is used in Executive Order 12866. Such analysis should be included in the administrative record of the final rule.

Encouraging Foreign Investment in the U.S. Banking System

Treasury considers foreign investment in the U.S. banking system to be an aid to diversifying the risk of the financial system and propelling economic growth. Among other reasons, such investment and related connection back to the home jurisdiction of these banks can frequently enhance a bridge of further foreign corporate investment in the United States.

The application of U.S. enhanced prudential standards to foreign banking organizations (FBOs) should be based on their U.S. risk profile, using the same revised threshold as is used for the application of the enhanced prudential standards to U.S. bank holding companies, rather than on global consolidated assets.

Treasury supports the continuation of the Federal Reserve’s intermediate holding company (IHC) regime to promote consolidated prudential supervision over FBOs’ U.S. banking and non-banking activities (including investment banking and securities dealing) and the application of the TLAC rule to improve the resolvability of G-SIBs. However, changes to the current framework should

be considered to encourage foreign banks to increase investment in U.S. financial markets and provide credit to the U.S. economy.

Consistent with the thresholds recommended for U.S. BHCs, Treasury recommends that the threshold for IHCs to comply with U.S. CCAR be raised from the current \$50 billion level to match the revised threshold for the application of enhanced prudential standards, subject to the ability of the Federal Reserve to impose these requirements on smaller IHCs in cases where the potential risks posed by the firm justify the additional requirements.

Treasury recommends that the Federal Reserve review the recalibration of the internal TLAC requirement. In assessing the appropriate calibration, the Federal Reserve should consider the foreign parent's ability to provide capital and liquidity resources to the U.S. IHC, provided arrangements are made with home country supervisors for deploying unallocated TLAC from the parent, among other factors.

Other IHC regulatory standards, such as living wills and liquidity, should also be recalibrated. In considering such a recalibration, greater emphasis should be given to the degree to which home country regulations are comparable to the regulations applied to similar U.S. BHCs. Where regulations are sufficiently comparable, FBOs should be allowed to meet certain U.S. requirements through compliance with home country regimes.

Background



The U.S. Depository System

Introduction

The U.S. banking system is the largest and most diverse in the world. Currently in the United States there are approximately 5,900 regulated banks that range in size from a few million dollars in assets to well over two trillion dollars in assets.¹ There are also approximately 5,800 credit unions with total assets of \$1.3 trillion.² Regulated depository institutions held total assets of almost \$21.4 trillion dollars in 2016, or 115% of GDP.³ The U.S. banking system is estimated to employ almost 2.8 million Americans and is indispensable to producing long-term economic growth.⁴

The U.S. banking system provides a secure way for consumers and businesses to store deposits. It is a primary conduit for capital markets activities, and a source of credit for consumer mortgages, credit cards, auto loans, small business, and commercial lending. The banking system facilitates the free flow of capital domestically and globally. Recent research indicates that debit card, credit card, ACH, and check payments facilitated through the U.S. banking system amounted to over 144 billion payment transactions in 2015 with a value of almost \$178 trillion.⁵

Key Segments

The U.S. banking system is composed of a diverse set of banking organizations that provide critical financial services to the U.S. economy, local communities and regions, and to the global financial system. The key segments of the banking system can be grouped as follows:

- The largest, most complex banks are the G-SIBs, identified as such through the U.S. and international G-SIB score methodology;
- Regional banks are BHCs or banks with more than \$50 billion in assets and that are not among the G-SIBs defined above;⁶
- Mid-sized banks are BHCs or banks with \$10 to \$50 billion in assets;
- Community banks are BHCs or banks with less than \$10 billion in assets;
- Foreign banking organizations participate in the U.S. banking system through investments or ownership positions across this array of segments as well as through their U.S. branches and agencies; and
- Credit unions are member-owned financial cooperatives that serve designated communities.

1. SNL Financial Data on all U.S. Depositories filing Call Reports. SNL Financial, May 2017 (SNL Data).

2. National Credit Union Administration. "Industry at a Glance," (Dec. 31, 2016), available at: www.ncua.gov/analysis/Pages/industry/at-a-glance-dec-2016.pdf.

3. SNL Data.

4. Id.

5. Board of Governors of the Federal Reserve System. "The Federal Reserve Payments Study 2016", (Feb. 16, 2017), available at: www.federalreserve.gov/paymentsystems/files/2016-payments-study-20161222.pdf.

6. This definition of regional banks will include large internationally active banks (i.e. banking organizations with more than \$250 billion in assets or more than \$10 billion in on-balance sheet foreign exposure) that are not G-SIBs.

G-SIBs

U.S. G-SIBs, eight firms in total, have \$10.7 trillion in assets, comprising almost 50% of domestic banking assets, and play an important role in capital markets intermediation domestically and globally.⁷

U.S. G-SIBs' financial results have recovered since the financial crisis and benefit from their size, geographic scope, diverse client base, and revenue sources. Capitalization rates have improved since the financial crisis, and the range of Tier 1 Common Equity ratios at the G-SIBs stands between 10 and 16% of risk-weighted assets. As of the fourth quarter of 2016, these institutions produced returns on equity between 6% and 12%.⁸

Regional and Mid-sized Banks

Regional and mid-sized banks, as defined here, hold \$5.3 trillion in assets (25% of industry assets) and \$1.4 trillion in assets (6% of industry assets), respectively.⁹ These institutions generally have balance sheets and business models that are more closely aligned with lending and deposit taking. There are approximately 90 institutions in these two groups.

Regional and mid-sized banks' results have generally recovered in recent years like the G-SIBs. Capitalization rates and asset quality performance have continued to improve during the post-crisis recovery in line with industry-wide trends. The unusually low interest rate environment and significantly increased regulatory burden arising from the implementation of Dodd-Frank has had an effect on performance of regional and mid-sized banks.¹⁰ In particular, asset thresholds used to apply regulatory requirements, especially Dodd-Frank's \$10 billion threshold for applying stress tests and \$50 billion threshold for applying enhanced prudential standards, have created barriers that have deterred regional and mid-sized banks from expanding their operations. Treasury is concerned that such thresholds are limiting competition against the largest institutions and, consequentially, may be contributing to the solidification of the market position of the largest institutions.

Community Banks

Community banks hold \$2.7 trillion or 13% of industry assets and are providers of local banking services to communities across America. These banks employ business models that are concentrated in local real estate, consumer, and small business lending. Community banks are generally funded, owned, and operated locally. There are approximately 5,500 such banks in the United States today.¹¹

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7. SNL Data. This information is consolidated for top-tier bank holding companies (BHCs) and standalone banks not controlled by a BHC parent.
 8. SNL Data.
 9. Due to rounding, numbers may not add up precisely to the totals provided and percentages may not precisely reflect the absolute figures.
 10. See Bouwman, Christa H.S., Hu, Shuting (Sophia), Johnson, Shane A., *Differential Bank Behaviors around the Dodd-Frank Act Size Thresholds* (May 25, 2017), available at: <https://ssrn.com/abstract=2974235>. See also Baily, Martin N., Holmes, Sarah E., *The regional banks: The evolution of the financial sector, Part II* (Aug. 13, 2015), available at: <https://www.brookings.edu/research/the-regional-banks-the-evolution-of-the-financial-sector-part-ii/>.
 11. SNL Data.

Among community banks, there is a subset of institutions (less than 1%) designated as Community Development Financial Institutions (CDFIs) and Minority Depository Institutions (MDIs) by Treasury¹² and FDIC,¹³ respectively. CDFIs and MDIs operate under the same business models as community banks; however, they are often considered a distinct sector of the banking industry because of their CDFI/MDI designations. CDFIs and MDIs are often the only source of credit and financial services in impoverished urban and rural low- and moderate-income areas with limited access to the banking system. As of the fourth quarter 2016, the median asset size of a CDFI and MDI was \$240 million and \$263 million, respectively.¹⁴

While the generally positive post-crisis trends in capitalization rates and stronger asset quality extend to many community banks, the increased regulatory burden imposed since the implementation of Dodd-Frank has had a disproportionate impact on the competitiveness and viability of community banks as reflected in the sustained decline in number of institutions. FDIC data shows that the number of federally insured banks declined from 17,901 banks in 1984¹⁵ to 5,913 banks in 2016.¹⁶ While many factors may contribute to this long-term trend, regulatory burden is certainly a contributing factor. At the same time, de novo applications for new bank charters are at all-time lows.

Community banks disproportionately serve the needs of the nation's small businesses and rural communities, accounting for 43% of all small loans to businesses and 90% of agriculture loans.¹⁷

Credit Unions

Credit union charters are granted by federal or state governments, and the credit union system is comprised of approximately 5,800 credit unions with assets totaling \$1.3 trillion. 95% of credit unions in the system have assets of less than \$1 billion.¹⁸

Currently, the credit union system is very well capitalized, with the aggregate net worth ratio (equivalent to bank leverage ratio) of approximately 11%. However, the number of credit unions

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12. Banks certified as CDFIs by Treasury's CDFI Fund are institutions that must demonstrate that at least 60% of total lending, services, and other activities serve a community or targeted population of individuals who are low-income persons or lack adequate access to financial products or services.
 13. The FDIC deems an institution as a MDI according to either: (1) a concentration of ownership among members of a certain minority group, or (2) a concentration of board membership among that minority group by an institution that primarily serves that minority group. The FDIC classifies MDIs based on minority status as African American, Asian American, Hispanic American, multi-racial, and Native American.
 14. Treasury analysis; FDIC call report data, Fourth Quarter 2016.
 15. Federal Deposit Insurance Corporation. "FDIC Community Banking Study 2012". Dec. 2012, available at: www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.
 16. FDIC Quarterly Banking Report on all FDIC-insured institutions.
 17. Federal Deposit Insurance Corporation. "Community Bank Performance: Fourth Quarter 2016". (Feb. 28, 2017), available at: www.fdic.gov/bank/analytical/qbp/2016dec/qbpcb.html.
 18. National Credit Union Administration. Call Report Quarterly Summary Reports. Dec. 2016. available at: <https://www.ncua.gov/analysis/Pages/call-report-data/Reports/PACA-Facts/paca-facts-2016-12.pdf>.

has declined by approximately 18% since 2011.¹⁹ Consolidation is largely seen as a long-term trend with the decline concentrated in small credit unions.²⁰

Foreign Banking Organizations

FBOs are foreign banks, including all banking and nonbanking subsidiaries, which have a U.S. presence generally through controlling investments in U.S. banks or BHCs, or that operate U.S. branches or agencies. Collectively, the U.S. operations of FBOs have total assets that exceed \$4.5 trillion.²¹

The U.S. Financial Regulatory Structure

Overview of Federal and State Regulators

The eight major U.S. federal financial regulators can be categorized into those focused on prudential banking regulation promoting safety and soundness, including the Federal Reserve, FDIC, OCC, and NCUA; those focused on financial markets, including the SEC and the CFTC; one focused on housing finance, the FHFA; and one focused on consumer financial protection, the CFPB. Additionally, self-regulatory organizations help regulate and oversee certain parts of the financial sector, including the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), and the National Futures Association (NFA). Insurance is primarily regulated at the state level.

Federal Banking Regulators

The Board of Governors of the Federal Reserve System (Federal Reserve)

The Federal Reserve serves a central role in the financial system overseeing monetary policy through the Federal Open Market Committee as well as operating, through the Federal Reserve Banks, key components of the payment, clearing, and settlement system. It also regulates BHCs, savings and loan holding companies, state-chartered member banks, and nonbank financial companies designated by the FSOC for Federal Reserve supervision. The Federal Reserve's mission also includes maintaining the stability of the financial system.

While the Federal Reserve regulates and supervises all BHCs on a consolidated basis, it generally defers to the functional regulator of a BHC's subsidiary on matters related to that specific subsidiary. Federal Reserve supervision is generally conducted by the Federal Reserve Banks acting under delegated authority, though the Federal Reserve also directly supervises firms within its Large Institution Supervision Coordinating Committee (LISCC) framework²²

19. *Id.*

20. National Association of Federal Credit Unions. 2016 NAFCU Report on Credit Unions. Nov. 2016, available at: <https://www.nafcu.org/research/reportoncreditunions/>.

21. SNL Data; see also Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks per Federal Reserve as of 2016, available at: <https://www.federalreserve.gov/econresdata/releases/assetliab/current.htm>.

22. Federal Reserve, Large Institution Supervision Coordinating Committee, July 2016, available at: www.federalreserve.gov/bankinforeg/large-institution-supervision.htm.

Dodd-Frank required the Federal Reserve to establish enhanced prudential standards for large U.S. BHCs and for certain U.S. operations of foreign banking organizations, as well as for nonbank financial companies designated by the FSOC. The Federal Reserve is one of the five agencies responsible for implementing the Volcker Rule, the Qualified Residential Mortgage Rule, and other agency rules. It also administers stress tests for BHCs and, in conjunction with the FDIC, reviews the living wills of large BHCs and FSOC-designated nonbank financial companies.

Federal Deposit Insurance Corporation (FDIC)

The FDIC works to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, working to make large and complex financial institutions resolvable, and acting as receiver of failed banks. The FDIC is the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System, and has authority to monitor and conduct examinations at insured depository institutions where it is not the primary regulator. The FDIC is appointed receiver for all insured depository institution failures.

The agency was mandated by Dodd-Frank to issue rules covering, among other things, the Volcker Rule, living wills, and Title II orderly liquidation authority implementation, and to work with the other financial regulatory agencies regarding capital, liquidity, and stress-testing.

Office of the Comptroller of the Currency (OCC)

The OCC charters, regulates, and supervises all national banks and federal savings associations as well as federal branches and agencies of foreign banks.

The agency was mandated by Dodd-Frank to work with the other financial regulatory agencies to enact rules covering credit risk retention for asset-backed securitizations, capital, liquidity, stress testing, the Volcker Rule, and executive incentive compensation. Title III of Dodd-Frank abolished the Office of Thrift Supervision and transferred the supervision and regulation of federally chartered savings associations to the OCC.

National Credit Union Administration (NCUA)

The NCUA promotes safety and soundness by regulating and supervising the credit union system, which provides confidence in the national system of cooperative credit and protects consumer rights and member deposits. The NCUA charters, regulates, and supervises federal credit unions. The NCUA also administers the National Credit Union Share Insurance Fund, which provides deposit insurance for deposit accounts of all federal and most state-chartered credit unions.

Under Dodd-Frank, the NCUA is one of several regulators tasked with writing new executive incentive-based compensation rules. The NCUA has also implemented a stress testing rule for credit unions with more than \$10 billion in assets.

Other Federal Regulators

Consumer Financial Protection Bureau (CFPB)

Created by Dodd-Frank, the CFPB regulates the offering and provision of consumer financial products and services under federal consumer financial laws, develops consumer education initiatives,

and researches and monitors the market for financial services. The CFPB has supervisory and enforcement authority over: 1) banks, thrifts, and credit unions with assets over \$10 billion, as well as their affiliates, 2) all nonbank residential mortgage originators, brokers, and servicers, 3) all payday lenders, 4) all nonbank private student lenders, 5) larger participants in markets for other consumer financial products or services as determined by CFPB rulemaking, and 6) other firms where the CFPB has reasonable cause to determine their conduct poses risks to consumers related to the offering or provision of consumer financial products or services. Authority over 18 enumerated federal consumer financial laws, which was previously divided among seven agencies, was consolidated within the CFPB under Dodd-Frank. Dodd-Frank specifically granted the CFPB authority to write and enforce rules covering, among other things, mortgage lending and servicing, unified mortgage disclosures, and the prohibition on UDAAP.

Federal Housing Finance Agency (FHFA)

The FHFA is responsible for the oversight of components of the secondary mortgage markets—the government-sponsored enterprises of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. Since 2008, FHFA has been the conservator of Fannie Mae and Freddie Mac.

The FHFA was mandated by Dodd-Frank to enact specified joint rules with other agencies on topics such as mortgage originator compensation, mortgage risk retention, appraisal requirements, and stress testing.

State Banking Regulators

All 50 states, the District of Columbia, and U.S. territories have banking regulators that supervise approximately 5,000 depository institutions with aggregate assets of more than \$4.9 trillion. Insured state depository institutions are also subject to supervision and regulation by the FDIC, and state depository institutions that elect to become members of the Federal Reserve System are also subject to supervision and regulation by the Federal Reserve.

The states also supervise most non-depository financial institutions, including mortgage loan originators and servicers, consumer finance companies, payday lenders, and money service businesses. As part of their non-depository authority, many state regulators supervise financial institutions in the growing financial technology sector. Currently, state regulators license approximately 16,000 mortgage companies and more than 138,000 non-depository financial institutions.

Markets Regulators

Commodity Futures Trading Commission (CFTC)

The CFTC was established in 1974 as an independent federal regulatory agency with exclusive jurisdiction over the markets for commodity futures and options on futures. The Commodity Exchange Act is the federal law governing futures markets and the CFTC's authorities. Though originally focused on agricultural commodity futures contracts, the CFTC's jurisdiction also extends to futures contracts on energy products, metals, financial assets and indexes, interest rates, and other financial, commercial, or economic contingencies. In 2010, Dodd-Frank amended the Commodity Exchange Act to expand the CFTC's jurisdiction to include swaps and implement the Volcker Rule.

The CFTC’s mission is to foster open, transparent, competitive, and financially sound markets to avoid systemic risk and to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act.²³ To promote market integrity, the CFTC polices the markets and participants under its jurisdiction for abuses and brings enforcement actions. The CFTC oversees industry self-regulatory organizations, including traditional organized futures exchanges or boards of trade known as designated contract markets. The CFTC also registers and oversees other market entities such as swap execution facilities, derivatives clearing organizations, and swap data repositories. Further, the CFTC requires registration of market intermediaries and their personnel, including swap dealers, futures commission merchants, introducing brokers, commodity pool operators, and commodity trading advisors.

Securities and Exchange Commission (SEC)

The SEC’s mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Broadly, the SEC has jurisdiction over brokers and dealers, securities offerings in the primary and secondary markets, investment companies, investment advisers, credit rating agencies, and security-based swap dealers.

The SEC was mandated by Dodd-Frank to enact rules in areas including registration of certain private funds (hedge funds and private equity funds), the Volcker Rule, security-based swaps, clearing agencies, municipal securities advisors, executive compensation, proxy voting, asset-backed securitizations, credit rating agencies, and specialized disclosures.

Self-regulatory Organizations

Financial Industry Regulatory Authority (FINRA)

FINRA’s mission is to provide investor protection and to promote market integrity through effective and efficient regulation of its member broker-dealers. It has responsibility for overseeing securities markets and their members, establishing the standards under which their members conduct business, monitoring business conduct, and bringing disciplinary actions against members for violating applicable federal statutes, SEC rules, and FINRA rules.²⁴

Municipal Securities Rulemaking Board (MSRB)

The mission of the MSRB is to protect investors, state and local government issuers, other municipal entities and the public interest by promoting a fair and efficient municipal market through (i) the establishment of rules for dealers and municipal advisors, (ii) the collection and dissemination of market information, and (iii) market leadership, outreach, and education.²⁵ The MSRB develops

23. CFTC, Agency Financial Report, Fiscal Year 2016, available at: <http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/2016afr.pdf>.

24. GAO. Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness (Complex and Fragmented Structure) (Feb. 2016) at 22, available at: www.gao.gov/assets/680/675400.pdf.

25. Id. at 23.

rules for broker-dealers engaged in underwriting, trading, and selling municipal securities with the goals of protecting investors and issuers and promoting a fair and efficient marketplace.²⁶

National Futures Association (NFA)

The NFA is a self-regulatory organization whose mission is to provide regulatory programs and services that ensure futures industry integrity, protect market participants, and help NFA members meet their regulatory responsibilities. The NFA establishes and enforces rules governing member behavior including futures commission merchants, commodity pool operators, commodity trading advisors, introducing brokers, designated contract markets, swap execution facilities, commercial firms, and banks.²⁷

Regulatory Structure and Issues of Regulatory Duplication, Overlap, and Fragmentation

Regulatory Fragmentation, Overlap, and Duplication

A strong financial regulatory framework is vital to promote economic growth and financial stability, and to protect the safety and soundness of U.S. financial institutions. Regulatory fragmentation, overlap, and duplication, however, can lead to ineffective regulatory oversight and inefficiencies that are costly to the taxpayers, consumers, and businesses. Significant opportunities exist to rationalize and streamline the U.S. regulatory framework. Doing so could both improve the efficacy of the regulatory framework and also facilitate saving and increase investment in the economy.

The U.S. financial regulatory system has developed over more than 150 years through a series of incremental legislative and policy actions in response to financial crises and market developments. While reforms have eliminated some regulatory agencies, they have also created new ones. The financial regulatory structure is fragmented among regulators with varying missions, including safety and soundness, consumer protection, securities and derivatives markets regulation, insurance supervision, and systemic risk oversight. This fragmentation results in overlapping and duplicative mandates and could benefit from streamlining and coordination.

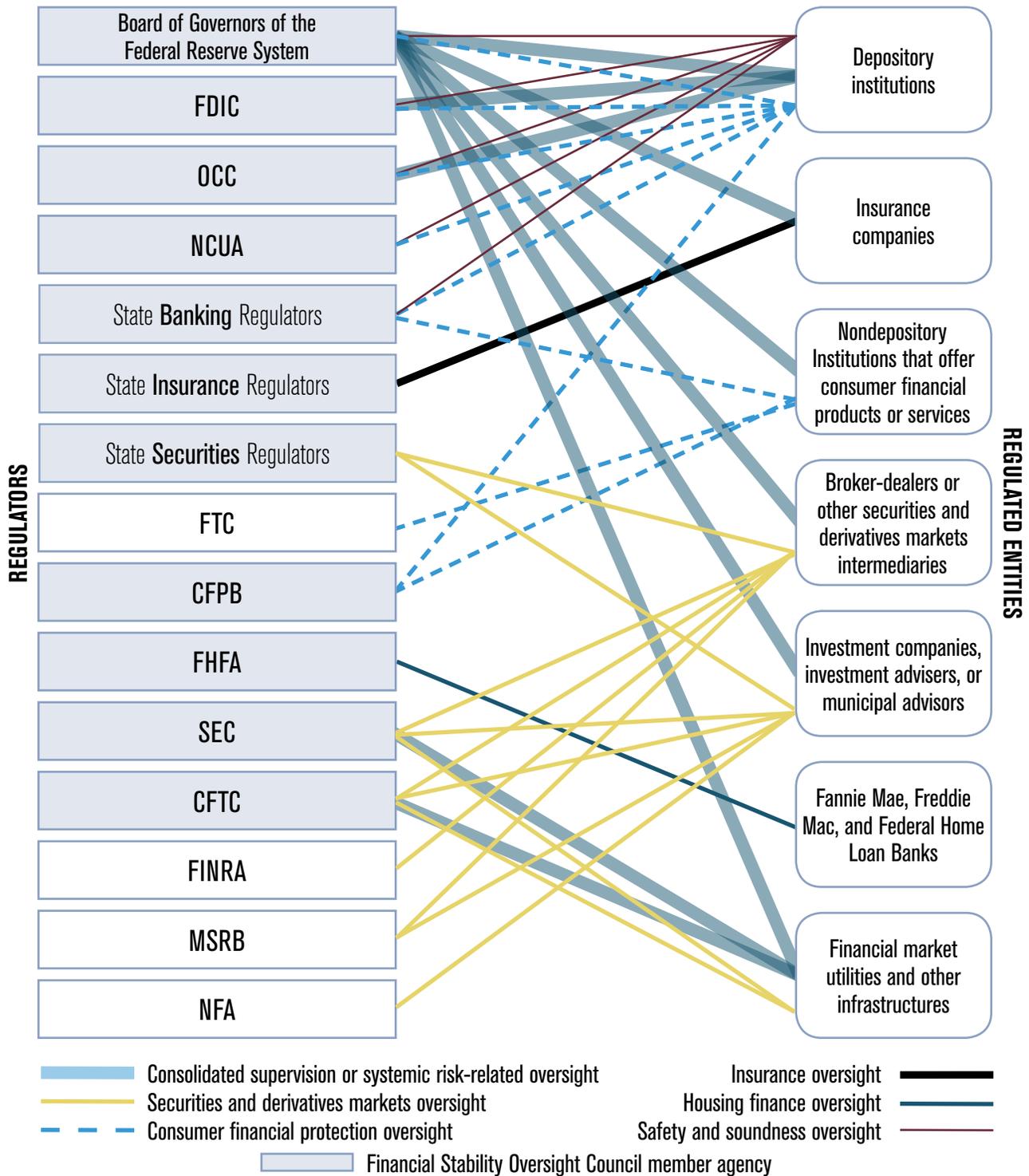
In 2016, the Government Accountability Office (GAO) released a report in which it reviewed the current financial regulatory structure and the effects of fragmentation and overlap.²⁸ The GAO found that the existing regulatory structure does not always ensure (1) efficient and effective oversight, (2) consistent financial oversight, and (3) consistent consumer protections. Specifically, the report concluded that significant fragmentation, overlap, and duplication exist within the regulatory framework.

26. Id.

27. Id. at footnote 32.

28. GAO, *Complex and Fragmented Structure*. The GAO defined fragmentation, overlap, and duplication as follows: (1) fragmentation: more than one federal agency is involved in the same broad area of need and opportunities exist to improve service delivery; (2) overlap: multiple agencies have similar goals, engage in similar activities or strategies, or target similar beneficiaries; and (3) duplication: two or more agencies or programs are engaged in the same activities or provide the same services to the same beneficiaries.

Figure 1: U.S. Financial Regulatory Structure, 2016



Note: This figure depicts the primary regulators in the U.S. financial regulatory structure, as well as their primary oversight responsibilities. "Regulators" generally refers to entities that have rulemaking, supervisory, and enforcement authorities over financial institutions or entities. There are additional agencies involved in regulating the financial markets and there may be other possible regulatory connections than those depicted in this figure. A list of acronyms is available on page iv. Source: GAO GAO-16-175

There are numerous examples of overlap in the depository regulatory framework. For example, state and federal regulators (including the FDIC and the Federal Reserve) share oversight of the safety and soundness of state-chartered banks. As another example, as administrator of the Deposit Insurance Fund, the FDIC has backup supervisory authorities over all banks and thrifts that are federally insured. Thus, there is overlap between the FDIC, the Federal Reserve, the OCC, and state banking regulators regarding supervisory responsibilities. For credit unions, there are elements of overlap between the NCUA, as consolidated regulator, and the CFPB and state regulators. These areas of overlap can create confusion and increased costs for supervised entities, as well as increased burdens for the regulatory agencies themselves. Although Dodd-Frank created the CFPB in part to rectify the fragmentation of authority among regulators with respect to consumer financial protection, its authority on such matters is not unique and is duplicative with the supervisory activities of the Federal Reserve, OCC, FDIC, NCUA, and state regulators.

In light of this regulatory fragmentation, enhanced coordination among federal and state agencies is vital. There are numerous examples of regulators' current efforts to coordinate. For example, as the GAO noted, the federal banking regulators, CFPB, and state banking regulators coordinate through the Federal Financial Institutions Examination Council.²⁹ Further, the Riegle Community Development and Regulatory Improvement Act of 1994 requires the prudential regulators to coordinate examinations. The Federal Reserve, FDIC, and Conference of State Bank Supervisors (a non-governmental association of state regulators) executed an agreement aimed at providing a seamless supervisory process and minimizing regulatory burden.³⁰ In addition, in 2013, the Conference of State Bank Supervisors and the CFPB developed a supervisory coordination framework that established a process for how state regulators and the CFPB will share supervision of non-depository financial services providers and state-chartered depository institutions with more than \$10 billion in assets.³¹ The FSOC also provides a forum for regulators to convene and collaborate. Further, cybersecurity is addressed among a broad group of federal and state regulators through the Financial and Banking Information Infrastructure Committee (FBIIC). While these efforts have increased the amount of coordination among the regulators, improved coordination and streamlining are necessary to ensure the efficiency and effectiveness of the regulatory framework.

Opportunities for Reform

Treasury recommends that Congress take action to reduce fragmentation, overlap, and duplication in financial regulation. This could include consolidating regulators with similar missions and more clearly defining regulatory mandates. Increased accountability for all regulators should be achieved through oversight by an appointed board or commission, or in the case of a director-led agency, appropriate control and oversight by the Executive Branch, including the right of removal at will by the President.

The statutory mandate of the FSOC should be broadened so that it can assign a lead regulator as primary regulator on issues where multiple agencies may have conflicting and overlapping regulatory jurisdiction. This new authority would allow the FSOC to play a larger role in the coordination

29. *Id.* at 40.

30. *Id.* at 41.

31. *Id.*

and direction of regulatory and supervisory policies. The FSOC should also be reformed to further facilitate information sharing and coordination among the member agencies regarding financial services policy, rulemaking, examinations, reporting, and enforcement.

The Office of Financial Research was created by Dodd-Frank, in part, as an independent resource to support the FSOC and its members in advancing the FSOC's financial stability mission. Congress should reform the structure and mission of the Office of Financial Research to improve its effectiveness and to ensure greater accountability. As part of this assessment, Treasury recommends that the OFR become a functional part of Treasury, with its Director appointed by the Secretary, without a fixed term and subject to removal at will, and that the budget of OFR come under the control of the Treasury appropriation and budget process.

Cyber-Security Regulatory Overlap

Technology is a critical feature of the U.S. financial markets and plays an integral role in the operations of financial institutions. Given the increasingly important role of technology, the possibility exists for new vulnerabilities and risks of operational disruption in the financial sector due to a cyber incident. Thus, cybersecurity is a critical component of financial regulation. In cybersecurity, financial institutions share the same goal as regulatory agencies: maintaining the safety and soundness of the financial system by mitigating and protecting financial institutions and the sector from cybersecurity risks.

Better coordination on cybersecurity regulation is needed to achieve this goal and enhance the resiliency of the sector. Given the risk of fragmentation and overlap, Treasury recommends that federal and state financial regulatory agencies establish processes for coordinating regulatory tools and examinations across sub-sectors. Furthermore, these efforts can serve as a foundation for additional necessary work.

Treasury recommends that further coordination should occur on two fronts. First, financial regulatory agencies should work to harmonize regulations, including using a common lexicon. Second, financial regulators should work to harmonize interpretations and implementation of specific rules and guidance around cybersecurity. For example, currently, there may be a risk of overlap in requirements for the various sub-market segments where some financial regulatory agencies have each finalized differing cybersecurity requirements that impact the same financial institutions. Coordination around these two important aspects of cybersecurity regulation will enable additional efficiencies in staffing personnel and resources related to regulatory compliance and oversight.

This additional work will be aided by ongoing activities among financial regulators through the Financial and Banking Information Infrastructure Committee (FBIIC). The FBIIC is a public sector body consisting of 18 federal agencies and state member organizations from across the financial regulatory community charged with coordinating efforts to improve the reliability and security of the financial sector infrastructure.

Finally, the agencies should work together to increase coordination of supervision and examination activities. The agencies should also consider coordinating enforcement actions such that only one regulator leads enforcement related to a single incident or facts or set of facts.

The Dodd-Frank Act

The U.S. Financial Crisis

The financial crisis that engulfed the U.S. economy in 2008 was initially precipitated by weaknesses in U.S. housing prices, an increase in mortgage delinquencies, and plummeting values of mortgage-backed securities (MBS), particularly those backed by sub-prime mortgages. Major developments during 2008 included: the merger of Bear Stearns with JPMorgan Chase, facilitated by an emergency financing package provided by the Federal Reserve Bank of New York; the placing of the two mortgage GSEs, Fannie Mae and Freddie Mac, into conservatorship by the FHFA; the bankruptcy of Lehman Brothers; and the extension of substantial government assistance to AIG.

As the financial crisis expanded from the mortgage sector into a system-wide liquidity crisis, the U.S. government responded with significant administrative and legislative interventions. The Federal Reserve developed numerous financing facilities across a wide range of asset classes and implemented a significant GSE MBS purchase program (following Treasury's GSE MBS Purchase Program).³² Congress approved the \$700 billion Troubled Asset Relief Program (TARP), which was primarily deployed in the form of capital investment in U.S. banks and non-bank financial institutions.³³ The FDIC introduced a debt guarantee program for depository institution holding companies, insured depository institutions, and affiliates.³⁴ In 2008 and 2009, economic stimulus packages were instituted totaling more than \$1 trillion.

In 2009, the Federal Reserve and the other federal banking agencies completed a large bank stress test to assess the adequacy of capital in the system. This became a prelude to subsequent stress-testing regimes to assess capital adequacy under adverse and severely adverse scenarios.

In the summer of 2009, the Administration issued a legislative reform plan that would later serve as a basis for legislation. After significant congressional revisions, President Obama signed Dodd-Frank into law on July 21, 2010.³⁵

Overview of Key Objectives of Dodd-Frank

Dodd-Frank is enormous in its scale, reach, and complexity. Much of this report evaluates the structure and effectiveness of portions of Dodd-Frank, relative to both its objectives and the nature of its implementation, which has unfolded for nearly seven years since enactment.

32. See Federal Reserve, *Agency Mortgage-Backed Securities (MBS) Purchase Program* (Feb. 12, 2016), available at: www.federalreserve.gov/regreform/reform-mbs.htm.

33. See generally 12 U.S.C. §§ 5211–5241.

34. See e.g. FDIC, *Temporary Liquidity Guarantee Program* (Feb. 27, 2013), available at: www.fdic.gov/regulations/resources/tlqp/index.html.

35. Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010).

Given its scale, it is difficult to summarize the totality of Dodd-Frank. The key characteristics of Dodd-Frank most relevant to the scope of this report include the following:

- **Mitigation of Systemic Risk**

Dodd-Frank established the FSOC for the oversight of systemic risks.³⁶ Among other responsibilities and authorities, the FSOC can designate nonbank financial companies for Federal Reserve supervision,³⁷ and can designate financial market utilities as systemically important.³⁸ Dodd-Frank also required the Federal Reserve to adopt enhanced prudential standards for U.S. BHCs having total assets of at least \$50 billion, along with certain foreign banking organizations and designated nonbank financial companies.³⁹ Among other elements, these banking organizations are subject to DFAST.⁴⁰ These standards also provide for higher capital and liquidity requirements to decrease both the incidence and severity of the failure of a large, complex financial institution. Dodd-Frank established the OFR in part to support the FSOC and its member agencies.⁴¹

- **Resolution Planning**

Dodd-Frank established the Dodd-Frank Title I framework for a resolution planning process at certain financial companies, which included the development of “living wills,”⁴² and the Orderly Liquidation Authority in Dodd-Frank Title II.⁴³

- **Creation of the CFPB**

The CFPB was created as an independent bureau in the Federal Reserve System⁴⁴ to have primary regulatory authority for consumer financial products and services under federal laws, including supervisory and enforcement authority with respect to federal consumer financial laws over insured banks, thrifts, and credit unions having assets over \$10 billion.⁴⁵ In light of the significant role that residential mortgage lending played in contributing to the crisis, the CFPB also has authority over all non-bank residential mortgage originators, brokers and servicers.⁴⁶ Dodd-Frank also establishes several elements of structural reform of mortgage finance standards and establishes federal standards in this area.

- **Volcker Rule**

Dodd-Frank includes the Volcker Rule,⁴⁷ which prohibits banking entities from engaging in proprietary trading and limits investment in certain hedge funds and private equity funds.

36. Dodd-Frank §§ 111(a), 112.

37. *Id.* at § 113.

38. *Id.* at § 804(a).

39. Dodd-Frank § 165(a).

40. *Id.* at (i)(2).

41. Dodd-Frank § 152.

42. *Id.* at § 165(d)(1).

43. *Id.* at § 204.

44. *Id.* at § 1011(a).

45. *Id.* at § 1025.

46. *Id.* at § 1024.

47. *Id.* at § 619.

- **Central Clearing of Swaps and Derivatives**
Dodd-Frank requires the exchange trading and clearing of certain derivatives that were previously traded on an over-the-counter basis.⁴⁸ The law also increased the reporting requirements for such trading through repositories and required the registration of certain previously unregistered market participants.⁴⁹ Central counterparties can be designated systemically important by the FSOC, which results in additional risk-management standards and potential access to the Federal Reserve discount window.⁵⁰
- **Investor Protections**
Dodd-Frank addressed numerous investor protection concerns that arose during the financial crisis, including reform of the credit rating agencies.⁵¹
- **Elimination of the Office of Thrift Supervision**
Dodd-Frank eliminated the Office of Thrift Supervision and transferred its duties to the OCC, the Federal Reserve, and the CFPB.⁵² This reorganization made the Federal Reserve the consolidated regulator of savings and loan holding companies with insurance company subsidiaries.⁵³

Dodd-Frank significantly changed the federal financial regulatory landscape, imposed new requirements on a broad array of U.S. financial institutions, prescribed more than 390 agency rulemaking requirements, and mandated 67 studies by various federal entities.⁵⁴ The net result of Dodd-Frank has been the largest and most complex increase in financial regulation in modern times.

Much of this report explores the impact of Dodd-Frank. Among other things, this report finds that Dodd-Frank has increased the burden of regulatory compliance without adequate cost-benefit analysis and that Dodd-Frank has prolonged the moral hazard arising from regulations that could lead to taxpayer-funded bailouts.

48. See Dodd-Frank §§ 721-74.

49. See 7 U.S.C. § 6s(a); see also 15 U.S.C. § 78o-10(a).

50. Dodd-Frank § 804(a).

51. See, e.g., Dodd-Frank §§ 932, 935, 939.

52. Dodd-Frank §§312-3.

53. Dodd-Frank §606.

54. See: Davis Polk, *Dodd-Frank Progress Report* (July 19, 2016) at 2, available at: www.davispolk.com/files/2016-dodd-frank-six-year-anniversary-report.pdf.

Findings and Recommendations



IMPROVING THE EFFICIENCY OF BANK REGULATION

Capital and Liquidity

Overview

The capital and liquidity standards established by banking regulators are critically important to a sound regulatory framework. Such standards also have a tremendous impact on a bank's balance sheet strategy and its ability to raise capital to expand its business. The capital treatment of assets frames an institution's approach to the selection and prioritization of lines of business, branch footprint, and client segmentation. It also has a tremendous impact on how the needs of retail and commercial clients are served. In a similar manner, liquidity standards dictate the portion of the balance sheet that must be invested in short-term, high-quality assets to provide sufficient and quick access to liquidity as needed. Although such standards are necessary for supporting the safety and soundness of individual institutions as well as for promoting systemic stability, they can decrease the resources a bank has available for customer loans.

Capital and liquidity requirements must work together in providing a cushion against potential losses and providing adequate funding to reduce the risk of insolvency during periods of distress. Conversely, an excess of capital and liquidity in the banking system will detract from the flow of consumer and commercial credit and can inhibit economic growth.

The U.S. banking system is significantly better capitalized today than it was prior to the financial crisis. For the largest U.S. bank holding companies, which are subject to the Federal Reserve's CCAR stress tests, discussed further below, high-quality common equity capital has increased by more than \$700 billion, to \$1.2 trillion since 2009.¹ The combined common equity risk-based capital ratio has similarly more than doubled, from 5.5% to 12.2%.² These firms are projected to be able to withstand almost \$600 billion in losses generated by a period of severe distress, like a financial crisis, and still have enough capital to continue to lend and provide critical services to the economy.³

Large U.S. banks hold nearly 24% of their assets in high-quality liquid assets such as cash, U.S. Treasury securities, and agency securities, which is about five times higher than their pre-crisis share.⁴ Moreover, the largest banks have significantly reduced their reliance upon less-stable, short-term wholesale funding.

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1. Press Release, CCAR, *Federal Reserve Releases Results of Comprehensive Capital Analysis and Review* (Jun. 29, 2016), available at: www.federalreserve.gov/newsevents/pressreleases/bcreg20160629a.htm.
 2. *Id.*
 3. *Id.*
 4. The Clearing House, *The State of American Banking: An assessment of the resiliency of U.S. banks and their ability to support steady economic growth* (Nov. 2016), available at: www.theclearinghouse.org/-/media/action%20line/documents/volume%20vii/20161201_state-of-american-banking-report_tch.pdf.

Figure 2: Tier 1 Capital Ratios

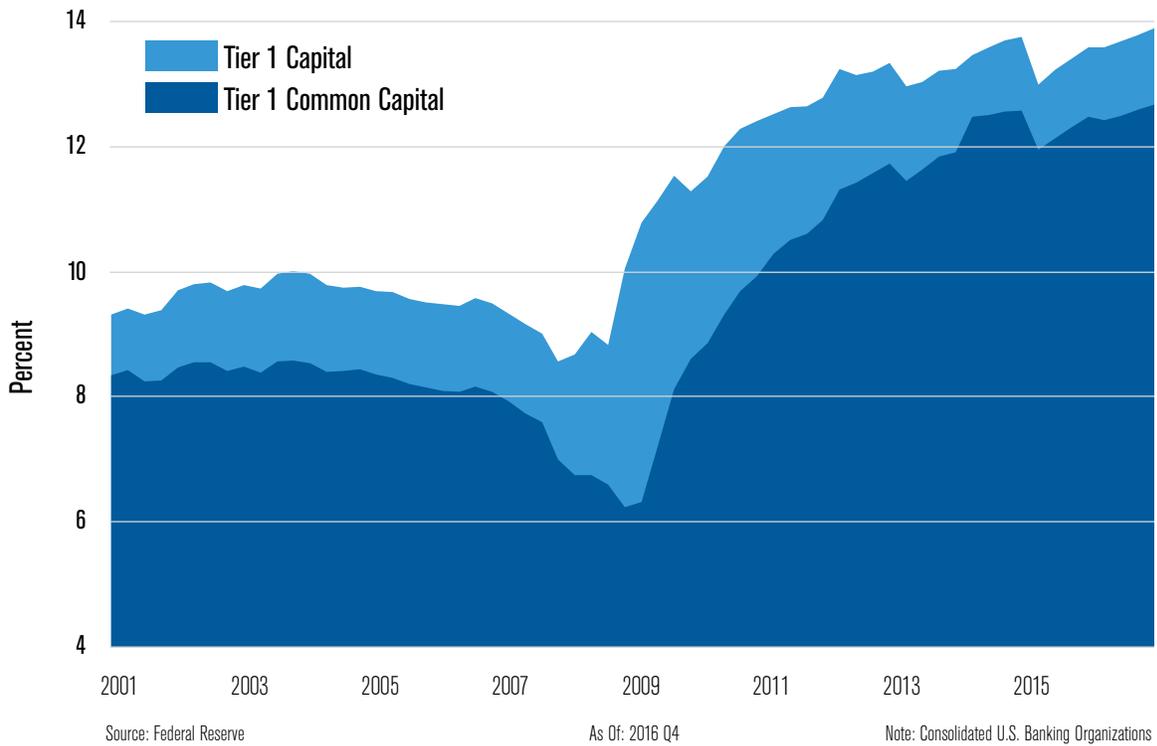


Figure 3: Select Liquid Assets

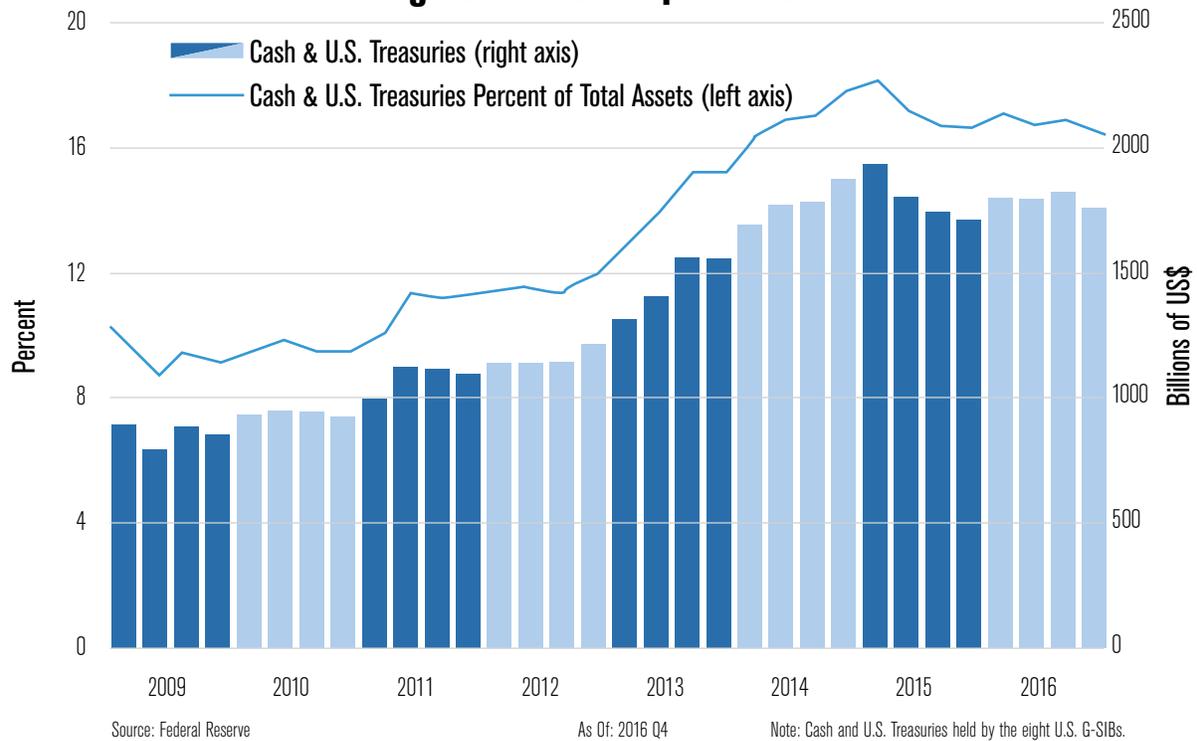
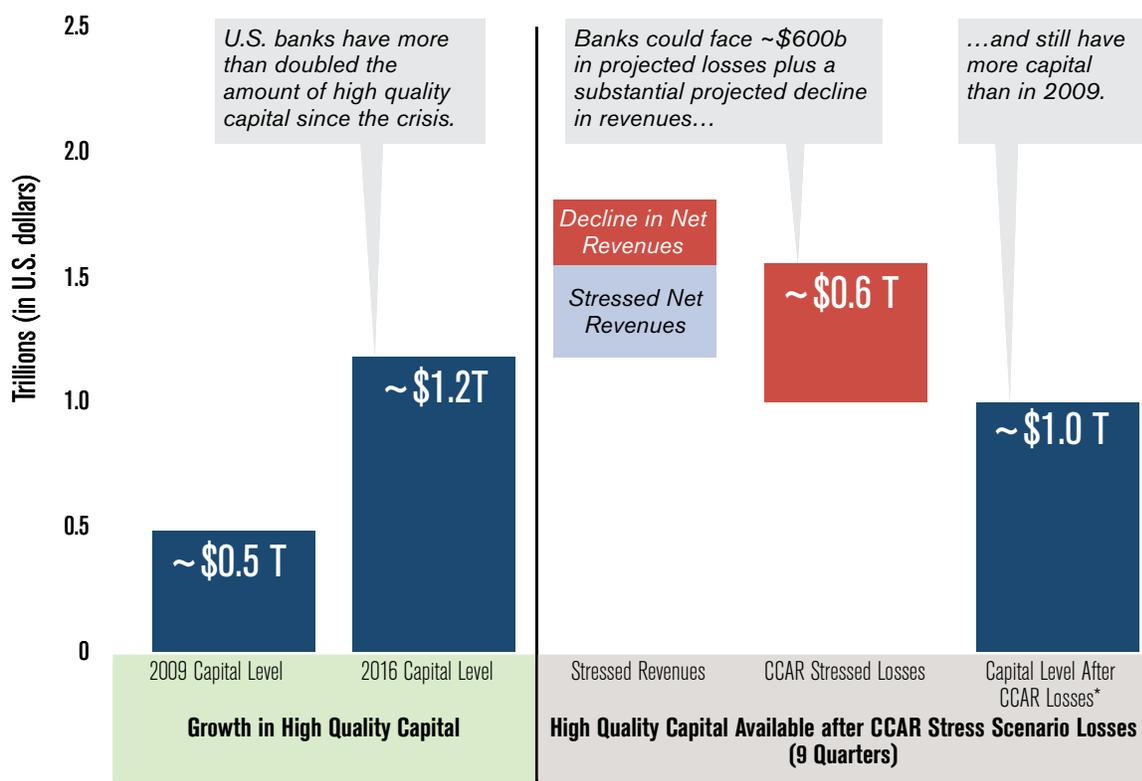


Figure 4: Strengthened Capital Position of the U.S. Banking System



Source: Treasury staff calculations based on Federal Reserve 2016 DFAST Results

* Before any capital distributions

Improved Safety of the Largest U.S. Bank Holding Companies

Figure 4 shows the change in capital levels from 2009 to 2016 and shows the amount of such capital relative to projected losses under the severely adverse scenario calculations of the regulatory stress tests.

The table below lists the rules that constitute the key elements of the U.S. bank capital and liquidity regulatory regime. A more robust discussion of the various elements of the regime is set forth as Appendix C.

Table 1: Key Elements of the Capital and Liquidity Regime

Capital Regime	Liquidity Regime
<ul style="list-style-type: none"> • Risk-based capital ratios calculated under both the advanced (internal models) and standardized (regulator-determined) approaches for calculating risk-weighted assets, with applicable capital buffers (e.g., G-SIB capital surcharge and the countercyclical capital buffer) • Leverage capital ratios including the U.S. leverage ratio, SLR, and eSLR • Stressed risk-based capital and leverage ratios to be met under CCAR (which includes firms’ planned capital distributions to shareholders) and Dodd-Frank stress tests 	<ul style="list-style-type: none"> • Quantitative liquidity rules including the LCR and the proposed NSFR • Internal company liquidity stress testing • Supervisory assessments including the Federal Reserve’s Comprehensive Liquidity Assessment Review (CLAR) and the Federal Reserve’s and FDIC’s resolution planning-related capabilities assessment (Resolution Liquidity Execution Need (RLEN) and Resolution Adequacy and Positioning (RLAP) requirements)

Tailoring of U.S. Bank Regulations

In the implementation of Dodd-Frank and the Basel Committee international banking standards, U.S. regulators have relied upon asset thresholds to apply regulations. Dodd-Frank section 165 sets a \$50 billion asset threshold for application to bank holding companies of most of the enhanced prudential standards, including requirements for annual supervisor-administered stress tests and living wills, among others. In addition, banks with assets over \$10 billion and less than \$50 billion are subject to annual company-run stress test requirements and certain risk-management requirements. Banks with total assets less than \$10 billion are exempt from the stress-test requirements.

The U.S. implementation of the international Basel III standards has differentiated among banking organizations principally through two approaches: the “internationally active” bank threshold, which is generally stated as having at least \$250 billion in assets or at least \$10 billion in total on-balance sheet foreign exposure, and the complex “global systemically important bank” methodology, which scores banks based on a comparison of key indicators of systemic risk. Internationally active banks become subject to a number of new requirements, including the LCR, the SLR, and the countercyclical capital buffer. Banks with sufficiently high systemic risk scores are identified as G-SIBs and become subject to the most extensive capital requirements, including capital buffers on the risk-based and leverage ratio capital rules and the TLAC and minimum debt rules.

Since the implementation of these rules, regulators have been actively engaged in efforts to listen to regulated firms and fine-tune their rules. Among other efforts by regulators, the Federal Reserve recently exempted bank holding companies with less than \$250 billion in assets and less than \$75 billion in nonbank activities from the qualitative assessment of the CCAR stress-testing process. As required by Congress, in February 2016, the banking agencies expanded the number of smaller banks eligible for an 18-month examination cycle instead of the previously applicable one-year exam cycle. The final rule raised the threshold for this determination from \$500 million to \$1 billion. The Federal Financial Institutions Examination Council (FFIEC), the banking agencies, and the NCUA also recently concluded their review of bank and credit union regulations. This review was conducted in accordance with the Economic Growth and Regulatory Paperwork Reduction Act and identified outdated, unnecessary, or unduly burdensome regulations.*

Despite such efforts, industry participants and policymakers have continued to question the effectiveness of the calibration of these regulatory thresholds. Insufficient tailoring results in bank regulators misallocating staff time and resources by focusing on firms that do not present the greatest risks to the financial system. Further, the magnitude of regulatory requirements applicable to regional, mid-sized, and community banks that do not present risks to the financial system requires such banks to expend resources on building and maintaining a costly compliance infrastructure, when such resources would be better spent on lending and serving customers.

* FFIEC, Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act, (Mar. 2017), available at: www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf.

Excessive regulation creates barriers to entry for mid-sized and community banks that solidify and protect the positions of the largest banks. Asset thresholds for increased regulatory requirements create inappropriate incentives. “One-size-fits-all” regulatory standards undermine a diversification of business models.

Table 2 summarizes the current tailoring of the capital and liquidity standards adopted or proposed by the U.S. banking agencies.

Table 2: Current Regulatory Tailoring of U.S. Bank Capital and Liquidity Rules

Applicable Regulations	Current Tailoring of Rules				
	G-SIB	Int'l Active (\$250b+)*	Regional (\$50-250b)	Mid-size (\$10-50b)	Small (<\$10b)
COMPREHENSIVE CAPITAL ANALYSIS & REVIEW (CCAR)					
Global market shock for trading**	Yes (6/8)	No	No	No	No
Counterparty default scenario**	Yes (8/8)	No	No	No	No
Qualitative Fed-run process review	Yes	Yes***	No***	No	No
Quantitative Fed-run stress tests	Yes	Yes	Yes	No	No
Fed ability to object to capital plans through CCAR	Yes	Yes	Yes	No	No
DODD-FRANK ACT STRESS TESTS (DFAST)					
Quantitative Fed-run stress tests	Yes	Yes	Yes	No	No
Company-run stress tests	Yes	Yes	Yes	Yes	No
Annual stress test	Yes	Yes	Yes	Yes	No
Mid-year stress test	Yes	Yes	Yes	No	No
CAPITAL STANDARDS					
Risk-based					
G-SIB capital buffers	Yes	No	No	No	No
Countercyclical capital buffer	Yes	Yes	No	No	No
Including AOCI changes in capital	Yes	Yes	No	No	No
Risk-based (i.e., Basel III)****	Yes	Yes	Yes	Yes	Yes
Leverage ratio					
Enhanced Supplementary leverage ratio (eSLR)	Yes	No	No	No	No
Supplementary leverage ratio (SLR) of 3%	Yes	Yes	No	No	No
U.S. leverage ratio	Yes	Yes	Yes	Yes	Yes
TLAC and long-term debt requirement	Yes	No	No	No	No
LIQUIDITY REQUIREMENTS					
Liquidity coverage ratio (LCR)	Yes	Yes	No	No	No
Modified LCR	No	No	Yes	No	No
Net stable funding ratio (NSFR), proposed rule	Yes	Yes	No	No	No
Modified NSFR, proposed rule	No	No	Yes	No	No

* Internationally Active includes banks with \$250 b or more in assets or more than \$10 b in on-balance sheet foreign exposure. **The global market shock and counterparty default scenario apply to G-SIBs because these firms have significant trading activities, not because they are G-SIBs. *** Large and noncomplex BHCs (i.e., non-G-SIBs with assets between \$50 b and \$250 b and with nonbank assets of less than \$75 b) are exempt from the qualitative assessment of the Federal Reserve CCAR exercise. **** Includes the Standardized Approaches to calculating risk-weighted assets (i.e., denominator) and the revised regulatory capital rules that increased the quantity and quality of capital (i.e., numerator).

Treasury supports robust, clearly defined capital and liquidity standards. Capital provides an important safeguard against losses and bank insolvency, and a rigorous liquidity regulatory regime mitigates the risk of runs on liquidity that can precipitate wide-spread financial system stresses. Likewise, Treasury supports a transparent regulatory process, with clear rules, analytical methodologies and procedures, and ample public disclosure to increase the public accountability of both banks and regulators.

Implementation of International Financial Regulatory Standards

In many instances, the U.S. banking agencies have implemented standards for U.S. G-SIBs and other large internationally active U.S. banks that are more conservative than the international standards established by the Basel Committee or the Financial Stability Board. U.S. leadership on international standard-setting bodies helps enable a level playing field for U.S. financial services firms by encouraging other jurisdictions to implement financial regulation consistent with our domestic priorities. When international compromise results in weaker-than-desired recommendations and the U.S. banking agencies have determined that a different standard is more appropriate for the U.S. market, U.S. regulators have applied additional stringency. Currently, U.S. banking rules with such elements include the G-SIB risk-based capital surcharge, the eSLR, the TLAC and long-term debt rule, the calculation of risk-weighted assets (RWA), and the LCR.

Table 3: U.S. Implementation of International Financial Regulatory Standards

	International Banking Standard*	U.S. Standard
CAPITAL RULES		
G-SIB risk-based capital surcharge	<ul style="list-style-type: none"> G-SIB surcharge ranges from 1 to 2.5% 	<ul style="list-style-type: none"> The U.S. G-SIB surcharge was calibrated to be roughly double the international standard and was calculated using short-term wholesale funding reliance as a factor.
Leverage Ratio (specifically, the eSLR in the U.S.)	<ul style="list-style-type: none"> 3% of leverage exposure (including on- and off-balance sheet exposures) 	<ul style="list-style-type: none"> For U.S. G-SIBs: 5% of leverage exposure for bank holding company; and 6% of leverage exposure for insured depository institution subsidiaries
Total Loss Absorbing Capacity (TLAC)	<ul style="list-style-type: none"> Leverage: 6.75% of leverage exposure Risk-based: 18% of risk-weighted assets plus regulatory capital buffers** Long-term debt: 33% of TLAC 	<ul style="list-style-type: none"> Leverage: 9.5% of leverage exposure Risk-based: 18% of risk-weighted assets plus regulatory capital buffers Long-term debt: higher of (1) 6% of risk-weighted assets plus the U.S. G-SIB surcharge or (2) 4.5% of total leverage exposure

* Several other jurisdictions have also adopted rules that exceed international standards, including the U.K. and Switzerland, which have added additional surcharges for the leverage ratio and risk-based capital requirements. See Bank of England, Supplement to the December 2015 Financial Stability Report: The Framework of Capital Requirements for UK Banks at 22 (Dec. 2015), available at: www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf.

** The FSB TLAC term sheet notes that “[t]his requirement does not include any applicable regulatory capital (Basel III) buffers, which must be met in addition to the TLAC RWA Minimum.” See FSB, Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution at 10 (Nov. 9, 2015), available at: www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

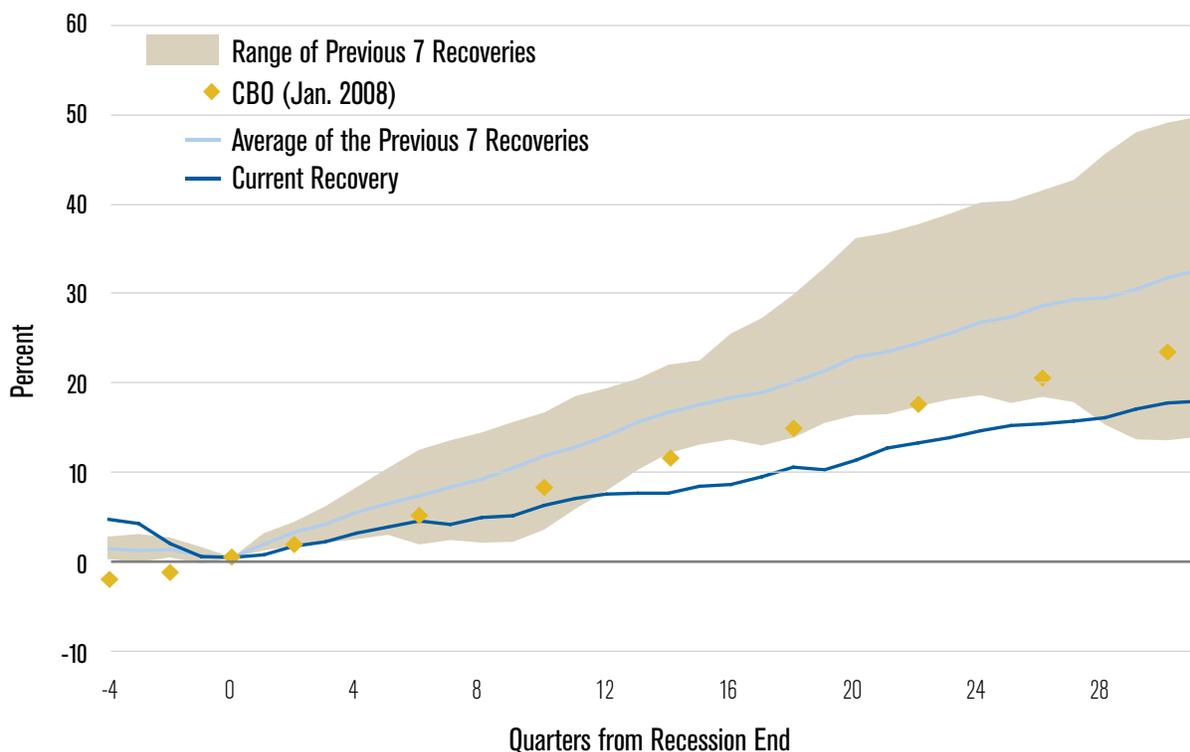
	International Banking Standard*	U.S. Standard
Calculation of Risk-weighted assets	<ul style="list-style-type: none"> No risk-weight floor. Non-U.S. banks make greater use of internal models, which can result in lower capital requirements relative to assets. 	<ul style="list-style-type: none"> Risk-weight floor, i.e., standardized approaches, is required under Dodd-Frank
	<ul style="list-style-type: none"> Operational risk calculation for risk-weighted assets permits: basic indicators, standardized, and internal models 	<ul style="list-style-type: none"> U.S. firms may only use an internal models approach, which is also subject to additional stringency because of a supervisory overlay.
	<ul style="list-style-type: none"> Securitization exposures: a risk-weight floor of 15% across three permitted approaches (internal models, external ratings, and a standardized approach). Simple, transparent, and comparable transactions are eligible for reduced capital requirements, e.g., a 10% risk-weight floor. 	<ul style="list-style-type: none"> Securitized (excluding agency MBS) are subject to a risk-weight floor of 20% based on a generally more conservative risk-weight approach, known as the simplified supervisory formula approach. This approach was adopted because Dodd-Frank generally prohibits reliance on external ratings.
LIQUIDITY RULES		
Liquidity Coverage Ratio (LCR)	<ul style="list-style-type: none"> Requires sufficient high quality liquid assets that can be converted into cash with little or no loss of value to survive a significant 30-day stress scenario 	<ul style="list-style-type: none"> The U.S. LCR rule (i) uses a stricter definition of high quality liquid assets (e.g., excludes most municipal securities and non-agency MBS); (ii) uses the largest liquidity mismatch over a 30-day stress period (while the Basel standard focuses on cumulative cash flows over the 30-day window); and (iii) applies a modified, less stringent LCR for non-internationally active banks.
Net Stable Funding Ratio (NSFR)	<ul style="list-style-type: none"> Requires a stable funding profile to reduce the risk that regular sources of funds will erode a bank's liquidity position 	<ul style="list-style-type: none"> The U.S. NSFR proposal (i) uses a stricter definition of high-quality liquid assets (same as U.S. LCR); and (ii) includes a modified NSFR for non-internationally active banks parallel to the LCR.

Challenges Facing the U.S. Economy

The United States is experiencing a historically weak economic recovery. The availability of bank credit to consumers and businesses in various segments of the economy has been restrained and is growing slowly. While it is unclear whether slow loan growth has weakened the economic recovery, there is some indication that the supply of credit in key areas of the economy is significantly curtailed due to regulatory restrictions, as discussed in this report. Regulatory requirements have increased the costs of providing services to consumers, steered lenders away from certain forms of lending, and otherwise impeded the efficient allocation of credit with improperly tailored regulation.

Real gross domestic product has grown at a pace that is slower than the past seven recoveries and is now only 113% of the 2007 level.⁵ The 2008-09 recession was the deepest since the Great Depression, and its negative impact has persisted because of the slow recovery.

5. Haver Analytics Financial Data on GDP based on data from the Bureau of Economic Analysis. Haver Analytics, May 2017.

Figure 5: Real GDP Change from Recession End

Source: BEA, CBO

As Of: 2017 Q1

The recovery in bank lending has mirrored the slow recovery in the broader economy, with particular weakness in small business and mortgage lending.⁶ A healthy banking sector enables an economy to flourish, while a weak or anemic banking sector can stall an economy.

Small businesses are historically large contributors to employment and economic growth.⁷ These businesses employ almost half of the private sector workforce and create three out of five net new jobs in the United States.⁸ Yet, small business lending by banks has been one of the most anemic sectors, barely recovering to the levels of 2008. By comparison, bank lending to large businesses is at record levels, though loan growth here has also been arrested recently.⁹

Figure 6 shows the rate of loan growth during the pre-crisis and post-crisis periods, including periods designated as recessions by the National Bureau of Economic Research. The average rate of loan growth in the post-crisis period is substantially below the rate experienced in the pre-crisis period.

6. Total residential mortgages and small business loan growth for FDIC-insured institutions is approximately negative to flat since 2008 per FDIC balance sheet data for all FDIC-insured institutions. See FDIC Quarterly Banking Profile, available at: www.fdic.gov/bank/analytical/qbp.

7. House Committee on Small Business. *Fast Facts on Small Business*, available at: smallbusiness.house.gov/uploadedfiles/april_recess_small_biz_talking_pts.pdf.

8. Small Business and Entrepreneurship Council, *Small Business Facts and Data*, available at: sbecouncil.org/about-us/facts-and-data.

9. Id.

Figure 6: Bank Loan Growth (Annual)

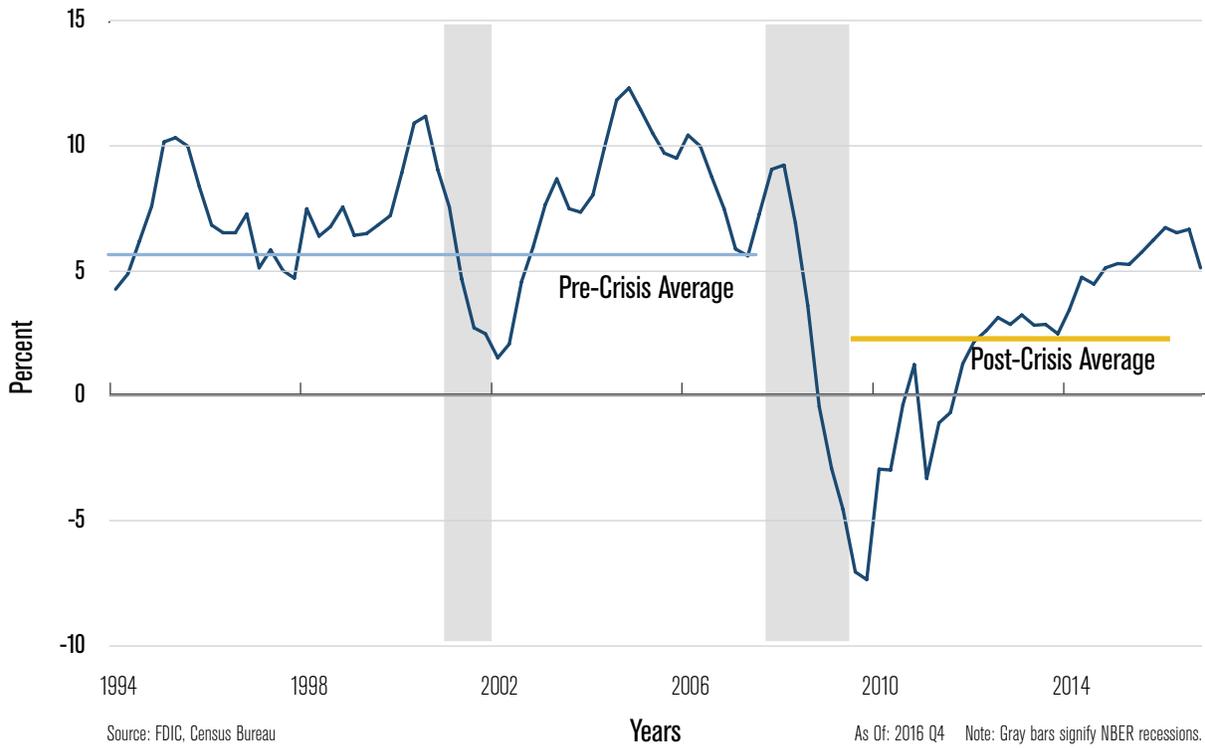


Figure 7: Growth in Bank Lending Since End of Recession

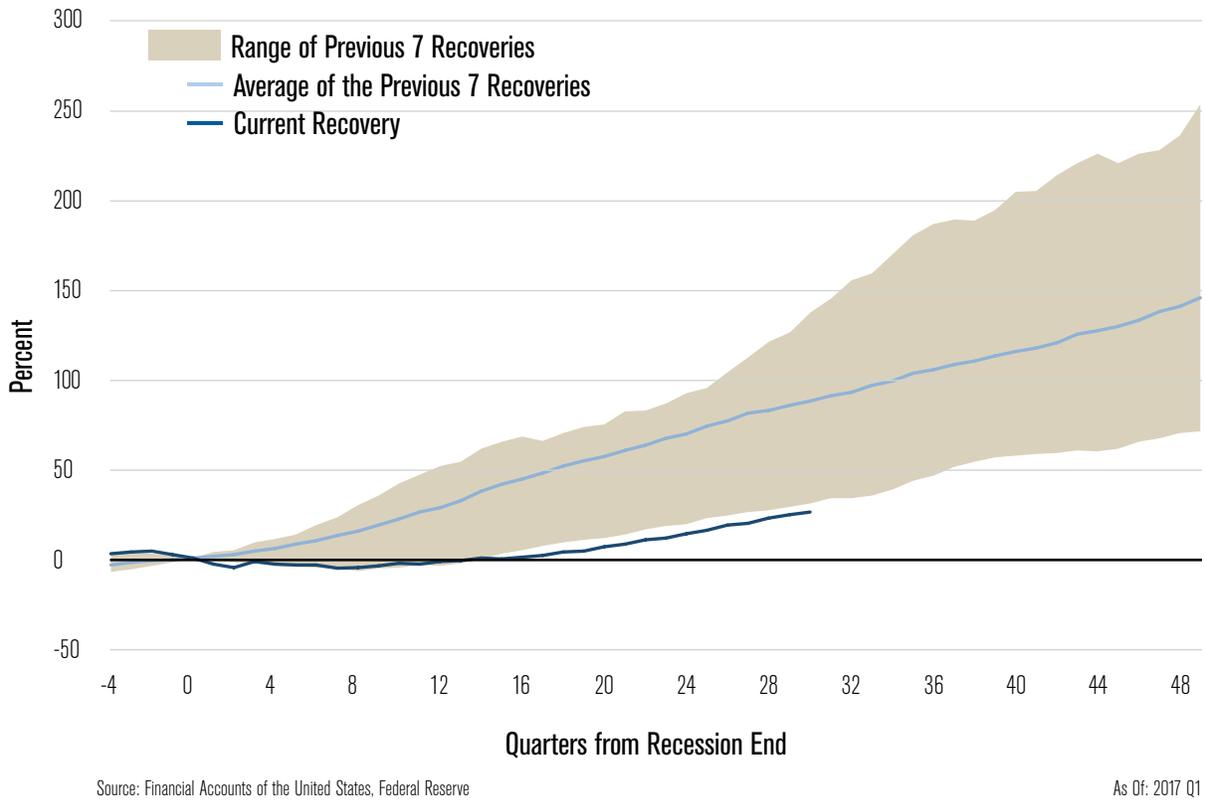


Figure 8: Change in Small Business Lending Since 2008

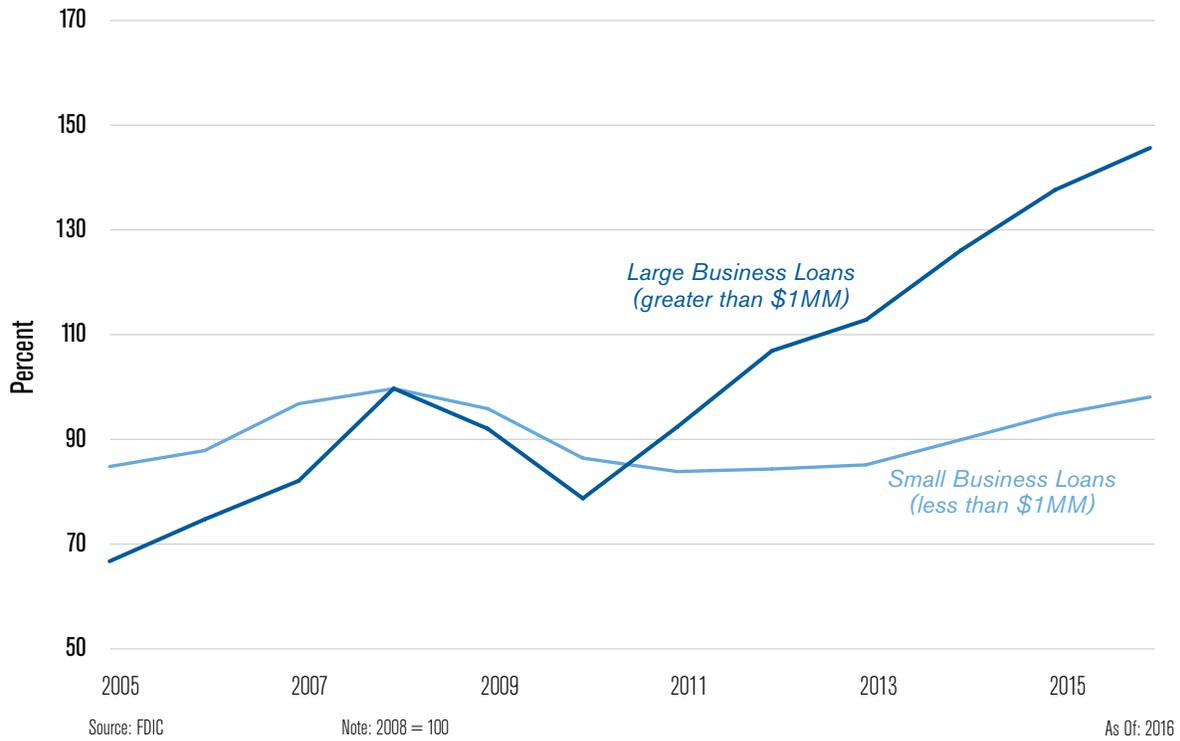


Figure 9: Small Businesses and Start-Ups

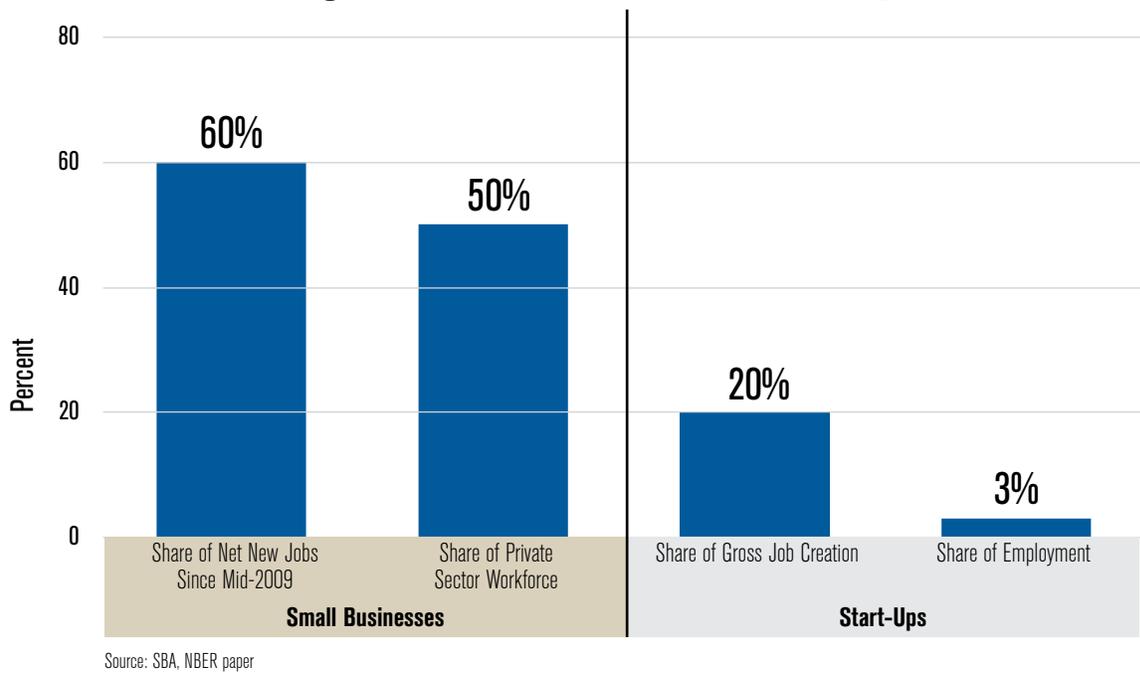
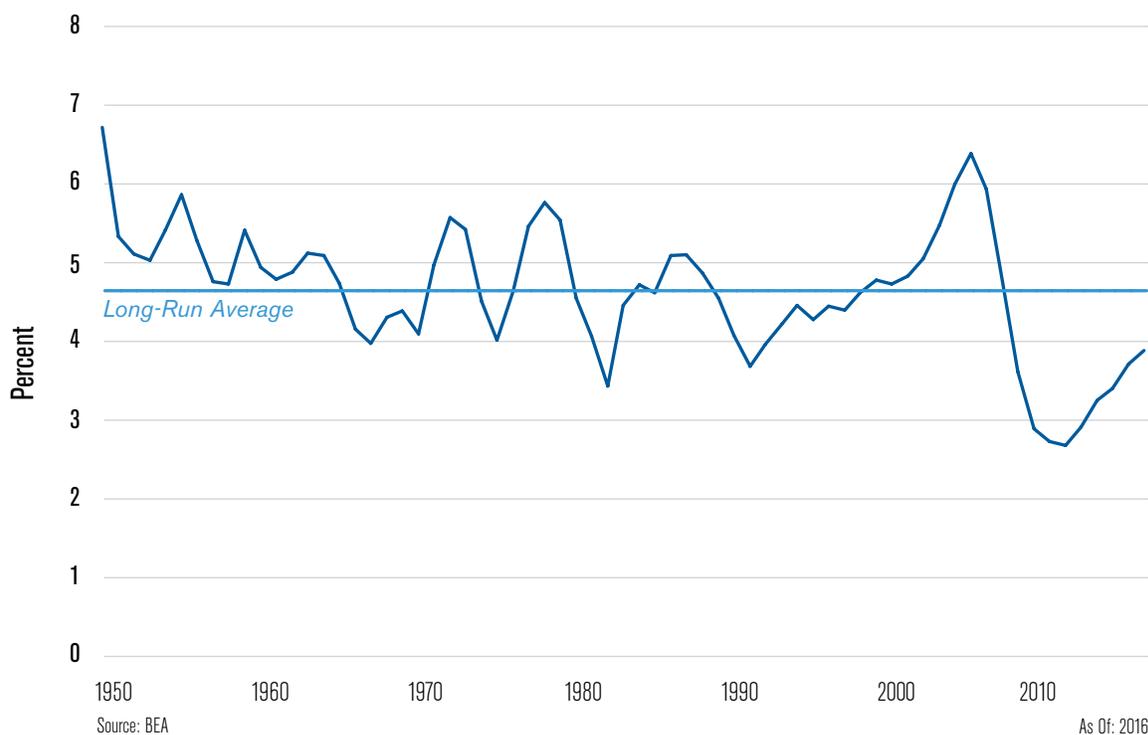


Figure 10: Residential Investment as a Share of GDP

As is the case with the overall economic recovery since the recession, bank lending has lagged when compared to prior recoveries (see figure 7). This disparity is most notable in the imbalance of availability of loans to large companies compared to small businesses (see figure 8).

Beyond small business lending, the growth of mortgage loans on bank balance sheets has also been slow (even after considering the effects of the liquidation of legacy mortgage portfolios). More broadly, credit availability in the residential mortgage market is constrained. The HCAI reported by the Urban Institute¹⁰ is at approximately half the level of the 2001-2003 period. More permissive standards in the FHA and VA programs and flexibility afforded the GSEs through exemption from the QM rule has contributed to a concentration of the mortgage market in government-supported mortgage programs, which funded nearly 70% of 2016 originations.¹¹

10. Urban Institute, *Housing Credit Availability Index*, (April 14, 2017), available at: www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-credit-availability-index.

11. Urban Institute, *Housing Finance at a Glance* (Mar. 2017), available at: www.urban.org/sites/default/files/publication/89056/march_chartbook_final.pdf.

Housing constituted a contribution to U.S. GDP of approximately 18% in 2016 and satisfies a basic need of all families.¹² A key component of housing's role in the economy is residential investment, which has averaged almost 5% of GDP over the long run but has yet to fully recover.

Small businesses and the housing industry are key contributors to job growth and GDP. Figures 9 and 10 show the importance of small businesses to job creation and the historic contribution of housing as a percentage of GDP.

Key Issues with Current Regulatory Regime

Treasury's recommendations concerning regulatory relief relating to capital and liquidity are designed to reform several aspects of the current regulatory regime. These include recommendations to: (1) better tailor rules according to an institution's size and complexity; (2) reduce unnecessary burdens of regulation and increase the transparency of regulatory requirements; and (3) improve regulatory coherence to improve the ability of banks to promote liquid markets. Together these reforms should result in a more efficient use of capital and liquidity and provide banks with greater capacity to increase the supply of credit to the economy and promote liquidity in our markets.

Insufficient Regulatory Tailoring

Among the most burdensome financial regulatory requirements are the enhanced prudential regulations which apply to financial companies with total consolidated assets of \$50 billion or more as well as company-run and supervisory stress tests, which begin to apply when financial companies have total consolidated assets over \$10 billion. The number of banks required to conduct some form of stress-testing has expanded to more than 100 firms,¹³ which is well beyond the 19 banks that underwent the original exercise known as the Supervisory Capital Assessment Program (SCAP). These 19 banks represented about two-thirds of the assets and about half of the loans in the U.S. banking system.¹⁴ In comparison, today's CCAR process covers more than 80% of U.S. bank holding company assets.¹⁵

Moreover, the burden of the exercise has greatly increased. Today, CCAR is the binding capital regime for the majority of large banks¹⁶ and results in significant supervisory intervention in the

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12. Internal Treasury Analysis. Data from Haver Analytics and U.S. Bureau of Economic Analysis News Release, Table 3 (May 26, 2017), available at: www.bea.gov/newsreleases/national/gdp/2017/pdf/gdp1q17_2nd.pdf.
 13. The company-run stress test requirement applies to all financial companies, not just BHCs. For the number of holding companies that exceed \$10 billion in assets, see National Information Center. *Holding Companies with Assets Greater than \$10 Billion*. Available at: www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.
 14. Press Release. The Federal Reserve Bank of New York, *Statement Regarding the Supervisory Capital Assessment Program* (May 7, 2009), available at: www.federalreserve.gov/newsevents/press/bcreg/bernan-kescap20090507.htm.
 15. Press Release. The Federal Reserve Bank of New York, *Federal Reserve Releases Results of Supervisory Bank Stress Tests* (June 23, 2016), available at: www.federalreserve.gov/newsevents/pressreleases/bcreg20160623a.htm.
 16. According to analysis by The Clearing House, the capital regime that requires the majority of large banks to hold the greatest level of capital is the Federal Reserve's CCAR exercise. See The Clearing House. *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test*. Jan. 2017, available at: www.the-clearinghouse.org/~media/TCH/Documents/TCH%20WEEKLY/2017/20170130_WP_Implicit_Risk_Weights_in_CCAR.pdf.

core capital planning decisions of firms' boards and management. Firms with more than \$50 billion in assets have monthly, quarterly, and annual data submissions in addition to undergoing the exercise twice a year, all of which requires these banks to expend significant amounts of time and resources. As detailed in a November 2016 GAO study, a wide range of costs to firms arise from this regulatory burden, including direct compliance costs (for staff, consultants, technology, and risk-management systems).¹⁷

In addition to stress-testing, a number of other prudential standards apply to more than 30 BHCs, including the LCR rule. The LCR rule can generate costs to firms through foregone net interest income because the rule requires firms to invest in high quality liquid assets that generally have low relative yields compared to many other assets. These costs can be more acute for firms that rely more heavily on net interest income than fee income. In general, smaller regional BHCs tend to generate more of their revenues from net interest income than the largest BHCs.

Reducing Complexity, Inconsistencies, and Unnecessary Costs

The current capital and liquidity regime could be made less costly by reducing its excessive conservatism, opacity, and duplication.

Strong capital requirements are critical in mitigating the harmful economic effects that result from an undercapitalized banking system. While some modest further benefits could likely be realized, the continual ratcheting up of capital requirements is not a costless means of making the banking system safer. Studies of the effects of higher capital requirements indicate that invariably some of the higher costs are passed on to borrowing households and businesses, although these studies disagree on the magnitude of such effects.¹⁸

17. GAO. *Additional Actions Could Help Ensure the Achievement of Stress Test Goals* at p. 30. Nov. 15, 2016, available at: www.gao.gov/products/GAO-17-48. GAO, for example, noted that that among surveyed CCAR firms: (i) annual costs ranged from \$4 to \$90 million, with about half of estimates between \$15 and \$30 million; (ii) staff dedicated to CCAR ranged from 100 to about 500 employees with part-time responsibility for the stress tests and an additional 2,000-plus employees spending part of their time supporting others; (iii) one-third of the surveyed CCAR firms used paid consultants; (iv) several said they expected continued growth in stress test-related costs because of the Federal Reserve's continually increasing supervisory expectations; and (v) the companies' estimates of the amount of additional capital they have held to avoid a CCAR objection ranged from \$500 million to \$15 billion.

18. Literature reviews conducted by Oliver Wyman and staff at the OFR, IMF, and Federal Reserve generally review a similar set of studies that attempt to estimate the costs of higher bank capital requirements. See Oliver Wyman. *Interaction, Coherence, and Overall Calibration of Post Crisis Basel Reforms*. August 9, 2016, available at: www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/aug/post-crisis-basel-reforms.pdf. See also Jihad Dagher, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong. *Benefits and Costs of Bank Capital*. IMF, March 2016, available at: www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf. See also Federal Reserve Board. *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US*. March 31, 2017, available at: www.federalreserve.gov/econres/feds/files/2017034pap.pdf. These reviewed studies generally found evidence of higher credit costs to borrowers and reduced lending capacity. The magnitude of the higher cost of credit upon borrowing costs generally ranged from 2 to 21 bps for a 1 percentage point increase in bank capital requirements. Oliver Wyman estimated that range would imply a gross increase in credit of between 15 to 109 bps (assuming an increase in capital requirements of 5.3% in the U.S.). The estimated range of credit contraction (see IMF table 4B) is focused on reduced volumes of bank credit during the implementation phase of higher capital requirements.

In addition to direct costs to borrowers, firms struggle with supervisory processes that are opaque, complex, and excessively conservative, such as the current design and implementation of the CCAR exercise and the process to determine a firm's operational risk capital requirements. The qualitative aspects of the CCAR process are particularly opaque. Likewise, the lack of transparency around the quantitative aspects of CCAR can make it more difficult for firms to efficiently allocate capital across products and exposures. Furthermore, the lack of transparency with CCAR creates opportunities for regulators to steer lending to particular asset classes.

The capital regime also has a number of current and expected redundancies. For example, the risk-based capital regime requires many of the largest banks to calculate capital requirements under both advanced approaches (i.e., internal models calculated by firms) and standardized approaches (i.e., regulator prescribed capital requirements).

Beyond the costs created by the capital and liquidity requirements currently in place, several potential rules, if adopted in the United States, could further increase the costs to banks of conducting their business. These include the FRTB standard meant to revise capital rules for banks' trading activities and the NSFR standard designed to promote greater funding stability.¹⁹ U.S. banks are already subject to rigorous rules meant to address these different areas of trading book and liquidity risk.²⁰ The proposed Single-Counterparty Credit Limit requirements, which are designed to limit interconnectedness between financial institutions, are also expected to require complex calculations that firms would likely find difficult or costly to implement. Moreover, the methodologies and calibrations used in the SCCL may not accurately reflect certain business activities, such as securities lending.

Another potential driver of costs is the pending intersection of the new CECL accounting standard and existing capital rules. CECL requires banks to set reserves using a lifetime forecast of losses, which generally requires a bank to provision a much larger amount for loan losses at the time of loan origination than would be required under the current "incurred loss" accounting model.²¹ It is unclear if such changes are needed to promote a more robust U.S. banking system.

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19. As an example of these significant expected costs, consider that the Basel Committee estimated that the final FRTB would raise trading book minimum capital requirements as much as 40% higher than the current capital requirements for such trading book exposures on a weighted-average basis and 22% higher for the median bank. See Basel Committee. *Explanatory Note on the Revised Minimum Capital Requirements for Market Risk*. Jan. 2016, available at: www.bis.org/bcbs/publ/d352_note.pdf.
 20. Consider that FRTB changes would be in addition to trading book capital requirements, which have increased by about two to three times after the crisis in 2009-10 (see Basel Committee on Banking Supervision, *Results of the Basel III Monitoring Exercise as of 30 June 2012* at Table 6. March 2013, available at: <http://www.bis.org/publ/bcbs243.pdf>). See also Standard and Poors. *Basel 2.5 Increases the Squeeze on Investment Banking Returns*. May 15, 2012, available at: www.standardandpoors.com/en_AP/web/guest/article/-/view/sourceId/7303774) and which are now subject to Volcker restrictions, greater central clearing requirements, and severe capital shocks under the supervisory CCAR stress regime. The NSFR would apply on top of the LCR, internal liquidity stress tests, and supervisory reviews of liquidity positions.
 21. Cristian Deritis and Deniz K. Tudor, *CECL's Implications for Bank Profitability, System Stability, and Economic Growth*, Moody's Analytics. Available at: www.moodyanalytics.com/~media/Insight/Publications/2016/cecls-implications-for-bank-profitability-system-stability-economic-growth.pdf.

Improve the Coherence of Regulations to Support Market Liquidity

A capital regime that is exclusively dependent upon a leverage ratio, or that makes it a primary binding capital constraint,²² could have the unintended outcome of encouraging risk-taking by banking organizations. Because the leverage ratio requires the same amount of capital irrespective of an exposure's risk profile, a binding leverage ratio generally encourages firms to invest in higher-risk assets (which are generally associated with higher yields) than they would if risk-based capital rules were their binding constraint. These incentive issues are generally more significant for banks subject to higher liquidity requirements and whose business models involve intermediating low-risk assets such as cash and government-related securities than for banks whose business models are predominantly focused on higher yielding lending activities.

The current interaction of the leverage ratio, particularly the enhanced supplementary leverage ratio, and other rules creates incentives that discourage critical banking functions, including taking low-risk deposits, providing access to centrally cleared derivatives for market participants, and providing secured repo financing, which supports market liquidity.

The eSLR and the LCR can make it difficult for banks to accept safe-haven deposits from customers. In order for a bank constrained by the leverage ratio to accept additional deposits from its customers, the bank would need to either issue new equity capital or sell other assets in a sufficient amount to free up enough capital to accept such customer funds. Likewise, a bank at its LCR limit may have to invest in additional low-yielding high quality liquid assets to accept additional deposits. These deposits, when placed at the central bank, add little incremental credit risk or funding risk mismatches to the banking system yet would be discouraged by these rules today.

The leverage ratio imposes significant capital requirements on initial margin, which is collected to reduce risk on centrally cleared exposures.²³ Because of the low-margin and high-volume nature of the business of providing clients access to central clearing, high leverage ratio capital charges discourage firms from providing such services. Acting CFTC Chair Giancarlo recently estimated that addressing the leverage ratio treatment of initial margin would reduce bank capital by only

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22. When a bank is required to hold more capital under risk-based capital standards than under leverage standards, risk-based capital would be considered its "binding constraint." Conversely, a bank that is required to hold more capital under leverage standards than under risk-based capital standards would consider leverage capital to be its "binding constraint." While both types of capital standards can incentivize firms to raise their absolute level of capital (i.e., the numerator), these standards encourage firms to manage their denominators in distinct ways. A bank bound by risk-based capital is incentivized to increase its exposures to assets that carry lower risk weights. However, such a bank may also seek to reduce its risk weights without reducing actual economic risks; a leverage ratio backstop is a key means to limit this incentive. If leverage standards are the binding constraint, a bank has an incentive to reduce its overall leverage, but with a preference for shedding lower-yielding exposures (generally correlated with lower risk weights) because the bank would seek to maintain returns even while reducing its size.
23. Futures Industry Association. *FIA Analysis: Leverage Ratio Proposals Will Negatively Impact Client Clearing*. July 7, 2016, available at: fia.org/articles/fia-analysis-leverage-ratio-proposals-will-negatively-impact-client-clearing. See also Bipartisan Policy Center, *Did Policymakers Get Post-Crisis Financial Regulation Right?* Sept. 2016, available at: cdn.bipartisanpolicy.org/wp-content/uploads/2016/09/BPC-FRRI-Post-Crisis-Financial-Regulation.pdf.

1% but would reduce clearing capital costs by 70% and promote additional market activity.²⁴ The number of firms engaged in this business has declined from 100 in 2002 to 55 at the start of 2017, of which only 19 firms actually were holding initial margin from clients.²⁵ Moreover, specific product classes may have even fewer market providers. Beyond the treatment of margin, the leverage ratio uses a methodology to measure derivatives exposures, known as the current exposure method, which is fairly insensitive to risk and which results in higher leverage ratio capital requirements for derivatives activities relative to risk-based capital requirements.

Recommendations

Appropriately Tailor Rules for Banks

Appropriate Tailoring of DFAST, CCAR, LCR, and SCCL

Reforms of the regulatory capital regime should be made to accomplish the objective of clear and transparent standards that do not impose undue burdens and that are based on the size and complexity of a bank's balance sheet and business.

Treasury recommends that the threshold for participation in the company-run DFAST be raised to \$50 billion in total assets (from the current threshold of more than \$10 billion). The banking regulators should be granted authority to further calibrate this threshold on an upward basis by reference to factors related to the degree of risk and complexity of the institution. Such an approach would help to avoid creating inefficient incentives and cliff effects around particular asset sizes.

In addition, the mid-year DFAST cycle should be eliminated, and the number of supervisory scenarios should be reduced from three to two—the baseline and severely adverse scenario. Further, as a company-led process, leeway should be granted for banks to determine the appropriate number of models that are sufficient to develop appropriate output results, aligned with the scale and complexity of the banking organization and nature of its asset mix.

Treasury recommends that Congress amend the \$50 billion threshold under Section 165 of Dodd-Frank for the application of enhanced prudential standards to more appropriately tailor these standards to the risk profile of bank holding companies. The Federal Reserve should also revise the threshold for application of CCAR to match the revised threshold for application of the enhanced prudential standards.

Beyond stress testing, the scope of application of the LCR should be narrowed: the U.S. LCR should be limited to G-SIBs and a less stringent standard should be applied to internationally active bank holding companies that are not G-SIBs. In addition, the complexity of the calculations required to comply with the proposed SCCL requirements are such that the rule should be limited in application to only the largest banks. Accordingly, the SCCL also should only apply to banks that are subject to the revised threshold for the application of the enhanced prudential standards.

24. J. Christopher Giancarlo. *Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets*. Remarks before the International Swaps and Derivatives Association 32nd Annual Meeting, Lisbon, Portugal. May 10, 2017, available at: www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22.

25. *Id.*

Creating an “Off-Ramp” for Highly Capitalized Banks

An alternative approach for providing regulatory relief that should be considered would be to establish a “regulatory off-ramp” from all capital and liquidity requirements, nearly all aspects of the Dodd-Frank’s enhanced prudential standards, and the Volcker Rule for depository institution holding companies and insured depository institutions. This approach would require the institution to elect to maintain a sufficiently high level of capital, such as a 10% non-risk-weighted leverage ratio, consistent with H.R. 10, the Financial CHOICE Act.

Reduce Unnecessary Burdens and Improve Transparency

Improve Capital and Liquidity Supervisory Processes and Guidance

Subjective assumptions built into the Federal Reserve’s CCAR models have resulted in an improperly calibrated stress test, which risks skewing capital requirements and bank activity away from what market-based decisions would otherwise dictate and in favor of activity favored by regulators resulting in excess capital retained by banks, which reduces lending capacity. Such assumptions also skew the amount of capital that banks hold. Assumptions in the CCAR process should be re-assessed, such as the assumption that firms continue to make capital distributions and grow their balance sheets and risk-weighted asset exposures in severely adverse scenarios. Moreover, the Federal Reserve’s modeling practices should be improved by better recognizing firms’ unique risk profiles.

Treasury also recommends that the Federal Reserve consider changing the CCAR process to a two-year cycle, with more frequent reviews permitted to allow revisions to capital plans in the case of extraordinary events.

In addition, the U.S. banking regulators should delay domestic implementation of the NSFR and FRTB standards until U.S. regulators can appropriately assess and calibrate them. Depending on their final calibration, applying these standards could be duplicative of other capital and liquidity requirements.

To simplify the capital regime over time, Treasury recommends keeping the standardized approaches for calculating risk-weighted assets, but reducing reliance upon the advanced approaches for calculating firms’ overall risk-based capital requirements. However, because risk sensitivity remains an important objective of risk-based capital and other standards, U.S. regulators should consider where it would be appropriate to introduce more appropriate risk sensitivity such as in the measurement of derivative and securities lending exposures for the standardized approaches and the proposed SCCL.

Treasury also recommends that the prudential regulators review the potential impact of the CECL standard on banks’ capital levels and formulate recommendations to harmonize the application of the standard with regulators’ supervisory efforts.

Improving the Transparency of the CCAR and Other Supervisory Processes

Treasury recommends that the Federal Reserve subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies.

The qualitative assessment of CCAR is subjective, with limited transparency into regulatory expectations. For this reason, Treasury recommends that the qualitative CCAR element should no longer be the sole basis for the Federal Reserve’s objection to capital plans for all banks subject to

CCAR. To further reduce regulatory burden, the qualitative assessment for all banking organizations should be adjusted to conform to the horizontal capital review standard the Federal Reserve has already implemented for non-complex banking groups with assets less than \$250 billion.

The CCAR process could also be modified to provide management with greater control of capital distribution planning by providing firms an accurate understanding of the capital buffers they would have after considering the projected results of the Federal Reserve's supervisory models under the severely adverse scenario. This additional certainty about the size of a firm's capital cushion could be achieved through changing the sequence of the current CCAR process or by making required capital amounts more certain through integrating the risk-based capital and CCAR stress testing regimes, without increasing post-stress capital requirements.²⁶

Further, any countercyclical capital requirements should be implemented through the existing CCAR and DFAST stress testing processes rather than through the countercyclical capital buffer currently included in the risk-based capital rules.

Finally, the method of calculating operating risk capital requirements under the advanced approaches should be made more transparent as compared to the current approach, which is driven in large part by supervisory actions.

Improving Regulatory Coherence to Improve the Functioning of Capital Markets

Addressing the Impact of the SLR

Significant adjustments should be made to the calculation of the SLR. In particular, deductions from the leverage exposure denominator should be made, including for:

- Cash on deposit with central banks;
- U.S. Treasury securities;
- Initial margin for centrally cleared derivatives.

Changing Liquidity Requirements

Treasury recommends expanded treatment of certain qualifying instruments as HQLA. This would include categorizing high-grade municipal bonds as Level 2B liquid assets (rather than generally not being counted as HQLA currently). In addition, improvements should be made to the degree of conservatism in cash flow assumptions incorporated into calculations of the LCR to more fully reflect banks' historical experience with calculation methodologies.

Recalibrating the U.S. Implementation of Certain International Financial Regulatory Standards

U.S. implementation of certain international standards in a manner more stringent than the international standard can make U.S. institutions less competitive globally. While international standards are not binding on the United States and should be implemented by domestic regulators in a manner tailored to the U.S. market, U.S. regulatory requirements that exceed the applicable international standard can sometimes create an undue burden of higher costs to our economy,

26. Daniel K. Tarullo. *Next Steps in the Evolution of Stress Testing*. Remarks at the Yale University School of Management Leaders Forum, New Haven, Connecticut. Sept. 26, 2016, available at: www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm.

U.S. Participation in International Financial Regulatory Standard-Setting Processes

One of the Core Principles is to advance American interests in international financial regulatory negotiations and meetings. To this end, U.S. engagement in international financial regulatory standard-setting bodies remains important to promote financial stability, level the playing field for U.S. financial institutions, prevent unnecessary regulatory standard-setting that could stifle financial innovation, and assure the competitiveness of U.S. companies and markets, including encouraging foreign investment in the U.S. banking system.

As part of the international response to the global financial crisis, the United States has played a leading role in the G-20 and the Financial Stability Board. The G-20 has played a key role in helping to set the post-crisis financial regulatory reform agenda, which the FSB helps implement. The FSB helps coordinate the work of international standard setting bodies, such as the Basel Committee, the International Organization of Securities Commissions (IOSCO), and the International Association for Insurance Supervisors (IAIS). These bodies use international financial regulatory standards to increase the resiliency of the global financial system, a crucial element to support strong, balanced, and sustainable economic growth.

The U.S. SSB representatives, including applicable U.S. regulators, advocate for our domestic financial regulatory agenda at SSBs, and influence the international standard setting process. These international financial regulatory standard setting processes enable the United States to promote international standards consistent with U.S. policy and a level playing field for U.S. financial institutions. As a result, domestic U.S. regulatory implementation of such standards for U.S. firms is largely consistent with the corresponding international standard.

While the Basel Committee does issue proposals for comment, it sometimes does so late in the standard setting process. As a result, public participation in the Basel Committee process sometimes comes after the United States and other regulators have already reached understandings on the basic framework, thus limiting the potential for the public to meaningfully influence the Basel Committee's process. Similar complaints about transparency and accountability have been raised with respect to other key international standard setting processes, specifically those taking place at IOSCO and IAIS.

Treasury recommends that rigorous thought be given to the structure and mandate of SSBs as well as processes through which international financial regulatory standards are established. In particular, the United States should lead efforts to narrow the scope of SSBs' initiatives, specifically by streamlining their mandates and eliminating existing overlapping objectives. In addition, Treasury recommends increased transparency and accountability, so that the views and concerns of external stakeholders are appropriately and timely considered and accounted for. Finally, Treasury recommends that the U.S. members continue to advocate for and shape international regulatory standards that are in alignment with domestic financial regulatory objectives.

and risk making U.S. firms less competitive internationally. U.S. rules that exceed international standards that should be recalibrated include (i) the U.S. G-SIB risk-based surcharge, including its focus on short-term wholesale funding reliance; (ii) the mandatory minimum debt ratio included in the Federal Reserve's TLAC and minimum debt rules; and (iii) the eSLR .

Refining U.S. Approach to Basel Committee Standards and Processes

Treasury supports efforts to finalize remaining elements of the international reforms at the Basel Committee including establishing a global risk-based capital floor in order to promote a more level playing field for U.S. firms and strengthen the capital adequacy of global banks. U.S. firms currently operate with high levels of capital compared to their international counterparts. They also are subject to a risk-based capital floor, while many foreign competitors do not adhere to such a standard. Moreover, more strongly capitalized foreign banks would further reduce risks for our largest, most globally active firms.

The banking agencies should carefully consider the implications on U.S. credit intermediation and systemic risk from the implementation in the United States of a revised standardized approach for credit risk under the Basel III capital framework. U.S. regulators should provide clarity on how the U.S.-specific adoption of any new Basel standards will affect capital requirements and risk-weighted asset calculations for U.S. firms.

Community Financial Institutions

Treasury strongly supports efforts to further enable our community bank and credit union sectors. Approximately one in four counties rely exclusively on community banks for banking services within county lines, and nearly half of the rural counties have only community banks located within them. As such, these institutions serve as a critical backbone to America's communities, including our rural economy, and are an essential provider of credit to small and mid-sized businesses.

Community financial institutions' business models have come under pressure from a slow economic recovery and low interest rate environment, additional competition (e.g., internet banks and nonbank lenders), and added compliance costs from new regulations. Together such factors have contributed to a difficult operating environment and the ongoing consolidation of smaller banks and credit unions. FDIC analysis shows that the number of federally insured banks declined from 17,901 in 1984²⁷ to less than 5,913 banks in 2016.²⁸ The impact of consolidation has been particularly profound on smaller banks as the number of institutions with assets less than \$100 million declined by 85% between 1985 and 2013.²⁹ Similarly, the total number of credit unions in

27. Gruenberg, Martin J., FDIC on Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections; to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Feb. 14, 2013), available at: <https://www.fdic.gov/news/news/speeches/archives/2013/spfeb1313.html>.

28. FDIC, *Quarterly Banking Profile*, All Institutions Performance, Fourth Quarter 2016, available at: <https://www.fdic.gov/bank/analytical/qbp/2016dec/qbpall.html>.

29. FDIC, *Community Banks Remain Resilient Amid Industry Consolidation*. FDIC Quarterly, 2014, Vol. 8, No. 2, available at: www.fdic.gov/bank/analytical/quarterly/2014_vol8_2/article.pdf.

the country has declined by approximately 18% since 2011 (from 7,094 institutions in 2011³⁰ to 5,785 institutions in 2016³¹), with the impact mostly concentrated among smaller credit unions.³² Feedback provided to Treasury suggests that the cumulative effects of regulatory requirements weigh heavily on community banks and credit unions.

Treasury has identified a number of issues and has made recommendations with respect to right-sizing capital requirements, enabling capital formation, encouraging new charters, and reducing a number of other regulatory burdens that hinder these institutions' ability to serve their customers.

Right-Sizing Capital Requirements for Community Banks and Credit Unions

Community banks operate under a mix of capital regimes, integrating aspects of regimes for larger banks with some adjustment in recognition of their smaller scale and lower systemic risk relative to larger banks. The federal banking agencies have elected to apply the Basel III risk-based capital regime and its attendant changes to the required quality and quantity of capital to smaller banks and BHCs. While regulators exempted smaller banks from stress-testing and liquidity standards applied to large banks and BHCs, they nevertheless required all banks to satisfy the Basel III common equity tier 1 capital (CET1) ratio of 4.5%, when fully phased-in by 2019, the 2.5% capital conservation buffer (aggregate 7% CET1), along with the complex rules used to calculate common equity, and meet higher capital requirements on specific asset classes through the introduction of higher risk-weights.³³ Regulations implementing Basel III standards have caused a number of issues for community banks, including the treatment of high volatility commercial real estate (HVCRE) and mortgage servicing assets (MSAs). In addition, community banks have concerns over the application of the capital conservation buffer to institutions with less than \$10 billion in assets as well as the CECL accounting standard discussed above.³⁴

Credit unions have also become subject to new capital rules in recent years. The NCUA finalized its risk-based capital rule in October 2015 for federally-insured credit unions with at least \$100 million in assets, which will become effective in 2019.³⁵ This rule generally parallels the Basel III standards for banks.³⁶ In addition, while stress testing is not required for credit unions under Dodd-Frank, the NCUA finalized a rule in April 2014 that requires federally insured credit unions with assets of \$10 billion or more to be subject to stress test requirements.³⁷ In February 2017, the NCUA issued an advance notice of proposed rulemaking to solicit comment on alternative

30. NCUA, *Financial Trends in Federally Insured Credit Unions* (Dec. 31, 2011), available at: <https://www.ncua.gov/Legal/Documents/Reports/FT20111231.pdf>.

31. NCUA, *NCUA Chart Pack* (Dec. 31, 2016), available at: <https://www.ncua.gov/analysis/Pages/call-report-data/Reports/Chart-Pack/chart-pack-2016-12.pdf>.

32. National Association of Federal Credit Unions. *2016 NAFCU Report on Credit Unions*. Nov. 2016, available at: <https://www.nafcu.org/research/reportoncreditunions>.

33. Federal Reserve Board, FDIC, and OCC, *New Capital Rule: Community Bank Guide* (July 2013), available at: https://www.federalreserve.gov/bankinfo/reg/basel/files/capital_rule_community_bank_guide_20130709.pdf.

34. Id.

35. NCUA, *Risk Based Capital*. 80 Fed. Reg. 66626. (Oct. 29, 2015).

36. Basel III was published in December 2010 and revised in June 2011. The text is available at <http://www.bis.org/publ/bcbs189.htm>.

37. NCUA, *Capital Planning and Stress Testing*. 79 Fed. Reg. 24311 (Apr. 30, 2014).

forms of capital that could help federally insured credit unions raise capital without solely relying on retained earnings.³⁸

Recommendations for Community Banks

Treasury recommends that the regulators simplify the overall capital regime for community banks, as the complex U.S. capital rules implementing Basel III standards are not appropriately tailored today. Several options could be considered to simplify and reduce the burden on community banks, which unless otherwise specified is a term we apply to banks with less than \$10 billion in assets.

The bank regulators should explore exempting community banks from the risk-based capital regime implementing the Basel III standards. The greater emphasis on common equity, achieved through adoption of the Basel III CET1 standard, is an important element of post-crisis rules that should be retained. In addition, if required to tailor the capital rules for community banks, section 171 of the Dodd-Frank Act, known as the Collins Amendment, should be amended. Exempting small banks from the U.S. Basel III risk-based capital rules would tailor capital regulations to better reflect the risk profile of community banks and would allow for revising the capital treatment of various asset classes including mortgage servicing assets and certain types of commercial real estate. This would allow community banks to better serve borrowers in their communities.

Credit losses on commercial real estate loans have been a key factor in bank failures, both in this most recent financial crisis and past crises.³⁹ As a result, federal banking regulators increased capital requirements for HVCRE⁴⁰ and have also issued guidance for concentration limits more recently.⁴¹ We recommend that regulators move forward with efforts to simplify and clarify the definition of HVCRE loans to avoid the application of higher risk-weights for loans where it would be unnecessary.

38. NCUA, *Alternative Capital*. 82 Fed. Reg. 9691 (Feb. 8, 2017).

39. See, e.g., GAO, *Financial Institutions: Causes and Consequences of Recent Bank Failures* (Jan. 2013), available at: <http://www.gao.gov/assets/660/651/651154.pdf>. (Ten states concentrated in the western, Midwestern, and southeastern United States—all areas where the housing market had experienced strong growth in the prior decade—experienced 10 or more commercial bank or thrift (bank) failures between 2008 and 2011. The failures of the smaller banks (those with less than \$1 billion in assets) in these states were largely driven by credit losses on commercial real estate (CRE) loans. The failed banks also had often pursued aggressive growth strategies using nontraditional, riskier funding sources and exhibited weak underwriting and credit administration practices. The rapid growth of CRE portfolios led to high concentrations that increased the banks' exposure to the sustained real estate and economic downturn that began in 2007. GAO's econometric model revealed that CRE concentrations and the use of brokered deposits, a funding source carrying higher risk than core deposits, were associated with an increased likelihood of failure for banks across all states during the period.)

40. *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*. OCC, Federal Reserve, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62018. (Oct. 11, 2013).

41. Federal Reserve Board, FDIC, and OCC, *Statement on Prudent Risk Management for Commercial Real Estate Lending*, (Dec. 8, 2015). available at: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20151218a1.pdf>.

Treasury recommends providing relief from the Federal Reserve’s Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (Policy Statement) requirements by further raising the threshold for compliance with bank holding company requirements.⁴² The Policy Statement allows BHCs with less than \$1 billion in assets to operate with higher levels of debt. The Federal Reserve’s Policy Statement recognizes that acquisition debt is often required in the transfer of ownership between small banks. Small institutions are often sold to other small institutions and small bank acquirers need the financing to make these acquisitions. The Federal Reserve raised the exemption limit from \$500 million to \$1 billion in accordance with the enactment of legislation in December 2014. At its current \$1 billion threshold, the Policy Statement covers over 80% of the BHCs and savings and loan holding companies.⁴³ Raising the threshold to \$2 billion would provide substantial additional and appropriate relief to several hundred more BHCs.⁴⁴

Recommendations for Community Development Financial Institutions and Minority Depository Institutions

In addition to above described regulatory relief, it may be appropriate to grant CDFI banks and MDIs additional flexibility in utilizing subordinated debt or capital, particularly capital that is borrowed by the holding company and injected into the bank. Such capital may include program-related investments (PRIs) received from foundations or impact investors.

Recommendations for Federally-Insured Credit Unions

Treasury supports a review and recalibration of NCUA regulations relating to credit union capital and stress-testing requirements.

NCUA should revise the risk-based capital requirements to only apply to credit unions with total assets in excess of \$10 billion or eliminate altogether risk-based capital requirements for credit unions satisfying a 10% simple leverage (net worth) test. This would eliminate the need for the October 2015 final rule implementing risk-based capital requirements for credit unions with over \$100 million in assets starting in 2019.⁴⁵

In line with the recommendation for the tailoring of capital regulations for community banks, Treasury recommends generally raising the scope of application for stress testing of federally-insured credit unions to \$50 billion in assets from the current \$10 billion threshold.

Consistent with the first recommendation above regarding the application of risk-based capital requirements only to credit unions with total assets in excess of \$10 billion, Treasury supports allowing such credit unions to rely in part on appropriately designed supplemental capital to meet a portion of their risk-based capital requirements. Such supplemental capital instruments, if

42. 12 C.F.R. Part 225, Appendix C. While the Policy Statement refers mostly to BHCs, the Policy Statement provides that most of its provisions apply to savings and loan holding companies as if they were BHCs.

43. Killian, Thomas W., Changes to Small BHC Policy Statement: Implications for M&A, Capital Planning, and Investment Strategy (April 20, 2015), available at: <http://www.sandleroneill.com/Collateral/Documents/English-US/Small%20BHC%20Policy%20Statement%20Note.pdf>.

44. Federal Reserve Y9C data per SNL Financial; staff estimates.

45. NCUA, Risk Based Capital. 80 Fed. Reg. 66626. (Oct. 29, 2015).

required to have essential prudential features (e.g., noncumulative perpetual preferred stock and subordinated debt with long-maturity and lack of early event acceleration), will allow credit unions to increase their capital from investors rather than relying solely on retained earnings.

Encouraging De Novo Activity

Formation of new banking institutions is crucial for a dynamic and growing economy, and Treasury strongly supports efforts to encourage de novo formation. Treasury recommends implementing changes to the existing regulatory capital requirements and other burdensome rules for community banks as discussed above and a critical review of capital requirements applicable to de novo banks. Further, the application process of obtaining deposit insurance should be significantly streamlined, and Treasury supports the FDIC's recent efforts to encourage de novo charters.

Simplifying Regulation

Regulatory Reporting

Currently, the bank Call Report form is over 80 pages and contains a substantial amount of data fields which are not applicable to community banks and their business model. The regulators have already taken steps to simplify Call Reports for smaller banks (those with under \$1 billion in assets)⁴⁶, but further changes are needed.

Treasury recommends that the regulators continue to streamline current regulatory reporting requirements for all community financial institutions. Treasury recommends that the regulators focus their efforts on applicability of each line item.

Examinations

As required by legislation enacted into law in 2015, in February 2016, the banking regulators expanded the number of smaller banks eligible for an 18-month examination cycle.⁴⁷ The final rule also raised the dollar threshold for this determination from \$500 million to \$1 billion. However, Treasury recommends that Congress consider raising this threshold further. The NCUA should also implement parallel changes to extend examination cycles for smaller credit unions. In addition, all regulators should expand upon current efforts to further coordinate and rationalize their examination and data collection procedures to promote accountability and clarity.

Agricultural and Rural Credit

Generally, agricultural banks are small institutions⁴⁸, with the median asset size of \$118 million. Providing banking services in rural areas is particularly difficult given the scarcity of key service

46. OCC, Federal Reserve, FDIC, Proposed Agency Information Collection Activities; Comment Request. 81 Fed. Reg. 54190. (Aug. 15, 2016).

47. OCC, Federal Reserve, FDIC, Expanded Examination Cycle for Certain Small Insured Depository Institutions and U.S. Branches and Agencies of Foreign Banks. 81 Fed. Reg. 90949 (Dec. 16, 2016).

48. American Bankers Association, 2016 Farm Bank Performance Report (May 3, 2016), available at: <http://www.aba.com/Tools/Function/Ag/Documents/2016FarmBankPerformanceReport.pdf>. Farm banks are defined by the ABA as banks whose ratio of domestic farm loans to total domestic loans are greater than or equal to the industry average, which was 15.6% in 2016.

providers, such as appraisers and other legal and compliance staff. As such, the regulators need to recognize these circumstances and provide special consideration to agricultural and rural banks' compliance challenges.

Increase Threshold for Making Small Creditor QM Loans

Treasury recommends changes to the CFPB's ATR/QM rule and raising the total asset threshold for making Small Creditor QM loans from the current \$2 billion to a higher asset threshold of between \$5 and \$10 billion to accommodate loans made and retained by a larger set of community financial institutions.

Improving the Regulatory Engagement Model

Overview

In an effort to identify opportunities to make regulation more efficient, effective, and appropriately tailored, Treasury has sought to identify cross-cutting areas of potential focus in the reassessment of banking regulation. Set out below is an exploration of these topics, including the regulatory requirements on a banking organization's board of directors, the enhanced use of regulatory cost-benefit analysis, and improvements in the process for remediating regulatory issues. Also included is a discussion of the nature of compliance expectations regarding the CRA.

Reassessing Regulatory Requirements on a Banking Organization's Board of Directors

The oversight provided by the Board of Directors of a U.S. banking organization is critical to the successful and sound operation of the enterprise. Maintaining discipline and accountability on the part of Boards, based on the recognition of core functions and consistent principles, is an important tenet for any successful governance model. The failure of Boards in oversight of banking organizations was a major contributor to the financial crisis.

One of the most fundamental elements of the governance framework is the separation of duties between management, responsible for day-to-day operations of the business, and the Board, responsible for oversight of the business and affairs of the organization. As noted by The Clearing House in its research on board governance, "blurring of this distinction detracts from effective governance by potentially reducing the Board's ability to focus on its core oversight functions, and therefore impairing the Board's ability to perform its critical oversight role, and creating uncertainty as to roles and responsibilities."⁴⁹

Through Treasury's discussion with a wide range of stakeholders, including chief executive officers, trade group representatives, Board members, and governance experts, several themes emerged. First, there are over 800 provisions in law, regulation, and agency guidance that impose obligations

49. The Clearing House. *The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations* (May 2016), at 6.

on bank Boards.⁵⁰ This volume crowds out time that should be allocated to oversight of the enterprise's business risk and strategy. Second, there is a considerable volume of non-strategic regulatory matters requiring Board attention that has the impact of blurring the appropriate line between management and Board duties. Finally, there is little coherence in the panoply of requirements imposed on Boards by various financial regulators, on top of federal and state statutory requirements. This has resulted in significant overlap, a lack of thoughtful coordination of aggregate requirements and expectations, and a lack of periodic review or reassessment of the impact of aggregate requirements placed on Boards. This has a particularly negative impact on mid-size and smaller banking organizations.

The duties imposed on Boards are too voluminous, lack appropriate tailoring, and undermine the important distinction between the role of management and that of Boards of Directors. A significant shift in the nature and structure of Board involvement in regulatory matters could be made with little or no increase in risks posed to the financial system. In fact, allowing Boards to fulfill a clearer set of agreed duties, per an enterprise's corporate governance model, would reduce risk by restoring their appropriate governance authority. Treasury recommends an inter-agency review of the collective requirements imposed on Boards in order to reassess and better tailor these aggregate expectations and restore balance in the relationship between regulators, Boards, and bank management.

Enhanced Use of Regulatory Cost-Benefit Analysis

For over three decades, presidents of both parties have directed executive agencies to evaluate the costs and benefits of new regulatory actions.⁵¹ The current framework, set forth in Executive Order 12866, directs executive agencies to assess the cost and benefits of new rules with particular focus on evaluation and review of economically significant regulations — actions expected to have an annual economic impact of \$100 million or more.⁵² Cost-benefit analysis in the regulatory process is premised on the common sense recognition that new rules should be designed to do more good than harm.⁵³ This analytical discipline promotes economic efficiency as well as accountability by better apprising the public of the expected impact of a new regulation.⁵⁴ Cost-benefit analysis also requires agencies to consider the trade-offs and potential unintended consequences of new government interventions in

50. See Letter of Bank Director Regulatory Burdens to Chairwoman Yellen available at: https://www.federalreserve.gov/SECRS/2016/March/20160329/R-1510/R-1510_021916_130213_541812673740_1.pdf.

51. Executive Order 12291, 46 FR 13193 (Feb. 17, 1981); Executive Order 12498, 50 FR 1036 (Jan. 4, 1985). Even before the issuance of Executive Order 12291, however, Presidents had sought to increase executive agencies' use of cost-benefit analysis. See Edward P. Fuchs and James Anderson, *The Institutionalization of Cost-Benefit Analysis*, 10 *Pub. Productivity Rev.* 25, 27-30 (1987) (examining efforts to implement cost-benefit analysis in Nixon, Ford, and Carter Administrations).

52. See section 3(f) of Executive Order 12866, 58 FR 51735 (Oct. 4, 1993).

53. Cass Sunstein, *The Cost-Benefit State* (Coase-Sandor Institute for Law & Economics Working Paper No. 39, 1996), at 1.

54. *Id.* at 4 ("Cost-benefit requirements . . . can be understood as a way of diminishing interest-group pressures on regulation and also as a method for ensuring that the consequences of regulation are not shrouded in mystery but are instead made available for public inspection and review.").

the free market.⁵⁵ Finally, cost-benefit analysis aids the President and Congress in assessing whether proposed regulations, and their underlying statutes, promote the public interest.⁵⁶

Importantly, however, while Congress has imposed discrete cost-benefit analysis requirements on independent financial regulatory agencies – including the CFTC, SEC, FDIC, Federal Reserve, OCC, and CFPB⁵⁷ – these agencies have long been exempt from Executive Order 12866.⁵⁸ As a result, the financial regulators have not adopted uniform and consistent methods to analyze costs and benefits, and their cost-benefit analyses have sometimes lacked analytical rigor.⁵⁹ GAO has therefore recommended that the financial regulatory agencies more fully apply Office of Management and Budget (OMB) guidance on cost-benefit analysis issued under Executive Order 12866,⁶⁰ and there is bipartisan legislative support for broader cost-benefit analysis by these agencies.⁶¹

Although the financial regulatory agencies have sought to incorporate cost-benefit analysis in their rulemakings, the current approach remains fragmented and inconsistent. Requiring these agencies to apply cost-benefit analysis to at least all economically significant regulations in a uniform and consistent manner would improve the design and implementation of the financial regulatory framework. In addition, a more consistent, comprehensive, and uniform approach to cost-benefit analysis would improve the transparency of the rulemaking process and make the agencies more accountable to Congress and to the public.⁶²

With respect to at least all economically significant proposed regulations, Treasury recommends that financial regulatory agencies perform and make available for public comment a cost-benefit analysis. That analysis should be included in the administrative record of the final rule. Some variations are to be expected given the differing statutory mandates of each agency, but the financial regulatory agencies should seek to achieve greater consistency in their methodology and use of cost-benefit analysis—modeled on Executive Order 12866 and OMB Circular A-4. These agencies should also be required to coordinate their cost-benefit analysis when proposing joint or related regulations.

55. See section 1(a) of Executive Order 12866 (requiring agencies to assess costs and benefits of “available regulatory alternatives”).

56. Sunstein, *The Cost-Benefit State*, at 22-23.

57. See Maeve Carey, *Cost-Benefit and Other Analysis Requirements in the Rulemaking Process*, Congressional Research Service (Dec. 9, 2014) at 16-22, available at <https://fas.org/sgp/crs/misc/R41974.pdf>, for an overview of the statutory requirements to perform cost-benefit analysis applicable to certain independent regulatory agencies.

58. Section 3(b) of Executive Order 12866; see also definition of “independent regulatory agency” in 44 U.S.C. § 3502(5). The OCC became an independent agency for purposes of Executive Order 12866 following enactment of Dodd-Frank.

59. Dodd-Frank Act Regulations: Implementation Could Benefit from Additional Analyses and Coordination, GAO (2011) at 17-18, available at <http://www.gao.gov/assets/590/586210.pdf>. (“However, none of the benefit-cost analyses of the federal financial regulators [for Dodd-Frank rulemakings] that we reviewed either explained why benefits and costs could not be monetized or quantified or discussed the strengths and limitations of the available qualitative information.”).

60. *Id.* at 18.

61. See, e.g., The Independent Agency Regulatory Analysis Act of 2015 (S. 1607) (sponsored by Senators Portman and Warner).

62. See Paul Rose and Christopher Walker, *The Importance of Cost-Benefit Analysis in Financial Regulation*, U.S. Chamber of Commerce Center for Capital Markets Competitiveness (March 2013), at 11-15.

Community Reinvestment Act (CRA)

The Community Reinvestment Act of 1977¹ was enacted in response to concerns that federally insured banking institutions were not making sufficient credit available in local areas in which they were chartered and operate. The CRA applies to depository institutions insured by the FDIC.² The CRA does not apply to credit unions and other nonbank entities.³ The OCC, the Federal Reserve, and the FDIC administer the CRA for the insured depository institutions that they supervise.⁴ The CRA requires the banking regulators to rate how well the institutions meet local credit needs in their designated “assessment areas,” defined as those where institutions have local deposit-taking operations.⁵ CRA examination reports and ratings are made public through the FFIEC.⁶ While all three prudential regulators are involved in checking CRA compliance, none are responsible for evaluating how well the CRA accomplishes its mission.⁷

Regulators use CRA ratings as a factor when approving firms’ applications to engage in certain activities, such as opening branches, relocating the main office or a branch office, and making acquisitions (business combinations).⁸ If a bank is downgraded to a level that is below “satisfactory,” it would be restricted from mergers, acquisitions, opening branches and entering into business arrangements until its next CRA exam.⁹ Because CRA exams are typically conducted only every three to five years, and the receipt of a final rating can take a year or more, the remediation of CRA issues can often take years to complete. Until such remediation occurs, firms’ ability to expand and grow their business can be constrained for multiple years, including undertaking mergers.

The CRA examination process and rating system needs to reflect the variety of ways banks do business and meet the needs of diverse consumers and communities. Increasingly, banks use technology, such as automated and online offerings, to extend services outside of physical branches. Consideration should also be given to effective, innovative means of serving consumers and communities, as

1. 12 U.S.C. § 2901; see also at 12 C.F.R. 228 (Regulation BB).
2. 12 U.S.C. § 2902.
3. *Id.*
4. *Id.*
5. See, e.g., 12 C.F.R. § 228.41.
6. 12 C.F.R. 25.43. Examination Reports are available at: <https://www.ffiec.gov/craadweb/DisRptMain.aspx>.
7. See Getter, Darryl E., *The Effectiveness of the Community Reinvestment Act*, Congressional Research Service, (2015), at 8, available at: <https://www.newyorkfed.org/medialibrary/media/out-reach-and-education/cra/reports/CRS-The-Effectiveness-of-the-Community-Reinvestment-Act.pdf>.
8. See OCC. Comptroller’s Licensing Manual, Public Notice and Comments (May 2017), available at: <https://www.occ.gov/publications/publications-by-type/licensing-manuals/PublicNCbooklet.pdf>.
9. Getter, *The Effectiveness of the Community Reinvestment Act*, at 6.

demonstrated by measures such as customer satisfaction reviews, needs assessments, and partnerships with community-based organizations. In addition, when assessing the extent to which the convenience and needs of the community would be served by an acquisition or a merger, regulators should give careful and equal weight to the views of individuals who support and oppose the activity.

Treasury expects to comprehensively assess how the CRA could be improved, which will include soliciting input from individual consumer advocates and other stakeholders. Aligning the regulatory oversight of CRA activities with a heightened focus on community investments will be a high priority for the Secretary. Treasury plans to review several aspects of the CRA framework, including assessing the need for: improvement in how banks' CRA investments are measured to improve their benefit to communities; additional harmonization of CRA supervision given the oversight by multiple regulators; changes in the way CRA geographic assessment areas are defined because of the changing nature of technology and other factors; and improvement in the regulatory review and rating assessment process, which would consider the frequency of examinations, the ability of institutions to remediate ratings, and the transparency of how the overall CRA assessment rating is determined.

Treasury believes that it is important that banks' CRA investments better align with the needs of the communities that they serve, are made in a manner that is consistent with a firm's safety and soundness, and that such investments be subject to efficient and effective supervision.

Improving the Process for Remediating Identified Regulatory Issues

Areas that could benefit from review and improvement include the breadth and nature of regulatory actions, including matters requiring attention (MRAs), matters requiring immediate attention (MRIAs), and consent orders (COs), and the use and impact of regulatory ratings on banking operations and effectiveness.

Treasury endorses rigorous procedures and accountability for the regulation of depository institutions. Likewise, as noted above, it is critical that both the Board and management play their appropriate role in the oversight of regulatory compliance and the remediation of identified regulatory lapses. An appropriate “tone at the top” at both regulators and banking organizations is required to fulfill these expectations, with mutual accountability and a common understanding of responsibility. This must grow from relationships between firms and regulators based on transparency and clear rules and guidance.

Treasury recommends an interagency reassessment of the volume and nature of MRAs, MRIAs, and COs to evaluate their impact, consistency, and overlap and to establish consistent interagency standards. Treasury also recommends that regulators and banking organizations develop an improved approach to addressing and clearing regulatory actions. Many banking organizations report multi-year delays in even receiving a plan to clear regulatory actions, which clouds their business activities during such delays. This is reported to be particularly acute in circumstances where there is a lack of transparency in rules and rulemaking in enforcement-led regulatory compliance regimes.

Living Wills

Overview

Section 165(d) of Dodd-Frank requires large bank holding companies (those with \$50 billion or more in total consolidated assets) and nonbank financial companies designated by the FSOC to prepare living wills for their rapid and orderly resolution under the U.S. Bankruptcy Code or other applicable law.⁶³

Living wills are reviewed by the Federal Reserve and the FDIC.⁶⁴ Following their review, the Federal Reserve and the FDIC may jointly determine that a plan is not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code.⁶⁵ Treasury supports the ongoing requirements of living wills, subject to refinements as set forth below, in particular properly tailoring the threshold of participation.

Dodd-Frank requires the agencies to take actions upon jointly determining that a firm's living will is deficient, or "not credible."⁶⁶ In the first phase, the Federal Reserve and the FDIC issue a joint notice of deficiency.⁶⁷ The firm then has 90 days to resubmit a living will that addresses the outlined deficiencies, although the agencies may jointly agree to extend or reduce this time period.⁶⁸ Thereafter, if the resubmitted living will is still deemed deficient, a two-stage process is initiated:

- First, if a firm does not cure the deficiencies in a timely manner, the Federal Reserve and the FDIC may jointly impose (a) more stringent capital, leverage, or liquidity requirements or (b) restrictions on the company's growth, activities, or operations.⁶⁹
- Second, if the Federal Reserve and the FDIC have jointly imposed any of the requirements or restrictions under the first step above, and the firm has still failed to submit a revised living will that adequately remedies the identified deficiencies within two years, the agencies may jointly order the divestiture of certain assets or operations, subject to the following requirements: (a) the agencies must first consult with the FSOC; and (b) the agencies must jointly determine that divestiture is necessary to facilitate an orderly resolution under the Bankruptcy Code in the event of the company's failure.⁷⁰

To date, the Federal Reserve and FDIC have issued joint deficiency determinations only once—to five of the largest firms following their 2015 submissions. Four of the five firms remedied their plans upon the subsequent re-submission. Only Wells Fargo's plan remained deficient, and it was

63. Dodd-Frank § 165(d).

64. *Id.*

65. Dodd-Frank § 165(d)(4).

66. *Id.*

67. *Id.*

68. Dodd-Frank §165(d)(4); 12 C.F.R. §243.5 (Federal Reserve); §381.5 (FDIC).

69. Dodd-Frank § 165(d)(5)(A); 12 C.F.R. §243.6 (Federal Reserve); §381.6 (FDIC).

70. Dodd-Frank § 165(d)(5)(B); 12 C.F.R. §243.6(c) (Federal Reserve); §381.6(c) (FDIC).

subjected to restrictions on the growth of its international and nonbank activities. These restrictions were lifted in April 2017 upon a satisfactory re-submission by Wells Fargo.⁷¹

The slow accretion of guidance for living wills without the benefit of public notice and comment has imposed an undue burden on participating institutions. Living wills' thresholds of participation should be more appropriately tailored to the size and complexity of banks' business models and not serve as supplemental capital and liquidity regulatory guidance requirements. Current guidance has required the pre-positioning of excess amounts of liquidity and capital by requiring banks to pre-fund a bankruptcy through the Resolution Liquidity Execution Need (RLEN) and Resolution Adequacy and Positioning (RLAP) standards.⁷² Further improvement on guidance for living wills should be made, subject to public notice and comment.

Recommendations for Regulatory Reform

The following are Treasury's recommendations for improving the regulatory approach to living wills.

Raise threshold for living will requirements

Treasury recommends changing the threshold for compliance with living will requirements for BHCs from the current threshold of \$50 billion to match the revised threshold for application of enhanced prudential standards. The Federal Reserve and FDIC have used their authority to tailor the application of these requirements for smaller institutions, but the statute still compels the agencies to require bank holding companies at or above the \$50 billion asset threshold to periodically submit some sort of a living will.

Adjust living will submission frequency

Section 165(d) of Dodd-Frank does not specify a timeframe for living will submissions. The agencies, in a 2011 joint rulemaking, required annual submissions, although the agencies have since granted numerous extensions.⁷³ The agencies should formalize a change of the living will process to a two-year cycle.

The agencies could require firms to provide notice of material events that occur between living will submissions. If the agencies identify potential concerns arising from such a material event, the agencies could require the firm to submit a revised living will.

Improve living will guidance

The agencies should be held accountable to develop specific, clear, and accountable guidance for living will submissions as well as the assessment framework for determining deficiencies in living

71. See Hamilton, Jesse, *Wells Fargo's Living Will Approved After Third Try*, Bloomberg (Apr. 24, 2017), available at: <https://www.bloomberg.com/news/articles/2017-04-24/wells-fargo-s-third-time-a-charm-as-it-clears-living-will-hurdle>.

72. See Federal Reserve Board and FDIC, *Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015* (Apr. 13, 2016), available at: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160413a1.pdf>.

73. 12 C.F.R. §243.3 (Federal Reserve); §381.3 (FDIC).

will submissions (including remediation procedures). All assessment framework and guidance should be subject to a public notice and comment process.

As noted above, the agencies' living will guidance has effectively required companies to increase capital and liquidity standards through Resolution Liquidity Execution Need (RLEN) and Resolution Liquidity Adequacy and Positioning (RLAP) requirements. It is particularly important that any such guidance that effectively acts as a regulatory requirement should be minimized and that such guidance be subject to notice and public comment before going into effect.⁷⁴

Consolidate regulatory oversight and improve timeliness of feedback

While the Federal Reserve and the FDIC have increased their coordination and responsiveness to companies seeking guidance on the preparation of their living wills, ongoing discrepancies in guidance remain. Treasury recommends that section 165(d) of Dodd-Frank be amended to remove the FDIC from the living wills process. In addition, the Federal Reserve should be required to complete its review and give feedback to firms on their living wills within six months.

Foreign Banking Organizations

Overview

Foreign banking organizations operate in the United States across a spectrum of business models and sizes, ranging from a single U.S. branch to mid-sized banks with traditional retail footprints to some of the largest broker-dealers in the United States. FBOs represent 20% of total U.S. banking system assets, provide about one-third of U.S. business loans,⁷⁵ and comprise more than half of the 23 primary dealers of the Federal Reserve Bank of New York.⁷⁶

The financial crisis demonstrated a need to reassess the extent of reliance on home country supervision of risk management, capital, and liquidity of the U.S. operations of FBOs. In recognition of the increased complexity, interconnectedness, and concentration of U.S. operations of FBOs, reforms introduced new requirements to improve the supervisory framework and create a more level playing field between U.S. and foreign banks. However, as discussed below, the application of these requirements needs to be reevaluated so that FBOs are not unduly constrained.

74. Moreover, as noted in the capital, leverage and liquidity section, requirements to pre-fund a bankruptcy filing via RLEN and RLAP standards should be calibrated in a way that does not unnecessarily trap capital and liquidity in subsidiaries.

75. Federal Reserve Board, Share Data for the U.S. Offices of Foreign Banking Organizations, (Sep. 30, 2016), available at: <https://www.federalreserve.gov/releases/iba/fboshr.htm>. The Federal Reserve asset figures do not include certain non-bank affiliates and credit unions.

76. Federal Reserve Bank of New York, Primary Dealers, available at: <https://www.newyorkfed.org/markets/primarydealers>.

Enhanced Prudential Standards

Section 165 of Dodd-Frank requires the Federal Reserve to adopt tailored enhanced prudential standards applicable to large BHCs and certain FBOs.⁷⁷ As adopted by the Federal Reserve, the enhanced prudential standards applicable to FBOs with \$50 billion or more of total U.S. assets include extensive capital, liquidity, risk-management and stress testing requirements.⁷⁸ FBOs with global total consolidated assets of \$50 billion or more, but less than \$50 billion in combined U.S. assets, are subject to less-stringent enhanced prudential standards.⁷⁹ These smaller FBOs may comply with most of the new enhanced prudential standards by certifying that their compliance with home country requirements for capital, liquidity, and stress testing are consistent with U.S. requirements.⁸⁰ However, such FBOs must also satisfy risk management requirements adopted by the Federal Reserve.⁸¹ FBOs with global assets of between \$10 and 50 billion can also satisfy the Federal Reserve's stress testing requirements by certifying compliance with their home country stress testing regime, but are subject to the Federal Reserve's risk management requirements.⁸²

The Federal Reserve also adopted rules, as required by section 165 of Dodd-Frank, requiring FBOs with \$50 billion or more in total consolidated assets to submit resolution plans to the Federal Reserve and FDIC demonstrating how their U.S. operations would be resolved under the Bankruptcy Code.⁸³ Because the statutory threshold for application of these requirements is based on total consolidated assets, not U.S. assets, it has resulted in more than 100 FBOs being required to submit resolution plans, some of which have only a small U.S. presence.⁸⁴ Although the Federal Reserve and FDIC have tailored the resolution plan requirements for FBOs based on size and complexity (as well as for smaller, less complex U.S. bank holding companies), the requirement still places unnecessary burdens on institutions whose U.S. operations do not pose risks to financial stability.

Intermediate Holding Company Requirements

The Federal Reserve also requires FBOs with \$50 billion or more in U.S. non-branch assets to establish an intermediate holding company over its U.S. banking and non-banking subsidiaries.⁸⁵ The IHC requirement provides the Federal Reserve a platform for consolidated supervision and regulation of U.S. operations of large, complex FBOs consistent with those for U.S. BHCs of a similar size and structure. Generally, IHCs must meet the same risk-based capital, capital planning, and leverage standards that are applicable to U.S. BHCs with \$50 billion or more in total assets, though U.S. IHCs of FBOs do not have to comply with the U.S. requirements for advanced

77. See § 12 U.S.C. 5365(a)(1)(B).

78. 12 C.F.R. Part 252.

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. Dodd-Frank §165(d)(8).

84. Fields, Henry, Marc-Alain Galeazzi, Oliver Ireland, and Barbra Mendelson, *Summary of Final Rule Imposing Enhanced Prudential Standards on FBOs* (Feb. 24, 2014), available at: <http://media.mofa.com/files/uploads/Images/140224-Final-Rule-FBO-Standards.pdf>.

85. 12 C.F.R. Part 252.

approaches capital calculations or the U.S. eSLR that apply to U.S. BHCs. In addition, the Federal Reserve's 2016 TLAC and minimum debt rule requires IHCs of FBOs that are G-SIBs to maintain a certain amount of internal TLAC (including a certain percentage of debt) issued to their foreign parent company.⁸⁶

Challenges with the Post-Crisis Regulatory Framework

One of the principal concerns raised regarding the post-crisis regulatory framework for FBOs has been how it has discouraged FBOs' appetite to participate in U.S. markets. Some view the requirements for U.S. capital and liquidity as excessive because the FBO's ultimate parent is already supervised and capitalized at the consolidated level, including its U.S. operations, under applicable international banking standards. Moreover, requiring such capital and liquidity at the IHC level results in requirements that can often exceed what would be required if the U.S. activities were treated as part of the IHC's consolidated parent.

In addition, too many FBOs that have a relatively small U.S. presence are subject to regulatory burdens. Approximately 110 FBOs exceed the statutory threshold of \$50 billion in global total consolidated assets and are thus subject to some form of the U.S. enhanced prudential standards.⁸⁷ Most of these 110 firms are not FBOs with a large U.S. presence, with nearly 80% having less than \$50 billion in U.S. assets and nearly 60% having less than \$10 billion in U.S. assets.⁸⁸

Recommendations for Regulatory Reform

Treasury supports a regulatory regime for FBOs that addresses the risks that they present to the U.S. financial system and promotes a level playing field between domestic and foreign banks operating in the United States. Specifically, Treasury supports the continuation of the Federal Reserve's IHC regime to promote consolidated prudential supervision over FBOs' U.S. banking and non-banking activities (including investment banking and securities dealing). Treasury also supports application of the Federal Reserve's long-term debt and TLAC rule to improve the resolvability of G-SIBs. However, changes to the current framework should be made to encourage foreign banks to continue to participate in U.S. financial markets and provide credit to the U.S. economy. Treasury recommends the following changes to address the principal concerns regarding the FBO regulatory regime:

Applying enhanced prudential standards for FBOs based upon their U.S. footprints rather than global consolidated assets

The application of enhanced prudential standards and living will requirements to FBOs should be based on their U.S. risk profile, using the same revised threshold as is used for the application of enhanced prudential standards to U.S. bank holding companies, rather than on global consolidated

86. *Id.*

87. See Fields, Summary of Final Rule Imposing Enhanced Prudential Standards on FBOs, at 1.

88. Institute of International Bankers, Executive Order 13772, U.S. Supervision and Regulation of International Banks (April 28, 2017), p. 6, available at: <http://www.iib.org/news/347089/IIB-submitted-recommendations-to-Treasury-regarding-Executive-Order-13772.htm>.

assets. FBOs' U.S. regulatory requirements should be proportional to the risks presented by such firms to the U.S. financial system.

Recalibrating IHC requirements

Consistent with the thresholds recommended above for U.S. BHCs, the threshold for IHCs to comply with U.S. CCAR should be raised from the current \$50 billion level to match the revised threshold for the application of enhanced prudential standards, subject to the ability of the Federal Reserve to impose these requirements on smaller IHCs in cases where the potential risks posed by the firm justify the additional requirements.

Other IHC regulatory standards, such as resolution planning and liquidity, should also be recalibrated. In considering such a recalibration, greater emphasis should be given to the degree to which home country regulations are comparable to the regulations applied to similar U.S. BHCs. Where regulations are sufficiently comparable, FBOs should be allowed to meet certain U.S. requirements through compliance with home country regimes.

Recalibrating the Federal Reserve's long-term debt and TLAC rule

Maintaining the Federal Reserve's internal TLAC requirement for the IHCs of foreign G-SIBs is important for improving their resolvability. However, Treasury recommends the Federal Reserve consider recalibration of this internal TLAC requirement. In assessing the appropriate calibration, the Federal Reserve should consider the foreign parent's ability to provide capital and liquidity resources to the U.S. IHC, provided arrangements are made with home country supervisors for deploying unallocated TLAC from the parent, among other factors.

Improving the Volcker Rule

Section 619 of Dodd-Frank, known as the "Volcker Rule," generally prohibits insured depository institutions from engaging in proprietary trading or investing in hedge funds or private equity funds.⁸⁹ This prohibition also applies to banks' affiliates and holding companies, as well as certain foreign banking organizations with U.S. operations. Banking organizations have been required to comply with most provisions of the Volcker Rule since July 2015.⁹⁰

Banks with access to the federal safety net — FDIC insurance and the Federal Reserve discount window — should not engage in speculative trading for their own account. Insured banks that engage in proprietary trading enjoy a government-conferred advantage that invites moral hazard.

In its design and implementation, however, the Volcker Rule has far overshot the mark. The rule has spawned an extraordinarily complex and burdensome compliance regime due to a combination of factors: the scope of firms subject to the rule's prohibitions, the number of regulators charged with enforcement, the ambiguous definitions of key activities under the rule, and the extensive compliance programs that the rule requires firms to adopt. Most important, the rule has hindered

89. 12 U.S.C. § 1851 (2010).

90. Federal Reserve, Order Approving Extension of Conformance Period (Dec. 10, 2013), available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf>.

both market-making functions necessary to ensure a healthy level of market liquidity and hedging necessary to mitigate risk.⁹¹

The recommendations detailed below would reduce the scope and complexity of the Volcker Rule and allow banks more easily to hedge the risks of their activities and conduct the market-making activities on which the liquidity of our markets depends.

Recommendations for Regulatory Reform

Exempt Smaller Institutions from the Volcker Rule

Applying the Volcker Rule to firms whose failure would not pose risks to financial stability, or to firms that engage in little or no proprietary trading or covered funds activities, imposes substantial regulatory burdens but offers little benefit. Therefore, as described below, firms that are small or do not engage in significant proprietary trading should not be subject to the Volcker Rule. We make this recommendation with the expectation that any limited proprietary trading conducted by such a firm would continue to be subject to supervision and examination by the banking regulators to ensure it is conducted in a safe and sound manner.

Banks With \$10 Billion or Less in Assets

Most small banks do not engage in proprietary trading or invest in or sponsor private equity funds and hedge funds.⁹² Although the regulations provide banking entities with \$10 billion or less in assets with accommodations from the rule's compliance program requirements,⁹³ these banks have still been required to expend considerable resources to ensure that their activities do not constitute prohibited proprietary trading. In particular, such institutions, even if they do not engage in any trading, have had to expend resources to confirm that transactions they engage in for hedging their interest rate and other business risks are permitted under the Volcker Rule. The relatively small risk that these institutions pose to the financial system does not justify the compliance burden of the rule, and the risk posed by the limited amount of trading that banks of this size could engage in can easily be addressed through existing prudential regulation and supervision. For these reasons, banking organizations with \$10 billion or less in total consolidated assets should be entirely exempt

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91. See Jack Bao, Maureen O'Hara, and Xing (Alex) Zhou, *The Volcker Rule and Market-Making in Times of Stress*. Board of Governors of the Federal Reserve System Finance and Economics Discussion Series Working Paper No. 2016-102. (Sept. 2016), available at: <https://ssrn.com/abstract=2890846> (presenting evidence that the Volcker Rule has a deleterious effect on corporate bond liquidity during times of stress). See also Adrian Tobias, Nina Boyarchenko, and Or Shachar, *Dealer Balance Sheets and Bond Liquidity Provision*, *Journal of Monetary Economics* (2017), available at: <https://doi.org/10.1016/j.jmoneco.2017.03.011> (subscription required) (finding that institutions more impacted by post-crisis regulation are less able to intermediate customer trades).
92. Federal Reserve. *The Volcker Rule: Community Bank Applicability* (Dec. 10, 2013), available at: <https://www.federalreserve.gov/aboutthefed/boardmeetings/volcker-rule-community-bank-20131210.pdf>.
93. See, e.g., 12 C.F.R. 248.20, (e), (f)(2). The regulations promulgated by the five agencies responsible for implementing the Volcker Rule are found at 12 C.F.R. part 248 (Federal Reserve), 12 C.F.R. part 44 (OCC), 12 C.F.R. part 351 (FDIC), 17 C.F.R. part 255 (SEC), and 17 C.F.R. part 75 (CFTC). Citations herein are to the Federal Reserve's regulations, for convenience.

from all aspects of the Volcker Rule. This exemption would allow these banks to focus on their core business of lending to consumers and small and mid-size businesses.

Banks Over \$10 Billion in Assets with Few Trading Assets

Banks with over \$10 billion in assets should not be subject to the burdens of complying with the Volcker Rule's proprietary trading prohibition if they do not have substantial trading activity. A further exemption from the proprietary trading prohibition should be provided for all consolidated banking organizations, regardless of size, that have less than \$1 billion in trading assets and trading liabilities and whose trading assets and trading liabilities represent 10% or less of total assets. Trading conducted in amounts below these thresholds does not warrant the extensive burden of compliance with the Volcker Rule but rather can be more efficiently addressed through appropriate capital requirements and through prudential supervision and regulation.

These thresholds have already been adopted by the Federal Reserve, OCC, and FDIC for determining which banks have sufficient market exposure to require application of the agencies' market risk capital rules.⁹⁴ The market risk capital rules require banks with trading assets and trading liabilities that exceed these thresholds to adjust their risk-based capital ratios to reflect the market risk in their trading activities. Therefore, an added benefit of using the same thresholds to determine application of the proprietary trading restrictions—potentially with adjustments to the market risk capital definition of trading assets to exclude assets like loans and U.S. Treasury securities that are exempt from the Volcker Rule's proprietary trading restrictions—is that it would avoid subjecting banks to an additional calculation requirement to determine whether they fall within the Volcker Rule's scope.

In addition, limiting the application of the Volcker Rule's proprietary trading restrictions to those banks that are subject to the market risk capital rules would, as discussed below, permit the elimination of the purpose test in the current proprietary trading definition.

Under this recommendation, all banking entities with more than \$10 billion in assets would remain subject to the covered funds provisions of the Volcker Rule. The potential risk to the safety net and conflicts of interest presented by covered funds activities apply to all banks. The reforms to the covered funds restrictions discussed below would, however, substantially reduce the compliance burden of the rules and permit additional activities that pose no significant risks to banks.

Improve Regulatory Coordination

The current framework, in which five different regulators have responsibility for overseeing implementation of the Volcker Rule, results in fragmentation in responsibility and confusion for banks subject to the rule. In particular, the CFTC has jurisdiction over futures commission merchants and swap dealers; the FDIC over insured nonmember state banks; the SEC over brokers, dealers, registered investment companies, investment advisers, and security-based swap dealers; the OCC over national banks, federal savings associations, and federal branches of foreign banks; and the Federal Reserve over bank holding companies and savings and loan holding companies and their subsidiaries not otherwise regulated by the other regulators, state member banks, and foreign

94. 12 C.F.R. 217.201.

banking organizations.⁹⁵ In some cases, two agencies have responsibility for a single banking entity, such as a national bank that is a swap dealer, and a single trade and related hedge could be booked at two different entities, each of which is regulated by a different agency. This fragmentation of responsibility for determining how the rule should be applied to a particular banking entity or trading desk is inefficient for both the banks and the regulators.

The regulators' existing approach to coordination has not worked and, as a result, banks have had difficulty obtaining clear, consistent guidance. These agencies should ensure that their interpretive guidance and enforcement of the Volcker Rule is consistent and coordinated.

Clarify and Simplify the Proprietary Trading Prohibition and Exemptions

In addition to the reforms to the scope of the Volcker Rule described above, additional changes are necessary to clarify the rule's prohibitions, reduce unnecessary compliance burdens, and promote market making and other economically important activities. These concerns and recommendations are described below.

Simplify the Definition of Proprietary Trading

The Volcker Rule's definition of proprietary trading turns on three tests—two of which are relatively straightforward, and one of which has generated undue complexity. Each of the two “straightforward” tests has the virtue of being linked to objective determinations that provide clarity to regulated entities. Under the “market risk capital rule test,” for any banking entity subject to the market risk capital rule described above, the definition includes transactions in certain financial instruments that are covered under those capital rules. Under the “status test,” the definition includes transactions in financial instruments by a registered dealer, swap dealer, or security-based swap dealer, if the purchase or sale is made in connection with the activity that requires the entity to be registered as such.⁹⁶

The “purpose test,” by contrast, turns on a fact-intensive, subjective inquiry. To evaluate a trade under the purpose test, a banking entity is required to determine whether a trade was made principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging such a position.⁹⁷ A definition that centers on the purpose of a purchase or sale effectively requires an inquiry into the trader's intent at the time of the transaction, which introduces considerable complexity and subjectivity into the inquiry regarding whether transactions are permitted. Recognizing the difficulty of discerning the purpose of a transaction, the regulations create a rebuttable presumption that any position held for fewer than 60 days constitutes proprietary trading.⁹⁸ This presumption, however, simply replaces one problem with another—exchanging subjectivity for overbreadth. The 60-day presumption places the burden on firms to justify the permissibility of their trading, creating undue pressure on compliance programs and leading to excessive conservatism in firms' trading activities.

95. 12 U.S.C. § 1851(b)(2)(B)(i).

96. 12 C.F.R. 248.3(b)(1)(ii), (iii).

97. 12 C.F.R. 248.3(b)(1)(i); see also 12 U.S.C. 1851(h)(6).

98. 12 C.F.R. 248.3(b)(2).

The proprietary trading prohibition should be revised by eliminating the regulations' rebuttable presumption that financial positions held for fewer than 60 days constitute proprietary trading. In addition, policymakers should assess whether the purpose test should be eliminated altogether, to avoid requiring banks to dissect the intent of a trade. As discussed above, only banking organizations subject to the market risk capital rule should be subject to the proprietary trading prohibition. These firms are already required to determine their trading assets and liabilities for purposes of the market risk capital rule. Limiting the definition of proprietary trading to the market risk capital rule test and the status test would substantially reduce the burden on firms to determine whether a particular trade is proprietary trading.

Provide Increased Flexibility for Market-Making

Concerns have also been raised as to the Volcker Rule's market-making exemption and the effect the conditions currently placed on this activity may have on market liquidity. Market-making is an important service provided by banks that does not pose the same risks as speculative proprietary trading, but banks must comply with a host of conditions to fit within the market-making exemption under the rule. Banks must, among other things, stand ready to purchase and sell in particular markets and abide by limits as to the risk exposure of their market-making activity.⁹⁹

Under the Volcker Rule, banks conducting market-making activities must also engage in extensive analysis to ensure that their market-making inventory does not go beyond what regulators deem to be appropriate. Specifically, the amount, types, and risks of the bank's market-making inventory must be designed not to exceed the "reasonably expected near term demand" (the RENTD) of the bank's clients, customers, and counterparties.¹⁰⁰ Because a bank is generally not permitted to hold securities and derivatives in excess of this amount in its market-making inventory, if the RENTD standard is calibrated too tightly for a class of financial instruments, banks will not have enough inventory to make markets in those instruments. The difficulties of forecasting demand, accompanied by the rule's requirements for detailed planning regarding the amounts, types, and risks of financial instruments that market makers can maintain in their inventory, create considerable hurdles for banking entities to engage in market-making.

To address this problem, regulators should give banks additional flexibility to adjust their determinations of the reasonable amount of inventory. In particular, for illiquid securities, banks should be permitted to focus less on predicting with precision the future demands of clients based on past patterns and should have greater leeway to anticipate changes in markets that could increase demand for such securities. For over-the-counter derivatives, which are less suited to the RENTD framework, regulators should focus more on ensuring that banks appropriately hedge the positions they maintain. Banks that have not yet established a market-making presence in a particular asset class should have more discretion to meet the RENTD condition while they are building up customer volume. And block trades should be viewed as an important part of market-making activities with banking entities being able to enter into these trades even if they involve a trading volume outside of historical averages.

99. 12 C.F.R. 248.4(b)(2).

100. 12 C.F.R. 248.4(b)(2)(ii); see also 12 U.S.C. § 1851(d)(1)(B).

In addition, policymakers should evaluate the benefits of other potential modifications to the RENTD framework. One approach would be to provide banking entities with an ability to opt out of the RENTD requirement altogether if they meet certain conditions. For example, a banking entity should be able to opt out of the RENTD requirement if the firm adopts and enforces narrowly tailored trader mandates that ensure that its activities constitute market making, provided that the firm complies with all the other conditions of the market-making exemption. A more targeted RENTD opt-out could also be provided for a firm's transactions in a particular financial instrument if the firm fully hedges all significant risks arising from its inventory of that instrument. In either case, a firm that opts out of RENTD would still be required routinely to stand ready to purchase and sell the relevant instrument, satisfy the compliance program requirements, and maintain compensation arrangements designed not to reward or incentivize prohibited proprietary trading. Such an approach would spare both banks and regulators the complex analysis that the RENTD requirement entails while ensuring that the risks to the bank from any additional inventory are appropriately mitigated.

Reduce the Burden of Hedging Business Risks

Hedging that reduces a bank's interest rate, credit, market, and other risks has become a key way for banks of all sizes to manage their risks and allow their capital to be more efficiently deployed toward making loans to their customers. The Volcker Rule appropriately exempts risk-mitigating hedging transactions from the proprietary trading prohibition.¹⁰¹ However, the compliance program and documentation requirements that banks must comply with under the regulations to avail themselves of the exemption are unnecessarily burdensome. In particular, although banks should be required to establish policies and procedures to ensure that their hedging activity is designed to reduce particular risks to the bank, banks should not be required to maintain ongoing calibration of a hedge over time to ensure that it meets regulatory requirements.¹⁰² Instead, banks should be required to monitor risks as part of their standard business practice and should be responsible for taking reasonable action to mitigate material new risks that develop over time including from existing positions. Further, the requirement to maintain documentation of the specific assets and risks being hedged is overly burdensome and should be eliminated.

Reduce the Burdens of the Volcker Rule's Compliance Regime

Underlying the Volcker Rule's restrictions are extensive compliance program and trading metrics collection and reporting requirements.¹⁰³ The agencies provided for progressively more stringent requirements based on a banking entity's size and involvement in covered activities but further tailoring would reduce burdens without significantly increasing risks at banking entities.

As stated above, banks with less than \$10 billion in assets should be exempted from the rule entirely and banking organizations not subject to the market risk capital rules should be exempt from the proprietary trading restrictions.

101. 12 C.F.R. 248.5; see also 12 U.S.C. § 1851(d)(1)(C).

102. See 12 C.F.R. 248.5(b)(2)(iv)(C).

103. See 12 C.F.R. 248 Subpart D; 12 C.F.R. 248 Appendix A; 12 C.F.R. 248 Appendix B.

Further, the existing “enhanced” compliance program under the regulations should be focused in application so that it applies only to those banking entities with at least \$10 billion in trading assets and liabilities on a consolidated basis, rather than the current application to all banking entities with over \$50 billion in total consolidated assets.¹⁰⁴ All banks should be given greater ability to tailor their compliance programs to the particular activities engaged in by the bank and the particular risk profile of that activity. In addition, the agencies responsible for implementing the Volcker Rule should reevaluate the metrics that the largest firms are currently required to collect and eliminate any that are not necessary for effective supervision.

Focus and Simplify Covered Funds Restrictions

In addition to the restrictions on proprietary trading, the Volcker Rule restricts banking entities’ ability to make investments in and sponsor certain types of funds referred to as “covered funds.”¹⁰⁵ These restrictions are intended to eliminate banks’ ability and incentive to bail out their funds in order to protect their reputational risk, guard against conflicts of interest with clients of the bank, and prevent banking entities from engaging in proprietary trading indirectly through funds.

However, the covered funds provisions of the Volcker Rule are not well-tailored to these objectives. Treasury believes that changes to the covered fund provisions can greatly assist in the formation of venture and other capital that is critical to fund economic growth opportunities. First, the covered funds definition is overly broad, including types of entities beyond private equity and hedge funds. The current approach of defining covered funds by reference to whether they would be deemed investment companies under the Investment Company Act but for certain specific exemptions¹⁰⁶ requires banks to go through a highly technical, fact-specific legal analysis. Instead, regulators should adopt a simple definition that focuses on the characteristics of hedge funds and private equity funds with appropriate additional exemptions as needed.

Other revisions to the covered funds restrictions are necessary to further reduce complexity and undue compliance burden. The exemptions in Section 23A of the Federal Reserve Act should be restored in the Volcker Rule so that they apply to banking entities’ transactions with their covered funds.¹⁰⁷ The initial “seeding period” exemption from the covered funds investment restriction should be extended to three years, rather than one year, to provide banking entities with additional time to stand up new funds and allow them to establish the track records they need to attract investors.¹⁰⁸ Although the prohibition on depository institutions sharing a name with the funds they sponsor is appropriate to avoid customer confusion as to whether the fund is insured, banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor provided that the separate identity of the funds is clearly disclosed to investors.¹⁰⁹

104. See 12 C.F.R. 248.20(c).

105. 12 C.F.R. 248.10(a); see also 12 U.S.C. § 1851(a)(1)(B).

106. 12 C.F.R. 248.10(b); see also 12 U.S.C. § 1851(h)(2).

107. See 12 U.S.C. § 1851(f).

108. See 12 U.S.C. § 1851(d)(4)(B)(ii).

109. See 12 U.S.C. § 1851(d)(1)(G)(vi).

Finally, under the current rules, some foreign funds that are controlled affiliates of a foreign banking entity are themselves deemed “banking entities” subject to the Volcker Rule’s restrictions even when these funds are offered solely outside of the United States. This outcome imposes unreasonable and unnecessary limitations on foreign funds’ activities and should be eliminated. An exemption from the Volcker Rule’s definition of “banking entity” should be provided for foreign funds owned or controlled by a foreign affiliate of a U.S. bank or a foreign bank with U.S. operations.

Create an Off-ramp for Highly Capitalized Banks

The above reforms would greatly reduce the scope and complexity of the Volcker Rule, reduce the unnecessary burden it has placed on banks, and permit banks to engage in increased market-making activities. However, consideration should be given to permitting a banking entity that is sufficiently well-capitalized such that the risks posed by its proprietary trading are adequately mitigated by its capital, to opt out of the Volcker Rule altogether, as discussed under “Capital and Liquidity” above. Such an institution should remain subject to trader mandates and ongoing supervision and examination to reduce risks to the safety net.

PROVIDING CREDIT TO FUND CONSUMER AND COMMERCIAL NEEDS TO DRIVE ECONOMIC GROWTH

Consumer Financial Protection Bureau

Empowering Consumers: Opportunities to Reform the CFPB

Dodd-Frank established the CFPB, an independent agency in the Federal Reserve System, as the primary federal regulator of consumer financial products and services.¹¹⁰ Before the CFPB was created, responsibility for federal consumer financial protection was spread across multiple regulators, including the OCC, the Federal Reserve, and the Federal Trade Commission (FTC). These agencies had varying missions and levels of authority over their regulated entities. The CFPB was intended to centralize consumer financial protection regulation in a single agency with a single purpose.

Dodd-Frank gives the CFPB the exclusive authority to prescribe rules and issue orders and guidance under federal consumer financial law,¹¹¹ grants it enforcement and supervisory authority over most nonbanks engaged in the provision of consumer financial products and services¹¹² and over insured depository institutions and insured credit unions with total assets of more than \$10 billion,¹¹³ and requires it to establish a publicly available consumer complaint database.¹¹⁴ As of May 2017, the CFPB has publicly announced 185 enforcement actions and issued 62 final and interim final rules.¹¹⁵

The CFPB was created to pursue an important mission, but its unaccountable structure and unduly broad regulatory powers have led to regulatory abuses and excesses. The CFPB's approach to enforcement and rulemaking has hindered consumer choice and access to credit, limited innovation, and imposed undue compliance burdens, particularly on small institutions.

110. 12 U.S.C. §§ 5491, 5512.

111. *Id.* at § 5512.

112. *Id.* at § 5514.

113. *Id.* at § 5515. The CFPB has exclusive examination authority over these entities for purposes of assessing compliance with the requirements of Federal consumer financial laws, as well as primary enforcement authority.

114. *Id.* at § 5534.

115. Figures drawn list of publicly available rulemakings and enforcement actions at www.consumerfinance.gov. Enforcement Actions are available at: <https://www.consumerfinance.gov/policy-compliance/enforcement/actions>; Final and interim final rules are available at: <https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules>.

Issues Requiring Reform

The CFPB’s structure renders it unaccountable to the American people.

Dodd-Frank vests significant power in the CFPB, with few of the traditional checks and balances necessary to restrain regulatory abuses and arbitrary decision-making. The CFPB is led by a single Director who wields unilateral authority to enforce 18 enumerated federal consumer financial laws affecting major consumer decisions—from buying a home to paying for college. Despite this power, the unelected Director does not answer to the President or Congress in any meaningful sense.

Section 1011(b) of Dodd-Frank provides that the President can remove the CFPB Director only for “inefficiency, neglect of duty, or malfeasance in office” during his five-year statutory term.¹¹⁶ This limitation severs the line of public accountability created by Presidential oversight.¹¹⁷ The CFPB’s status as an independent regulatory agency also exempts it from the regulatory review regime including scrutiny of regulatory costs and benefits, administered by the OMB’s Office of Information and Regulatory Affairs.

The Director is further insulated from accountability and oversight by the CFPB’s funding structure. Rather than justify the CFPB’s annual funding needs through the annual Congressional appropriations process, the Director has the unilateral power simply to draw the funds he deems necessary from the Federal Reserve System’s earnings, subject to an annual cap.¹¹⁸ The CFPB budget is thus not subject to control by Congress through the annual appropriations process nor is it subject to OMB apportionment.¹¹⁹ In 2016, the Bureau received \$564.9 million in transfers from the Federal Reserve System.¹²⁰ The CFPB’s funding structure also sets a disconcerting precedent on the use of the Federal Reserve System for funding federal government programs outside of the annual appropriations process.

In addition, the CFPB has access to a civil penalty fund in which it deposits the monetary penalties it collects.¹²¹ Any funds not used to pay restitution to consumers are available to fund the CFPB’s “consumer education and financial literacy programs.”¹²² Amounts in the civil penalty fund are not subject to the annual appropriations process. The GAO has recommended that the CFPB take steps to improve transparency in the way it allocates funds used for these communication and outreach efforts.¹²³

116. 12 U.S.C. § 5491(c)(3).

117. See Kagan, Elena. *Presidential Administration*, 1144 *Harv. L. Review* 2245, 2332 (2001) (“[P]residential leadership establishes an electoral link between the public and the bureaucracy, increasing the latter’s responsiveness to the former....[P]residential control of administration at the least possesses advantages over any alternative control device in advancing these core democratic values.”).

118. 12 U.S.C. § 5497. Cf. *The Federalist No. 58* (Madison) (describing the appropriations process as “the most complete and effectual” method by which the legislature may provide “for carrying into effect every just and salutary measure.”).

119. 12 U.S.C. § 5497.

120. CFPB, *Report of the CFPB Pursuant to § 1017(E)(4) of the Dodd-Frank Act*, at 14 (Dec. 30, 2016).

121. 12 U.S.C. § 5497.

122. *Id.*

123. GAO, “Opportunity Exists to Improve Transparency of Civil Penalty Fund Activities,” GAO-14-551 (2014).

The CFPB's combination of an unaccountable structure and broad, unchecked regulatory power is unprecedented. In a recent decision invalidating the CFPB's structure as unconstitutional, a panel of the U.S. Court of Appeals for the D.C. Circuit observed that "the Director enjoys significantly more *unilateral* power than any single member of any other independent agency."¹²⁴ Historically, limitations on removal of an agency's head have been counterbalanced by the use of multi-member commissions which provide an internal safeguard against agency abuses and excesses. The CFPB has no such check. As the D.C. Circuit explained, "a single, unaccountable, unchecked Director not only departs from settled historical practice, but also poses a far greater risk of arbitrary decision-making and abuse of power, and a far greater threat to individual liberty, than does a multi-member independent agency."¹²⁵ This problem is exacerbated by the CFPB's independence from the Congressional power of the purse.¹²⁶

The CFPB's substantive authority is unduly broad, ill-defined, and susceptible to abuse.

The CFPB has two sets of authorities that, due to their breadth and lack of statutory detail, run the risk of depriving regulated parties of fair notice of the rules of conduct to which they must conform. The first is the CFPB's authority to take enforcement action against any "covered person"¹²⁷ engaged in "unfair, deceptive, or abusive acts or practices."¹²⁸ The statute defines the UDAAP standard only in broad strokes, leaving to the CFPB the authority to decide which specific practices fall within this ambiguous prohibition. The lack of clarity is most pronounced with respect to the prohibition on "abusive acts or practices," a relatively undeveloped legal concept. Despite requests from Congress and regulated parties, the CFPB has declined to provide additional guidance on the abusiveness standard and has instead followed an open-ended "facts and circumstances" approach.¹²⁹ Even in the more defined areas of "unfair" and "deceptive" conduct, the CFPB is not required to follow the well-established FTC precedents, but rather is free to pivot and adopt new interpretations whenever it identifies a practice it wishes to prohibit.¹³⁰

124. *PHH Corp. v. Consumer Financial Protection Bureau*, 839 F.3d 1, 16 (D.C. Cir. 2016), reh'g en banc granted, order vacated (Feb. 16, 2017). See also *The Bureau of Consumer Financial Protection's Unconstitutional Design: Hearing Before the Subcomm. on Oversight and Investigations, H. Comm. on Fin. Serv.*, 115th Cong. (2017) (written statement of Theodore Olson) ("The CFPB is the product of cherry-picking some of the most democratically unaccountable and power-centralizing features of the federal government's administrative agencies, and aggregating them into one massive and all-powerful body.")

125. *Id.* at 8.

126. See *id.* at 36 n.16 ("[T]he appropriations process brings at least some measure of oversight by Congress.")

127. A covered person is any person engaged in offering or providing a consumer financial product or service and any affiliate of such person if such affiliate acts as a service provider to such person. 12 U.S.C. § 5481.

128. 12 U.S.C. § 5531.

129. *How Will the CFPB Function under Richard Cordray: Hearing Before the Subcommittee on TARP Financial Services and Bailouts of Public and Private Programs of the Committee on Oversight and Government Reform*, 112th Cong. 69 et seq., (2012) (statement of Rep. Patrick McHenry, Chairman, Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs); see also Todd Zywicki, *The Consumer Financial Protection Bureau, Savior or Menace?*, *George Washington Law Review* 81 (2013), pp. 856, 918-923.

130. See Todd Zywicki, *The Consumer Financial Protection Bureau, Savior or Menace?*, *George Washington Law Review* 81 (2013), p. 918.

The second authority is the transfer to the CFPB of all interpretive authority over federal consumer financial law and the resulting judicial deference that CFPB's interpretation commands.¹³¹ The contours of many federal consumer financial regulations have been developed over decades by agencies with deep subject-matter expertise. Dodd-Frank permits the CFPB to depart from this settled precedent without any specific requirements for how the CFPB should promulgate its new standards and reversals of past policies on which parties have come to rely. In practice, the CFPB has avoided notice-and-comment rulemaking and instead relied to an unusual degree on enforcement actions and guidance documents, which the CFPB has consistently issued without opportunity for public comment, to announce new standards of conduct.¹³²

The CFPB has exercised its authorities in a manner aimed at maximizing its discretion, rather than creating a stable regulatory environment.

The CFPB itself has recognized that “regulatory uncertainty may discourage innovators from entering a market, or make it difficult for them to develop suitable products or attract sufficient investment or other support.”¹³³ But rather than seeking to provide clear rules on which regulated parties can rely as they offer credit to consumers and pursue innovation, the CFPB has exercised its authorities in a manner aimed at maximizing its own discretion and power. This approach has created confusion among regulated parties concerning their legal obligations, leading to a retrenchment in the provision of consumer financial products and services and erosion of consumer choice.

Excessive reliance on enforcement actions, rather than rules and guidance, to regulate conduct

This problem has manifested itself most clearly in the CFPB's habit of effectively announcing new prohibitions through enforcement actions. This practice forecloses the opportunity for public comment and deprives regulated parties of fair notice concerning the rules to which they must conform their conduct.

The CFPB has brought a range of enforcement actions that allege violations of law for practices that are common among financial services providers and that had not previously raised concerns among other regulators.¹³⁴ The CFPB brings such actions despite not having promulgated rules banning the targeted practice or issued guidance that it considered the practice contrary to law.¹³⁵ Remarkably, the CFPB has even sanctioned companies for complying in good faith with an interpretation adopted by a previous agency with respect to conduct that pre-dated the CFPB's

131. 12 U.S.C. § 5512(b)(4).

132. See Roberta Romano (Yale Law School), *Does Agency Structure Affect Agency Decision making? Implications of the CFPB's Design for Administrative Governance* (May 18, 2017) (unpublished article) (on file with author).

133. CFPB, Notice of Proposed Policy on No-Action Letters, 79 Fed. Reg. 62118, 62120 (Oct. 16, 2014).

134. Many lenders have identified the CFPB's enforcement actions alleging disparate impact discrimination in the indirect auto lending market as a particular source of concern. See Republican Staff of the House Committee on Financial Services, 114th Cong., *Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending* 15 et seq. (2015).

135. For instance, in one of its first enforcement actions, the CFPB entered into a \$210 million settlement with Capital One Financial Corp. over allegedly deceptive credit card marketing. The CFPB released only a compliance bulletin about its expectations for other credit card firms in conjunction with the settlement.

establishment.¹³⁶ This lack of clear regulatory standards may lead to excessive risk-aversion among regulated parties thereby undermining innovation and consumer choice.¹³⁷

The CFPB's excessive reliance on case-by-case adjudication over clear rules has been particularly problematic with respect to its UDAAP authority. Although the CFPB regularly brings actions asserting that a company or person has engaged in prohibited UDAAP conduct, it has failed to adopt regulations clearly delineating the reach of the UDAAP prohibition. Instead, it has used its UDAAP authority to extend its reach well beyond its enumerated authorities, including by initiating actions to effectively enforce state law.¹³⁸

The failure to issue clear ex ante rules has caused particular concern among regulated parties with respect to the authority to ban abusive practices. Indeed, when asked to provide examples of what might constitute an abusive practice in testimony before Congress, the CFPB Director declined.¹³⁹ Without meaningful standards that provide fair notice, many consumer financial firms are reluctant to innovate or offer new financial products or services.¹⁴⁰

Ineffective no-action letter policy

The CFPB's no-action letter policy also reflects its unwillingness to define its authority in the interest of providing fair notice and certainty to regulated parties. No-action letters promote consumer choice and innovation by providing businesses some reassurance that they can offer a particular product or service without fear of an unexpected enforcement action.¹⁴¹ But the CFPB's no-action letter policy has been hampered by the stringent standards that must be met before the agency will even consider a regulated party's request. For example, the policy permits the issuance of no-action letters only for products or services that may provide "substantial" consumer benefits – and then only when there is "substantial uncertainty" concerning how the CFPB would apply potentially relevant laws or rules.¹⁴² The CFPB itself has stated that it will rarely issue no-action letters,

136. See, e.g., *PHH*, 839 F.3d 1 at 16 (describing the CFPB's reversal of a longstanding HUD interpretation of Section 8(a) of the Real Estate Settlement Procedures Act and application of its new interpretation to conduct undertaken before the CFPB had even come into existence); *In the Matter of: Lighthouse Title, Inc.*, CFPB Consent Order 2014-CFPB-0015. The CFPB has entered into numerous consent orders addressing Section 8(a).

137. Todd Zywicki, *The Consumer Financial Protection Bureau, Savior or Menace?*, *George Washington Law Review* 81 (2013), p. 922201; Diane Katz, *The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect*, *The Heritage Foundation: Report* (Jan. 22, 2013), available at: <http://www.heritage.org/housing/report/the-cfpb-action-consumer-bureau-harms-those-it-claims-protect>.

138. See *CFPB v. CashCall, Inc., et al.*, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016). The Central District of California agreed with the CFPB that CashCall's attempts to collect debt that were in violation of state law constituted a deceptive practice under Dodd-Frank.

139. See *The Semi-Annual Report of the Bureau of Consumer Financial Protection Before the House Committee on Financial Services*, 114th Cong. 14-16 (Sept. 20, 2012) (statement of Richard Cordray, Director, Bureau of Consumer Financial Protection).

140. Alden Abbott and Todd Zywicki, *How Congress Should Protect Consumer's Finances* (Feb. 28, 2017), available at: <http://www.heritage.org/markets-and-finance/report/how-congress-should-protect-consumers-finances>.

141. CFPB, Final Policy Statement: Policy on No Action Letters, 81 Fed. Reg. 8686 (Feb. 22, 2016).

142. *Id.* at 8692.

particularly regarding UDAAP,¹⁴³ and it has made good on that promise by failing to issue a single no-action letter since the policy was adopted in February 2016. Given the severe limitations of the CFPB's approach, regulated entities and lawmakers have frequently complained that the policy has failed to mitigate their concerns about regulatory uncertainty.¹⁴⁴

Use of administrative adjudication proceedings to avoid procedural protections and the statute of limitations

For any enforcement action, the CFPB can choose between bringing suit in federal court and initiating an administrative proceeding before an administrative law judge.¹⁴⁵ The administrative proceedings afford respondents fewer protections than actions brought in federal court. For example, administrative proceedings occur on an expedited timeframe with the answer being due within 14 days of service rather than the 21 days provided for in federal court.¹⁴⁶ Participants in this process observe that “[i]n devising its rules for administrative enforcement proceedings, the CFPB seems to have taken the view that speed is the overriding goal.”¹⁴⁷ In addition, interrogatories and discovery depositions by respondents are not permitted in administrative proceedings and document discovery from the CFPB is limited to a narrow list of categories. One law firm with significant experience defending CFPB enforcement actions has noted “[t]he overall impression of these Rules is to suggest that a respondent subject to a proceeding under them will certainly lose many of the procedural protections afforded in a court proceeding...”¹⁴⁸

The CFPB has also taken the remarkable position that Dodd-Frank does not impose any statute of limitations on administrative enforcement actions, regardless of the limitations period in the underlying statute.¹⁴⁹ In *PHH*, the court rejected this interpretation and held that the limitations period for the underlying statute applies regardless of forum, noting that the CFPB's preferred outcome “would be absurd” and create a “nonsensical dichotomy between CFPB court actions and CFPB administrative actions.”¹⁵⁰

143. *Id.* at 8689.

144. Rep. Patrick McHenry (R-N.C.), *CFPB's 'project catalyst' has failed. Fintech deserves better*, *The American Banker* (Apr. 25, 2017), available at: <https://www.americanbanker.com/opinion/cfpbs-project-catalyst-failed-fintech-deserves-better>.

145. John Villa and Ryan Scarborough, *The Law of Unintended Consequences: How the CFPB's Unprecedented Legislative Authority and Enforcement Approach Has Invited Increasing Challenges*, *Banking & Financial Services* (July 2016); an overview of administrative adjudication proceedings is available at <https://www.consumerfinance.gov/administrative-adjudication-proceedings>.

146. See Fed. R. Civ. P. 12(a)(1).

147. Ballard Spahr, *CFPB's enforcement rules: a 'rocket docket' that looks strangely familiar* (Aug. 8, 2011), available at: <https://www.consumerfinance.com/2011/08/08/cfpbs-enforcement-rules-a-rocket-docket-that-looks-strangely-familiar>.

148. *Id.*

149. John Villa and Ryan Scarborough, *The Law of Unintended Consequences: How the CFPB's Unprecedented Legislative Authority and Enforcement Approach Has Invited Increasing Challenges*, *Banking & Financial Services* (July 2016); see also Integrity Advance, LLC and James R. Carnes, 2015-CFPB-0029, Bureau's Opposition to Respondents' Motion to Dismiss at 7 (Jan. 15, 2016); see, e.g., *PHH*, 839 F.3d 1 at 55 (discussing CFPB attorneys' reply that administrative enforcement action would not be brought 100 years after alleged unlawful conduct due to prosecutorial discretion, not because statute of limitations would have run).

150. *PHH*, 839 F.3d 1 at 53-55.

Inappropriate expansion of scope of jurisdiction via enforcement actions, rulemakings and other agency measures

The CFPB has sought to expand its jurisdiction to persons and businesses either not covered or even specifically excluded from its jurisdiction by Dodd-Frank. The CFPB has, for example, inappropriately attempted to extend its reach to entities including college accreditors and auto dealers and it has taken these actions outside the discipline and transparency of notice-and-comment rulemaking.

In an attempt to expand its authority in the area of higher education, the CFPB issued a civil investigative demand (CID) to a national for-profit college accreditor, the Accrediting Council for Independent Colleges and Schools (ACICS).¹⁵¹ A federal district court concluded that the CFPB had far overstepped its bounds. The court explained that the CFPB’s “investigative authority is limited to inquiries to determine whether there has been a violation of any Federal consumer financial laws,” and none of those laws “even tangentially implicate the accrediting process of for-profit colleges.”¹⁵² The court also admonished the CFPB that “[a]lthough it is understandable that new agencies like the CFPB will struggle to establish the exact parameters of their authority, they must be especially prudent before choosing to plow head long into field not clearly ceded to them by Congress.”¹⁵³

The CFPB has also attempted to regulate the activities of auto dealers despite a lack of jurisdiction. Dodd-Frank gives the CFPB the authority to regulate providers of credit for auto loans but specifically excluded auto dealers from the CFPB’s reach.¹⁵⁴ In 2013, the CFPB issued guidance intended to prevent indirect auto creditors, such as banks, from permitting auto dealers to exercise discretion to “mark up” loans.¹⁵⁵ The agency argued that this prohibition was necessary to avoid distorted economic incentives and because the discretion permitted by these policies created the risk of prohibited discriminatory pricing.¹⁵⁶ The House Financial Services Committee issued a report questioning the legal authority for the CFPB guidance, as well as the CFPB’s reliance on disparate impact as a theory of liability for pursuing discrimination cases in this area.¹⁵⁷ The report noted that in many cases, dealers enter into transactions without financing from indirect auto creditors and thus the creditors play no role in making a credit decision about a borrower.¹⁵⁸ Based on this factor and internal CFPB documents, the report concluded that the CFPB’s objective from the beginning had been the elimination of dealer discretion and the “mark up” of loans—an attempt to regulate exempt auto dealers through other means.¹⁵⁹

151. *CFPB v. Accrediting Council for Indep. Colleges & Sch.*, 183 F. Supp.3d 79 (D.D.C. 2016), aff’d on other grounds, 854 F.3d 683 (D.C. Cir. 2017).

152. *Id.* at 83.

153. *Id.* at 84.

154. 12 U.S.C. § 5519.

155. CFPB, Bull. No. 2013-02: Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act (2013), available at: http://files.consumerfinance.gov/f/201303_cfpb_march_-_Auto-Finance-Bulletin.pdf.

156. *Id.* at 2.

157. Republican Staff of the House Committee on Financial Services, 114th Cong., *Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending* (2015).

158. *Id.* at 19-20.

159. *Id.* at 46.

A civil investigative demand (CID) process lacking in appropriate safeguards

The CFPB’s process for issuing CIDs, a key enforcement tool, is fraught with risks for abuse. It combines a broad authority to seek information with limited procedural safeguards. However, the CFPB has failed to comply with even the basic protections required by Dodd-Frank. The D.C. Circuit recently concluded in the *ACICS* case that a CID issued by the agency did not comply with the minimum statutory requirements.¹⁶⁰ The court found that the CID at issue gave the recipient “no description whatsoever of the conduct the CFPB is interested in investigating.”¹⁶¹ Far from exceptional, the issues the court identified in the CID invalidated in *ACICS* are consistently raised by CID recipients petitioning to modify or set aside a CFPB CID.¹⁶²

Compounding this problem, the CID process provides little protection for parties seeking to modify or set aside a CID. CIDs issued by the CFPB are confidential but parties who wish to question the legality or scope of a CID must be prepared to suffer reputational injury: the CFPB publishes its decisions on challenges to CID requests, essentially publicizing that a company is under investigation before the agency has even assessed the evidence.¹⁶³ A person served with a CID may petition the CFPB to set aside or modify the demand within 20 days of receiving it unless an extension is granted.¹⁶⁴ The Director has sole authority to grant or deny such a petition even if he participated in the decision to open the investigation or issue a CID.¹⁶⁵ Although the CFPB has publicly disclosed 28 petitions to modify or set aside a CID on its website, it has not publicly granted any of these petitions. It has also denied several requests for confidential treatment of petitions challenging a CID.

CFPB’s Retrospective Review of Significant Regulations Could Be Improved.

Retrospective review of agency rules is a valuable process for ensuring that past regulations have not outlived their useful life.¹⁶⁶ The Administrative Conference of the United States encourages all agencies to engage in regular self-review of their regulations.¹⁶⁷ Reflecting the importance of such review, the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) requires the federal banking regulators to conduct a review of all existing regulations not less frequently than once every 10 years to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions and to report to Congress on the findings.¹⁶⁸

160. *CFPB v. Accrediting Council for Indep. Colleges & Sch.*, 854 F.3d 683 (D.C. Cir. 2017) (*ACICS*).

161. *Id.* at 690.

162. Of the 28 petitions to modify or set aside a CID that are publicly available on the CFPB’s website, more than half asserted that the CID failed to identify the nature of the conduct under investigation or the alleged violation of law. The CFPB has denied most of these petitions and has not publicly granted any of them. Petitions are available at <https://www.consumerfinance.gov/policy-compliance/enforcement/petitions>.

163. Decision and Order on PHH Corporation’s Petition to Modify or Set Aside Civil Investigative Demand, CFPB 2012-MISC-PHH Corp-0001.

164. 12 U.S.C. § 5562(f).

165. 12 C.F.R. § 1080.6.

166. Administrative Conference of the United States. *Retrospective Review of Agency Rules*. 9 Dec. 2014, available at www.acus.gov/recommendation/retrospective-review-agency-rule.

167. *Id.*

168. See 12 U.S.C. § 3311.

When the banking regulators had rulemaking authority with respect to consumer financial laws, regulations adopted under those laws were included in the review process.¹⁶⁹ However, the banking regulators have concluded that EGRPRA does not require the CFPB to conduct a review of the rules it has adopted and the CFPB did not participate in the recent EGRPRA review of regulations by the banking regulators.¹⁷⁰ Dodd-Frank requires limited retrospective regulatory review by the CFPB,¹⁷¹ but that review process falls short of EGRPRA in both scope and duration. It excludes rules deemed to be non-significant and rules administered by the CFPB but adopted before the CFPB came into existence. In addition, CFPB's review regime is limited to a single five-year lookback period even though the nature of regulated markets may change and render the old rules obsolete.

The Consumer Complaint Database lacks appropriate safeguards.

The CFPB maintains a Consumer Complaint Database on its website that allows consumers to submit and view complaints about a wide variety of providers of financial products and services including credit cards, mortgage providers, student loans, vehicle loans, payday loans, credit reporting, and debt collection.¹⁷² The CFPB takes steps to confirm a commercial relationship between the consumer submitting a complaint and the company, but does not otherwise attempt to verify the complaint submitted.¹⁷³

Commenters have objected that the database may provide misleading or incomplete information to consumers because it does not indicate whether a complaint reflects dissatisfaction with legitimate terms of service, as opposed to actual wrongdoing, and does not provide information on the size of the relevant market. As an example of the latter, “a total of 14,000 credit card complaints were submitted to the bureau in 2014, but there were 550 million credit cards in circulation that year—among just Visa, MasterCard, and American Express. Thus, the complaints represent only 0.0025 percent of credit card holders.”¹⁷⁴ One of the most frequent criticisms of the database is that, because it does not verify complaints or provide sufficient context regarding the related market and industry practices, it subjects companies to unwarranted reputational risk.¹⁷⁵

169. FFIEC. *Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act*, at 25-28. Jul. 2007, available at: egrpra.ffiec.gov/docs/egrpra-joint-report.pdf.

170. FFIEC. *Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act*, at 1 n.1. Mar. 2017, available at: www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf.

171. 12 U.S.C. § 5512.

172. CFPB, Consumer Complaint Database, available at <https://www.consumerfinance.gov/data-research/consumer-complaints>.

173. *Id.*

174. See Katz, *Consumer Financial Protection Bureau: Limiting Americans' Credit Choices*, The Heritage Foundation (April 28, 2016), available at http://www.heritage.org/government-regulation/report/consumer-financial-protection-bureau-limiting-americans-credit-choices#_ftn11. See also CFPB, Disclosure of Consumer Complaint Data, 78 FR 21223 (April 10, 2013). (“The Bureau acknowledges, as it did in the Proposed Complaint Data Disclosure Policy Statement, that there are significantly varying views among stakeholders about whether consumer and company provided data is useful to consumers.”)

175. See *Examining the Consumer Financial Protection Bureau's Mass Data Collection Program Before the H. Comm. on Fin. Svcs.*, 114th Cong. 8 (2015) (statement of Wayne Abernathy, Executive Vice President for Financial Institutions Policy and Regulatory Affairs, American Bankers Association).

The CFPB's supervisory authority is duplicative and unnecessary.

Dodd-Frank grants the CFPB supervisory powers that are potentially duplicative as applied to banking entities, unjustified as applied to nonbanks, and poorly suited to the mission of a consumer protection enforcement agency.

The CFPB has supervisory authority over banks and credit unions with total assets of more than \$10 billion for the purpose of assessing compliance with the requirements of federal consumer financial laws.¹⁷⁶ Many of these entities are subject to supervision in this area by both the CFPB and federal prudential regulators. In addition to monitoring compliance with safety and soundness regulations, federal prudential regulators monitor compliance with a number of federal consumer protection laws substantially similar to those overseen by the CFPB, increasing the potential for duplicative or inconsistent oversight by the various regulators.¹⁷⁷ In addition, the Federal Reserve Inspector General has criticized the CFPB for failing to provide timely examination reports, causing uncertainty among supervised institutions.¹⁷⁸ The Inspector General also criticized the CFPB's practice of bringing enforcement attorneys to examinations, a policy it has since discontinued.¹⁷⁹

The CFPB's supervisory authority over nonbanks represents a major shift in regulatory practice – with no clear benefits to justify the additional burdens. Federal supervision and examination of financial institutions are invasive regulatory tools that have traditionally been limited to financial institutions that receive federal deposit insurance or institutions that receive a federal charter.¹⁸⁰ In contrast, the CFPB's authority extends to state-licensed nonbanks that neither have special status nor privileges conferred by federal law nor is regulation needed to address moral hazard created by deposit insurance. Before Dodd-Frank, these companies were regulated by the states which continue to license them and supervise them in coordination with the CFPB.¹⁸¹ State authorities also coordinate with each other through the Conference of State Bank Supervisors to effectively supervise larger companies operating in multiple states. These state supervisors were often leaders in identifying consumer protection problems during the financial crisis and have a unique perspective into the financial services available and needed in their communities.

176. 12 U.S.C. § 5515.

177. See GAO, *Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*, GAO-16-175, at 17 (2016), available at: <https://www.gao.gov/assets/680/675400.pdf>. (“Overlap... exists in the consumer protection oversight of depository institutions with more than \$10 billion in assets. That is, because the primary federal prudential regulator (FDIC, the Federal Reserve, NCUA, or OCC) of these institutions retained authority to oversee their compliance with certain consumer protection laws, two federal agencies are responsible for reviewing these institutions' compliance with consumer protection laws.”) The possibility that regulated parties may be subject to duplicative and/or inconsistent supervision by one or more federal prudential regulators and the CFPB is increased by the CFPB's practice, discussed above, of using UDAAP authority to extend its reach well beyond its enumerated authorities.

178. Federal Reserve OIG, *The CFPB Can Improve the Efficiency and Effectiveness of Its Supervisory Activities* (2014), available at: <https://oig.federalreserve.gov/reports/CFPB-Supervisory-Activities-Mar2014.pdf>.

179. Federal Reserve OIG, *The CFPB Should Reassess Its Approach To Integrating Enforcement Attorneys Into Examination And Enhance Associated Safeguards* (2013), available at: https://oig.federalreserve.gov/reports/CFPB_Enforcement_Attorneys_Examinations_full_Dec2013.pdf.

180. See Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, Harv. L. Rev. 107 (1994), pp. 507, 563. (“Considerations of safety and soundness have traditionally been the most important regulatory justifications for public supervision of financial intermediaries.”)

181. 12 U.S.C. § 5514.

Recommendations for Regulatory Reform

Adopting structural reforms to make the CFPB more accountable to the President, Congress, and the American people.

The CFPB's structure should be reformed to ensure that it is accountable to elected officials and, ultimately, to the American people. The for-cause removal protection for the CFPB Director limits the President's authority, disperses executive power, and renders the CFPB less politically accountable than other agencies.¹⁸² An agency "headed by a single officer...embodies a quintessentially executive structure" for which for-cause removal protections are inappropriate.¹⁸³ The most straightforward remedy is to make the Director removable at-will by the President.¹⁸⁴ As an alternative, the CFPB could be restructured as an independent multi-member commission or board which would create an internal check on the exercise of agency power.

The CFPB should also be subject to the same degree of accountability to Congress as other regulatory enforcement agencies. The CFPB should be funded through the annual appropriations process to enable Congress to exercise greater oversight and control over how taxpayer dollars are spent. This enhanced accountability is particularly important given CFPB's broad regulatory and enforcement authority which reaches far beyond the banking sector regulated by other prudential regulators.

In addition, the CFPB should be subject to OMB apportionment. This would require the agency to obtain OMB approval for a plan to use its budgetary resources, providing additional transparency regarding agency spending and facilitating additional oversight by the President.

Finally, the CFPB's other funding mechanism, the Consumer Financial Civil Penalty Fund, should be reformed to permit the CFPB to retain and use only those funds necessary for payments to the *bona fide* victims of activities for which the CFPB has imposed civil money penalties. The CFPB should remit to the Treasury any funds in excess of payments to victims, similar to the practice of several other agencies with enforcement authority.¹⁸⁵ This would ensure that the CFPB does not spend unappropriated funds on programs that have not been specifically authorized via the annual appropriations process and OMB apportionment.

Ensuring that regulated entities have adequate notice of CFPB interpretations of the law before subjecting them to enforcement actions.

Requiring CFPB to promulgate rules before adopting novel positions in enforcement actions

The CFPB should issue rules or guidance subject to public notice and comment procedures before bringing enforcement actions in areas in which clear guidance is lacking or the agency's position departs from the historical interpretation of the law.

182. See Brief for the United States as Amicus Curiae at 14, *PHH Corp. v. Consumer Financial Protection Bureau*, No. 15-1177 (D.C. Cir. Mar. 17, 2017).

183. *Id.* at 13.

184. *Id.* at 19.

185. See, e.g., 12 U.S.C. § 1818(i)(2)(J) (applicable to FDIC, OCC, and Federal Reserve); see also GAO, *Financial Institutions: Fines, Penalties, and Forfeitures for Violations of Financial Crimes and Sanctions Requirements*, GAO-16-297, at 20 (2016), available at: <http://www.gao.gov/assets/680/675987.pdf>.

The CFPB wields broad authority to impose monetary sanctions through enforcement actions. The CFPB's excessive reliance on case-by-case enforcement to develop the UDAAP standard, in particular, too often deprives regulated parties of fair notice and chills innovation in financial products and services. Consumers ultimately pay the price in reduced choices or higher costs.

To create a more stable regulatory environment, the CFPB should adopt regulations that more clearly delineate its interpretation of the UDAAP standard. The agency should seek monetary sanctions only in cases in which a regulated party had reasonable notice — by virtue of a CFPB regulation, judicial precedent, or FTC precedent — that its conduct was unlawful.¹⁸⁶ The CFPB could implement this reform administratively through issuance of a regulation limiting the application of monetary sanctions to cases that satisfy this notice standard.

Importantly, this reform would not deprive the CFPB of the ability to target and stop practices not previously understood to be prohibited, as the agency would retain the authority to issue a cease-and-desist order or initiate an enforcement action seeking injunctive relief. If the CFPB concludes a new practice is a problem in the broader market, it should conduct notice and comment rulemaking to prohibit the practice. This reform would give regulated parties the certainty and predictability they need to meet diverse consumer financial needs without fear of unexpected sanctions, while preserving the CFPB's flexibility to respond to new risks.

Making the requirements for CFPB no-action relief less onerous

The CFPB's no-action letter policy has been hampered by the stringent standards that must be met before the agency will even consider a regulated party's request. The CFPB should align its policies for issuing no-action letters or analogous documents with the more effective policies of the SEC, CFTC, and FTC. To make the CFPB no-action letter policy a more useful tool for the providers and consumers of financial services, the CFPB should adopt the following changes: (a) expand the scope of the policy beyond "new" products; (b) require a consumer benefit, but not a "substantial" consumer benefit; (c) require some regulatory uncertainty to issue a no-action letter, but not "substantial" uncertainty; (d) address a broader number and range of UDAAP questions; and (e) revisit the requirement that applicants be required to share potentially proprietary data with CFPB, which the agency may not be able to adequately safeguard.

Adopting procedural reforms to curb excesses and abuses in investigations and enforcement actions.

Bringing enforcement actions in federal district court rather than in administrative proceedings

The CFPB should bring enforcement actions in federal district court rather than use administrative proceedings, due to (a) the undefined scope of UDAAP and resulting uncertainty for market participants and (b) the lack of procedural protections for respondents in administrative proceedings. Because of the added procedural protections available in federal district court, this recommended

186. Diane Katz, *The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect*, The Heritage Foundation: Report (Jan. 22, 2013), available at: <http://www.heritage.org/housing/report/the-cfpb-action-consumer-bureau-harms-those-it-claims-protect>.

change would still be appropriate even if the CFPB were to promulgate regulations designed to clarify the scope of UDAAP and provide greater certainty for market participants. At a minimum, to the extent CFPB continues to pursue some enforcement actions through administrative adjudications, it should promulgate a regulation specifying binding criteria that it will use when deciding whether to bring an action in federal court or before an ALJ in the first instance.

Reforming the CID process

The CID process should be reformed to ensure subjects of an investigation receive the benefit of existing statutory protections, backed by judicial review. The CFPB should adopt guidance to ensure that all of its CIDs comply with the standard set forth by the D.C. Circuit in the *ACICS* case. Such guidance would ensure that subjects being investigated for a potential violation of federal consumer financial laws receive clear notice of the conduct at issue, along with a description of the specific laws the CFPB believes may have been violated. In addition, the CFPB should adopt procedures to ensure that review of a CID appeal remains confidential if requested. This will prevent the chilling effect arising from the threat of publication of a denial. Finally, Congress should amend Dodd-Frank to permit persons who receive a CID to proactively file a motion in federal district court to modify or set aside a CID, rather than limiting recourse to an appeal to the Director.¹⁸⁷ This would bring the CFPB's procedures in line with the protections provided under the Department of Justice's authority to issue CIDs related to False Claims Act violations.¹⁸⁸

Expanding retrospective regulatory review.

The CFPB should promulgate a regulation committing it to regularly reviewing all regulations that it administers to identify outdated or otherwise unnecessary regulatory requirements imposed on regulated entities. Such review should occur no less frequently than once every 10 years for all regulations that the CFPB administers and should include solicitation of public comment on regulations that are outdated, unnecessary or unduly burdensome. The regulations should also provide for a public report summarizing any significant issues raised by public comments and a discussion of how the CFPB will address regulatory burdens associated with such issues. The CFPB should eliminate any regulations it concludes are outdated, unnecessary, or unduly burdensome as a result of such review.

Improving safeguards for Consumer Complaint Database.

The CFPB's Consumer Complaint Database should be reformed to make the underlying data available only to federal and state agencies, and not to the general public. The FTC also maintains a complaint database, known as Consumer Sentinel,¹⁸⁹ that is available only to local, state and federal law enforcement organizations that have entered into confidentiality and data security

187. See Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 716 (2017).

188. See 31 U.S.C. § 3733(j).

189. FTC, Consumer Sentinel Network, available at: <https://www.ftc.gov/enforcement/consumer-sentinel-network>.

agreements.¹⁹⁰ This confidentiality allows organizations that need the information to make use of it, while avoiding the serious costs and concerns expressed by critics. Indeed, the CFPB already contributes its data to the Consumer Sentinel network, meaning that law enforcement officials would have CFPB complaint information available even without publication to the CFPB Consumer Complaint Database.¹⁹¹

Eliminating CFPB’s duplicative and unnecessary supervisory authority.

To reduce needless duplication and regulatory burdens, Congress should repeal the CFPB’s supervisory authority. The responsibility to supervise banks should be entrusted to the prudential regulators. The Federal Reserve and OCC have deep expertise in supervision and examinations and they are best equipped to monitor compliance risks related to federal consumer financial laws. Supervision of nonbanks should be returned to state regulators, who have proven experience in this field and an existing process for interstate regulatory cooperation.

Residential Mortgage Lending

Overview

Housing contributes approximately 18% to U.S. GDP¹⁹² and also satisfies one of the most basic needs of all families. Today, national home prices have recovered to their pre-financial crisis levels¹⁹³ and interest rates remain near historic lows.¹⁹⁴ Outstanding residential mortgages have a balance of over \$10 trillion¹⁹⁵ on a total estimated value of housing stock of over \$23 trillion,¹⁹⁶ making it a debt market second in size only to the U.S. Treasury market.¹⁹⁷

The present conditions of continued tight mortgage lending in the private sector warrant a careful study of regulations and the extent to which they may be holding back the supply of mortgage credit.

190. FTC, Consumer Sentinel Network Members, available at <https://www.ftc.gov/enforcement/consumer-sentinel-network/members>. See also *An Examination of Wells Fargo’s Unauthorized Accounts and the Regulatory Response Before the S. Banking Comm.* 114th Cong. (2016) (testimony of Michael Feuer, Los Angeles City Attorney, asserting that the Los Angeles County Attorney used Consumer Sentinel data as well), available at https://www.banking.senate.gov/public/_cache/files/e5c17a33-d8b0-4e07-8913-a7aaa1ea334c/506BE968E3DBC0673D2DB0B731F45E61.092016-feuer-testimony.pdf.

191. FTC, Consumer Sentinel Network Data Contributors, available at <https://www.ftc.gov/enforcement/consumer-sentinel-network/data-contributors>.

192. Internal Treasury Analysis. Data from Haver Analytics and U.S. Bureau of Economic Analysis *News Release, Table 3* (May 26, 2017) available at: www.bea.gov/newsreleases/national/gdp/2017/pdf/gdp1q17_2nd.pdf.

193. S&P Dow Jones Indices LLC. S&P/Case-Shiller U.S. National Home Price Index. May 2017, available at fred.stlouisfed.org/series/CSUSHPINSA.

194. Federal Reserve Bank of St. Louis. 30-Year Fixed Rate Mortgage Average in the United States. May 2017, available at: fred.stlouisfed.org/series/MORTGAGE30US.

195. Federal Reserve Bank of St. Louis. Mortgage Debt Outstanding by Type of Property: One- to Four-Family Residences. Mar. 2017, available at: fred.stlouisfed.org/series/MDOTP1T4FR.

196. Federal Reserve Bank of St. Louis. Households; Owner-Occupied Real Estate including Vacant Land and Mobile Homes at Market Value. Mar. 2017, available at: fred.stlouisfed.org/series/HOOREVLMHMV.

197. SIFMA. US Bond Market Issuance and Outstanding. May 2017, available at: www.sifma.org/research/statistics.aspx.

Excessive regulation can unnecessarily drive up the cost of lending and restrict borrower access to credit. Given the passage of time since the financial crisis, incremental experience under the revised regulatory regime, and the widespread recovery of national housing indicators, it is timely to review these standards. In accordance with the Core Principles, proper calibration of regulations governing mortgage lending will empower Americans to make independent financial decisions and informed choices in the marketplace and make regulation more efficient, effective, and appropriately tailored.

In its review of the residential mortgage lending market, Treasury has made the following findings:

- The revised regulatory regime disproportionately discourages private capital from taking mortgage credit risk, instead encouraging lenders to channel loans through federal insurance or guarantee programs, or Fannie Mae or Freddie Mac;
- Regulatory requirements have significantly and unnecessarily tightened the credit box for new mortgage originations, denying many qualified Americans access to mortgages;
- Increased regulatory requirements have significantly increased the cost of origination and servicing activities, which, when passed on to borrowers in the form of higher mortgage rates, have decreased the number of Americans that can qualify for mortgages;
- Some regulatory regimes or approaches are viewed by industry participants as having inadequate transparency and mutual accountability, thus creating uncertainty and risk-aversion among lenders in serving certain market and client segments; and
- Capital, liquidity, and other prudential standards, in combination with a wide range of capital market regulations, have inhibited both private originate-to-hold lenders as well as lenders focused on origination and secondary sale in the private-label securitization market.

The financial crisis germinated in the U.S. residential mortgage market and was precipitated by years of reckless lending practices, poorly designed products with terms consumers may not have fully understood, weak underwriting, ill-designed public policies, inadequate oversight, and other practices that were not sustainable for consumers. This phenomenon arose from weak regulation and deteriorating credit and underwriting practices in the industry, including at the GSEs. These practices contributed to a rapid expansion of mortgage credit that, when it collapsed, led to precipitous home price declines that set back the financial security of households across the country. Furthermore, billions of dollars in losses for financial institutions jeopardized America's financial system and inhibited new mortgage lending.¹⁹⁸ All recommendations to revise the regulatory environment and expand mortgage credit should also serve the goal of avoiding any recurrence of the aforementioned patterns, particularly in-perpetuity subsidies in government-related programs that make private lenders uncompetitive.

Mortgage Loan Origination

For mortgage originators, the regulatory burdens and compliance costs from new regulations contribute to the current tight lending environment. The cost to originate a mortgage has increased

198. Financial Crisis Inquiry Commission. *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*. Jan. 2011.

from approximately \$4,400 in 2009 to over \$7,500 in 2016, according to the Mortgage Bankers Association (MBA) Performance Report.¹⁹⁹ Borrowers end up paying for these higher costs in the form of higher mortgage rates. We explore below a number of rules and regulations that may be driving these higher costs and contributing to a more restrictive credit environment.

The most significant post-crisis regulation impacting loan originations is the ATR/QM rule, which was promulgated and implemented by the CFPB.²⁰⁰ This rule is intended to ensure that lenders make loans to people who have the ability to repay them and to define loans that are considered presumptively “safe” for borrowers. The ATR/QM rule offers a legal “safe harbor” for loans that meet CFPB’s definition of a QM and a “rebuttable presumption” of compliance for certain higher-priced mortgage loans that otherwise meet the QM standards.

While Dodd-Frank and the ATR/QM rule were not intended to eliminate markets for loans that did not meet the QM standards, the reality is that the vast majority of lenders remain unwilling to make loans that do not meet those standards, eliminating access to mortgages for many credit-worthy borrowers.

The ATR/QM rule’s Appendix Q governs the determination of a borrower’s debt and income levels for purposes of satisfying the ATR/QM rule.²⁰¹ For a mortgage to be a QM, the borrower’s total debt-to-income (DTI) ratio cannot exceed 43%, as determined under Appendix Q. However, Appendix Q requirements are complicated and opaque and offer inadequate guidance for borrowers with non-traditional income sources. Furthermore, as Appendix Q is written to focus on borrower cash flow, it ignores borrower assets, which restricts lending to borrowers whose income is low and fixed. It is likely that the rigidity and opacity associated with Appendix Q is contributing to the tighter lending environment.

Under the current rule, loans that are eligible for purchase by the GSEs are QM loans.²⁰² This temporary GSE exemption is colloquially known as the “QM Patch” and expands the types of loans that can be considered QM beyond those where a borrower has a 43% or lower DTI ratio. Loans eligible for other federal insurance or guarantee programs (e.g., FHA and VA) are QM if they meet the QM standards promulgated by those programs. This relief creates an asymmetry, and regulatory burden, for privately originated mortgages.

Another feature of the ATR/QM rule that may limit originations is a cap on the points and fees that can be charged based on the loan size,²⁰³ a limitation that may impact the feasibility of originating low balance loans.

The CFPB adopted rules governing the status of loans made by a lender with less than \$2 billion in assets and fewer than 2,000 first-lien originations in the last calendar year (Small Creditor QM). Loans made by lenders meeting these criteria, and all other criteria for a loan to be a QM loan,

199. Mortgage Bankers Association (MBA). Quarterly Mortgage Bankers Performance Report; available at: www.mba.org/performance/report.

200. 12 C.F.R. pt. 1026.

201. 12 C.F.R. pt. 1026, App. Q.

202. 12 C.F.R. § 1026.43(e)(4).

203. 12 C.F.R. § 1026.43(e)(3).

are QM loans as long as the lender retains the loan in its portfolio for at least 3 years, even if the borrower's DTI ratio exceeds 43%.²⁰⁴

The TILA-RESPA Integrated Mortgage Disclosures (TRID) rule, also referred to as “Know Before You Owe,” was implemented by the CFPB to consolidate the complicated web of regulations intended to ensure that borrowers receive accurate information about their mortgage and understand the documents that they are signing when they close a mortgage loan. The TRID rule introduced new disclosure forms for mortgage application and settlement. These forms, known as the Loan Estimate and the Closing Disclosure, combined multiple detailed forms and were designed to facilitate borrower understanding of the information being provided by the lender. In addition to the disclosure forms, TRID also implemented substantive new rules governing real estate transactions.²⁰⁵

While the new forms provide increased clarity to borrowers, the TRID rules have generated significant confusion among lenders. Implementing these rules has increased compliance costs and raised questions about lender liability.²⁰⁶ The CFPB has provided only limited guidance in response to lender questions, and routinely advises that the guidance is not binding.

Loan originator compensation requirements under Regulation Z were updated by the CFPB in 2013 with the intention of protecting borrowers by reducing incentives for loan originators to steer borrowers into loans with specific terms and to ensure that loan originators are adequately qualified.²⁰⁷ The changes to loan originator compensation requirements were designed to deter the practices used by loan originators prior to the financial crisis to increase their compensation by steering borrowers to loans with higher interest rates or other terms that may not have been in the borrower's best interests. First-time homebuyers or those with poor or no credit history were particularly vulnerable to these practices. The Loan Originator Compensation rule prohibits compensation arrangements for loan originators that vary by product type. However, affordable loans may require different compensation structures than other loans, with the result that it is difficult for loan originators to offer affordable loans in compliance with this requirement of the loan originator compensation rules.

The Home Mortgage Disclosure Act (HMDA) was enacted in the 1970s to help combat redlining and racial profiling by requiring lenders to report data on the type of loan and demographic information about the borrower to whom the loan was made.²⁰⁸ HMDA continues to be an important resource today to identify lenders who engage in discriminatory activity. HMDA data also helps lenders identify strategies to expand mortgage lending into underserved communities. Dodd-Frank expanded HMDA by providing for additional data reporting requirements. The CFPB's amendments to the HMDA rule increases the loan-level data collected and reported to the government about applications from and loans to individual borrowers. The new rule goes into effect in 2018

204. 12 C.F.R. § 1026.43(e)(5).

205. 12 C.F.R. §§ 1024, 1026.

206. Brandy A. Hood and Benjamin K. Olson, “TRID Liability Will Be A Dominant Issue In 2016,” *Law360*. Jan. 12 2016, available at: www.law360.com/articles/743518/trid-liability-will-be-a-dominant-issue-in-2016.

207. See 12 C.F.R. § 1026.36.

208. FFIEC, *HMDA Background and Purpose*. Sep. 2016, available at: <https://www.ffiec.gov/hmda/history.htm>.

and includes 10 new fields required by statute in Dodd-Frank, plus 15 new fields added by the CFPB in its amendments.²⁰⁹

The new reporting requirements have created two concerns among market participants, both related to the public disclosure of the data. The new fields include additional borrower-specific data, which taken with existing HMDA fields and publicly available information, could be used to determine the specific identity of a borrower, raising privacy concerns. Additionally, the new fields contain loan-specific features, including mortgage note rate and fees. The new HMDA loan level data could help competitors re-engineer a lender's pricing models, which could cause competitive harm to the lender.

Mortgage Loan Servicing

While loan origination costs have increased since the financial crisis, servicing costs have also increased dramatically. The cost to service a performing loan has increased approximately fourfold, from approximately \$59 per annum in 2008 to approximately \$228 per annum by the first half of 2016, while the cost of servicing a delinquent loan has ballooned from approximately \$482 to more than \$2,500 per annum over the same period, according to the MBA.²¹⁰

Substantial opportunities exist to reduce the burden of regulation, which will decrease the costs of servicing and improve mortgage loan pricing to borrowers. Certain reforms would also promote a better national standard and help rejuvenate the private label mortgage-backed securities (PLS) market, helping to level the playing field between private sector mortgage lending and government-supported mortgage lending.

The financial crisis exposed fundamental deficiencies in mortgage servicing practices. The pre-crisis mortgage servicing industry, accustomed to minimal default rates and reliable MSA income, lacked the personnel and systems to effectively deal with the number of homeowners in need of assistance during the crisis. Post-financial crisis, oversight and regulation of the mortgage servicing industry increased significantly at both the federal and state level. At the federal level, the passage of Dodd-Frank provided authority to the CFPB to implement detailed regulations affecting mortgage servicing.²¹¹

The increased oversight and regulation has led to an increase in compliance costs, some of which are reflected in higher servicing costs today compared to prior to the financial crisis. Further, servicers indicate that they are forced to devote resources to complying with the new rules as opposed to spending those resources on developing more effective mortgage servicing platforms and technology or focusing on the borrower experience—particularly for delinquent borrowers.

209. Home Mortgage Disclosure (Regulation C), 80 Fed. Reg. 66127 (proposed Oct. 15, 2015).

210. See MBA's Servicing Operations Study and Forum for Prime and Specialty Servicers, available at: www.mba.org/sosf.

211. See 12 U.S.C. § 5538.

Private Sector Secondary Market Activities

It is important to establish a legal and regulatory framework that is conducive to a variety of private sector sources of funding, including private label securitization. In the post-financial crisis years, PLS issuance has been extremely small and mostly concentrated in securitizations of non-performing and re-performing loans as well as prime jumbo loans. According to Inside Mortgage Finance and the Urban Institute, the total non-agency share of new mortgage securitizations was 1.81% in 2016. This figure is tiny compared to a peak non-agency share of approximately 50% in 2005-2007 and approximately 20% in 2001-2003. While the GSEs' credit risk transfer (CRT) securities have provided an avenue for mortgage credit exposure for investors, the largest source of private capital for residential mortgage credit in recent years has come from bank portfolios.²¹²

In order to revitalize a responsible PLS market, it is important to improve incentives for issuers through reasonable reductions in costs and regulatory burdens (particularly adjusting relative economics to the GSEs and federal insurance and guarantee programs), align the interests between issuers and investors, and enhance protections for investors in PLS. Treasury supports regulatory changes to encourage the emergence of a safe and sound PLS market that accommodates more private capital and provides for more consumer choices in mortgage products. Decreasing the market share of government-supported mortgages, while increasing private sector funding of mortgage credit, should be a key policy goal consistent with the Core Principle that calls for decreasing the risk of taxpayer-funded bailouts.

The Qualified Residential Mortgage (QRM) definition originated from the Dodd-Frank provision that requires securitizers of asset-backed securities to retain not less than 5% of the credit risk of the mortgage loans or other assets that back the securitization. For mortgage loans, Dodd-Frank specifically provides that a securitizer is not required to retain the 5% credit risk if all of the mortgages that collateralize the securitization meet the definition of a QRM. In the final risk retention rule, the six rule-writing agencies made the determination to align the QRM definition with the QM definition, partly because Dodd-Frank provided that the QRM definition could be no broader than the QM definition.²¹³

Securitizers have experienced difficulty in receiving clear guidance on the risk retention rule's implementation because of the Dodd-Frank requirement that it be a joint rule among the six rule-writing agencies. Although the rule provides that the securitizer seek guidance from its primary regulator, any significant issue would require consideration by all of the rule-writing agencies.

The financial crisis exposed significant structural deficiencies in private label securitizations, which led to substantial losses and litigation, and damaged the trust of market participants. Pre-financial crisis, private label securitizations often had conflicts of interest, inadequate investor protections, contractual enforcement failures, and a lack of transparency into decisions affecting the value of trust assets. Enhanced governance and strong investor protections are necessary for a responsible and scalable PLS market, along with adequate economic incentives for all parties in securitization trusts. Furthermore, many secondary market investors are reluctant to purchase non-agency loans

212. See Urban Institute. *Housing Finance at a Glance*. May. 2017, pp. 8-10.

213. See 12 C.F.R. § 244.

or PLS due to concerns about potential assignee liability, in which an investor could be liable for rule violations committed during the loan origination process. These concerns may affect the cost and availability of credit for certain borrowers.

Given the substantial losses realized on private label securitizations during the financial crisis, international standard-setting bodies responded by establishing significant risk-weightings on structured products as a part of the post-financial crisis response. Under the Basel III capital framework, residential mortgage securitization is treated at a disadvantage to retained whole loans. Under the U.S. final rule implementing Basel III standards for U.S. banks, single-family residential real estate receives a 50% risk weight under the standardized approach. Senior retained tranches of residential mortgage-backed securities (RMBS) are risk-weighted at a minimum of 20% with mezzanine weightings exceeding 130%, and subordinate weightings of 1,250%.²¹⁴

A bank that originates a pool of QM loans is placed at a capital disadvantage when it securitizes those loans rather than hold them on its balance sheet as individual whole loans, despite the fact that the same underlying collateral would be held in both scenarios. In some cases, the capital required against an interest in an RMBS is greater than the maximum loss exposure for the security itself. Furthermore, the capital required is based on the par value of the security, so an interest that is purchased at a discount in the secondary market is treated even more negatively from a capital standpoint, further discouraging secondary market activity in these assets.

The Asset-Backed Securities Disclosure and Registration Final Rule (Reg AB II), finalized by the SEC in 2014, established asset-level disclosure requirements for registered asset-backed securities backed by auto loans, commercial real estate, and residential real estate as required by Dodd-Frank.²¹⁵ The securitization market that preceded the financial crisis was characterized by a gross lack of adequate disclosures on underlying loan collateral. Dodd-Frank required the SEC to promulgate regulations to address this shortcoming in order to help investors make better investment decisions in a securitization based on the quality of the underlying collateral. Most investors welcomed the enhanced disclosure requirements. However, issuers have stated that increased compliance burdens, lack of standardized definitions, and ambiguous regulatory guidance have had a negative economic impact on issuing new publicly available securitizations. Currently, Reg AB II requires 270 reporting fields per mortgage. Furthermore, many industry participants have expressed concerns about the rule's potential application to privately issued 144a securitizations and its impact on the viability of the market.

Several regulatory standards promulgated after the financial crisis, including the LCR, the NSFR, and the FRTB, have and could further constrain the liquidity of non-agency MBS. The LCR assigns different haircuts to classes of assets based on their expected liquidity in a period of economic stress. U.S. Treasury securities and Ginnie Mae MBS are assigned a zero haircut, while other assets, including GSE MBS, are assigned a 15% haircut when counting toward the LCR requirement. Non-agency MBS do not count at all toward LCR, effectively signaling that regulators view this asset as illiquid during a crisis, regardless of credit rating.²¹⁶

214. See Regulatory Capital Rules, 78 Fed. Reg. 62017 (Oct. 11, 2013).

215. See 17 C.F.R. §§ 229, 230, 232, 239, 240, 243, and 249.

216. See Liquidity Coverage Ratio, 79 Fed. Reg. 61440 (Oct. 10, 2014).

The Basel Committee issued its final update on the revised minimum capital standard for market risk in January 2016, known as the FRTB. The Federal Reserve has not announced how they might implement it for bank holding companies. The revised standard increases capital requirements for securitizations by changing the capital calculation under the current trading book capital requirements to a “revised standardized approach” for market risk.²¹⁷ Under this approach, banks would face increased capital requirements depending on bank-specific metrics, asset class, and ratings. Increasing the capital on trading activity and reducing the economics of market making for these assets could negatively impact liquidity. The secondary market for structured mortgage products has already shifted since the financial crisis, with the industry reporting increased concentration among the most active market participants, as a number of large participants have exited amidst the declining economics of this business.

Recommendations for Regulatory Reform

Treasury has a number of recommendations for regulatory reform of the mortgage origination process, mortgage servicing standards, and private sector secondary market activities that advance the Core Principles. If these reforms are appropriately implemented, they may result in a significant increase in the availability of mortgage credit, an increase in consumer choice, and a decrease in the subsidization and market share of government-supported mortgages. The objective of the reforms is to increase the viability of private sector lending so the share of government-sponsored lending can decrease. The distortion creates massive moral hazard on the part of borrowers, investors, and lenders.

Mortgage Loan Origination

Adjust and Clarify the ATR/QM Rule and Eliminate the “QM Patch”

The QM Patch for GSE-eligible loans creates an unfair advantage for government-supported mortgages without providing additional consumer protection, exposes taxpayers to potential losses, and inhibits consumer choices by restricting private sector flexibility and participation. The CFPB should engage in a review of the ATR/QM rule and work to align QM requirements with GSE eligibility requirements, ultimately phasing out the QM Patch and subjecting all market participants to the same, transparent set of requirements. These requirements should make ample accommodation for compensating factors that should allow a loan to be a QM loan even if one particular criterion is deemed to fall outside the bounds of the existing framework—e.g., a higher DTI loan with compensating factors. However, QM remains a borrower protection standard, and regulatory agencies should make sure that any changes prioritize consumer protection.

Modify Appendix Q of the ATR/QM Rule

Appendix Q should be simplified and the CFPB should release much clearer, binding guidance for its use and application. The CFPB should review Appendix Q standards for determining borrower debt and income levels to mitigate overly prescriptive and rigid requirements. Review of these requirements should be particularly sensitive to considerations for self-employed and

217. See Basel Committee on Banking Supervision. *Standards: Minimum Capital Requirements for Market Risk*. Jan. 2016, available at: <http://www.bis.org/bcbs/publ/d352.pdf>.

non-traditional borrowers. These issues are particularly acute for the self-employed, small business owners, seasonal workers, and retirees.

Revise the Points and Fees Cap for QM Loans

The CFPB should increase the \$103,000 dollar loan amount threshold for application of the 3% points and fees cap. This would encourage additional lending in the form of smaller balance loans. The CFPB should scale points and fees caps in both dollar and percentage terms for loans that fall below the adjusted loan amount threshold for application of the 3% points and fees cap.

Increase Maximum Asset Threshold for Making Small Creditor QM Loans

Smaller depository institutions, which generally follow conservative underwriting practices and are often very familiar with their local market, may be better positioned than larger institutions to determine the creditworthiness of local borrowers. Raising the total asset threshold for making Small Creditor QM loans from the current \$2 billion to a higher asset threshold of between \$5 and \$10 billion is recommended to accommodate loans made and retained by small depository institutions.

It is important to maintain a level playing field across institution types in order to encourage competition and generate cost-saving efficiencies for consumers. As a result, an alternative approach to the above recommendation would be to undertake a rulemaking to amend the ATR/QM rule and related processes for all lenders regardless of type, which in turn could resolve issues experienced by smaller lenders.

Clarify and Modify TRID

Lenders are seeking clear, written guidance from the CFPB on the TRID rules to foster a greater degree of certainty. Certainty could help mitigate the costs that arise from delays in the process and encourage the entrance of additional private capital. Because of the lack of guidance, investors take different, often conflicting, positions on what constitutes a violation. This results in delays when lenders try to sell loans, and in various cases lenders ultimately cannot sell loans because of minor technical errors. The CFPB could resolve these uncertainties through notice and comment rulemaking and/or through the publication of more robust and detailed FAQs in the Federal Register.

Furthermore, with regard to the rules themselves, the CFPB should allow a more streamlined waiver for the mandatory waiting periods. Longer transaction timelines can add to costs and are an undue burden to participants who understand the terms of the contract and prefer to move more quickly in closing their loan. Additionally, the CFPB should allow creditors to cure errors in a loan file within a reasonable period after closing. In any adjustment to the mandatory waiting period practices, all market participants, including both lenders and realtors, should be considered given their central role in the application and closing process.

Improve Flexibility and Accountability of Loan Originator Compensation Rule

The CFPB should improve the flexibility and accountability of the Loan Originator Compensation rule, particularly in those instances where an error is discovered post-closing, in order to facilitate post-closing corrections of non-material errors. The CFPB should establish clear ex ante standards through notice and comment rulemaking, which will clarify its enforcement priorities with respect to the Loan Originator Compensation rule.

Delay Implementation of HMDA Reporting Requirements

Fundamental concerns remain about the efficiency of the HMDA regime, borrower privacy, and competitive harm to lenders through disclosure of proprietary information. The CFPB should delay the 2018 implementation of the new HMDA requirements until borrower privacy is adequately addressed and the industry is better positioned to implement the new requirements. The new requirements should be examined for utility and cost burden, particularly on smaller lending institutions. Consideration should be given to moving responsibility for HMDA back to bank regulators, discontinuing public use, and revising regulatory applications.

Mortgage Loan Servicing

Place a Moratorium on Additional Mortgage Servicing Rules

The CFPB should place a moratorium on additional rulemaking in mortgage servicing while the industry updates its operations to comply with the existing regulations and transitions from HAMP to alternative loss mitigation options. In addition, the CFPB should work with prudential regulators and state regulators to improve alignment where possible in both regulation and examinations, which could help in decreasing the cost of servicing in general.

Private Sector Secondary Market Activities

Repeal or Revise the Residential Mortgage Risk Retention Requirement

Treasury recommends repealing or substantially revising the residential mortgage risk retention requirement. This recommendation is generally aligned with the recommended review of the QM standards in general, and is taken in the context of the significant body of other regulatory measures that improve credit standards and provide investor protections. If the residential mortgage risk retention requirement is revised rather than repealed, in order to improve regulatory efficiency, the legislation should also designate one agency from among the six rule-writing agencies to be responsible for the interpretation of the risk retention rule.

Enhance PLS Investor Protections

Congress should consider legislation providing additional protections for investors in PLS. Additionally, market-led and regulatory initiatives that improve transparency as well as standardization of documentation and data should be encouraged.

Clarify Limited Assignee Liability for Secondary Market Investors

The CFPB should clarify assignee liability for secondary market investors related to errors in the origination process where such errors are not apparent on the face of the disclosure statement and are not asserted as a defense to foreclosure.

Improve the Alignment of the Regulatory Capital Framework for Structured Mortgage Products

Prudential bank regulators should review the regulatory framework for risk-weighting applicable to securitizations in order to better align the framework with the risk of the asset and with international standards for securitized products. Increased capital and liquidity standards have negatively impacted the economic attractiveness of PLS. Additionally, harsh treatment of PLS in DFAST and CCAR stress-testing has exacerbated this problem, sometimes resulting in scenarios where a bank is required

to hold more capital against a PLS asset than the maximum economic loss on that asset. At a minimum, regulators should calibrate standards to resolve this type of counterintuitive result.

Amend Reg AB II

The SEC should amend Reg AB II as it applies to registered securitizations to reduce the number of required reporting fields. It is essential to provide loan-level disclosures on the quality of underlying collateral to maintain transparency and promote investor confidence. However, fewer fields and standardized definitions may provide sufficient transparency without placing excessive burden on the issuer.

Evaluate Impact of Liquidity Rules on the PLS Market

U.S. banking regulators should consider the impact that capital and liquidity rules implementing Basel III standards would have on secondary market activity and calibrate them to reduce complexity and avoid punitive capital requirements.

Leveraged Lending

Overview

One significant type of lending provided by banks and other financial institutions is leveraged loans. Leveraged loans are a type of corporate finance used for mergers and acquisitions, business recapitalization and refinancing, equity buyouts, and business or product line build-outs and expansions.²¹⁸ For companies that do not have an investment-grade credit rating, and therefore have limited access to the public capital markets, leveraged loans play a significant role in supporting their business growth and increasing returns to investors. Banks play a critical role in arranging, originating, and administering funding for leveraged loans to these borrowers.²¹⁹

The leveraged loan business has existed since at least the early 1980s, when issuance was less than \$50 billion.²²⁰ From 2004 to 2007, there was significant leveraged buyout business activity, leading to growth in leveraged loans, and a peak in issuance of more than \$500 billion in 2007.²²¹ During the financial crisis in 2008 and 2009, leveraged loan issuance dried up.²²² Since the financial crisis, leveraged loan issuance has recovered, reaching record levels in 2013.²²³ Today, the leveraged loan business remains fairly robust.²²⁴

218. OCC Leveraged Lending Comptroller's Handbook (Feb. 2008).

219. The Clearing House. *Submission to the U.S. Treasury Department: Aligning the U.S. Bank Regulatory Framework with the Core Principles of Financial Regulation*. (May 2, 2017), available at: www.theclearinghouse.org/~lmedia/TCH/Documents/TCH%20WEEKLY/2017/20170502_TCH_Submission_to_UST_re_Core_Principles_Study.pdf.

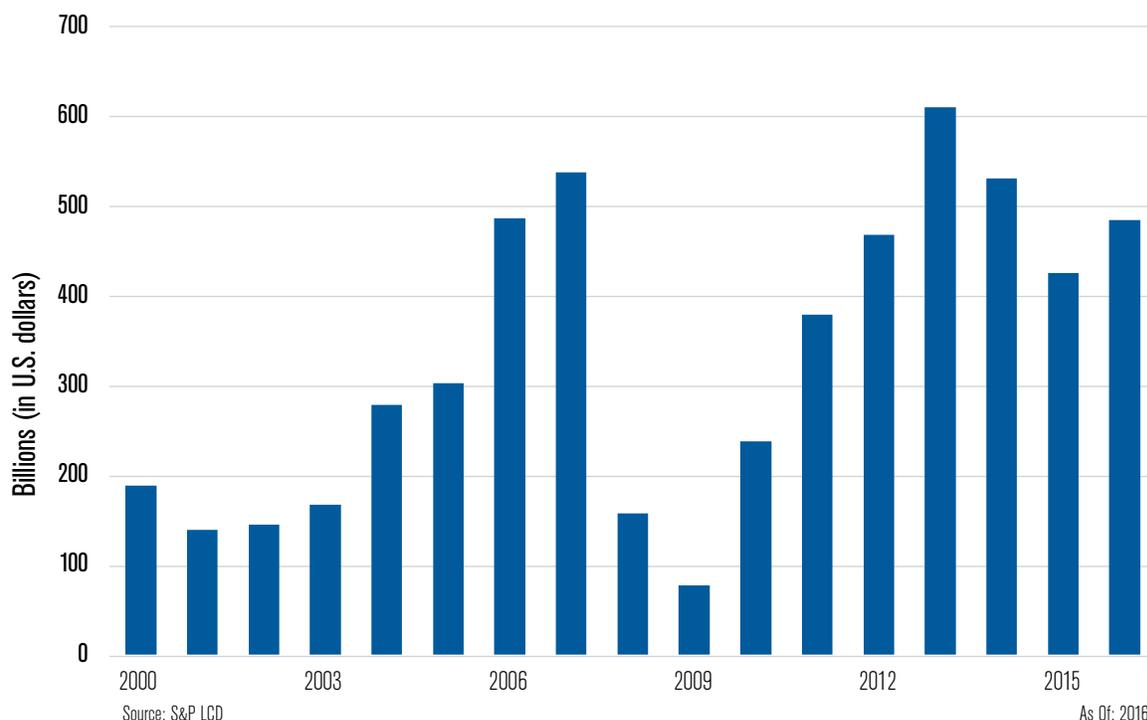
220. *Recent Developments in Corporate Finance*, 76 Fed.Res.Bull. 593, 595, 1990 WL 319954, at *2.

221. GAO. *Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention* p. 46. Sept. 2008, available at: www.gao.gov/new.items/d08885.pdf.

222. Ivashina, Victoria, Scharfstein, David, *Bank Lending During the Financial Crisis of 2008*, Harvard Business School (Nov. 5, 2008) at 5, available at: http://www.people.hbs.edu/dscharfstein/Lending_During_the_Crisis.pdf.

223. Doherty, Colm (C.J.), Pereira, Hugo, *Leveraged Loan Monthly*, Thomson Reuters LPC (Dec. 2016), at 7, available at: http://lipperalpha.financial.thomsonreuters.com/wp-content/uploads/2017/01/Leveraged-Loan-Monthly-Year-end_2016.pdf.

224. Id.

Figure 11: Leveraged Loan Issuance

Regulatory Guidance on Leveraged Lending

In conjunction with the surge in leveraged lending, standards for credit agreements became murkier, and participation by unregulated investors increased. For example, credit agreements for many leveraged loans relied on aggressive estimates of borrower repayment capacity, and they provided limited protections for lenders, for example by omitting meaningful maintenance covenants.²²⁵ Additionally, many financial institutions lacked satisfactory systems to monitor loan credit exposures, particularly during periods when buyer demand for risky assets weakened.²²⁶

Driven by this dynamic, in March 2013, the OCC, the Federal Reserve, and the FDIC issued updated supervisory guidance on leveraged lending to banks, which outlined principles for leveraged lending activity.²²⁷ In response to additional inquiries, the agencies issued responses to frequently asked questions on November 7, 2014.²²⁸ Together, the guidance and frequently asked

225. Maintenance covenants require the borrower to maintain its credit quality by adhering to predetermined ratios at specified intervals.

226. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar 22, 2013); see also Federal Reserve SR 13-3, Interagency Guidance on Leveraged Lending (Mar. 21, 2013), available at: <https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf>.

227. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar 22, 2013).

228. Federal Reserve, FDIC and OCC. *Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending*. November 2014, available at: www.occ.treas.gov/news-issuances/news-releases/2014/nr-ia-2014-153c.pdf.

questions outlined expectations on a range of topics related to leveraged lending. Those topics included underwriting and valuation standards, loan pipeline management, credit risk ratings, and managing problem credit exposures.

The 2013 guidance attempted to set forth the regulators' expectations for banks' risk management of leveraged lending. It emphasized the importance of structuring leveraged loans based on a sound business premise. It also highlighted the importance of a clear and consistent definition of leveraged lending, well-defined underwriting standards, appropriate credit limits and credit concentration parameters, sound systems to monitor credit exposures, and coherent guidelines for portfolio stress tests. The guidance further stated that leveraged lending credit agreements should contain covenant protections, including financial performance covenants such as debt to cash flow, interest coverage, or fixed charge coverage. It also stated that the agreements should include provisions related to compliance reporting and monitoring.²²⁹

Key Issues with Regulatory Guidance

Both experts and market participants have provided mixed feedback on the 2013 leveraged lending guidance. One of the primary concerns expressed with the guidance was the level of ambiguity left in the definition of leveraged lending. For example, while the guidance specifically expressed concern with loans exceeding six times (6x) leverage (defined as the ratio of total debt to EBITDA), the regulators simultaneously said the 6x limit is not a “bright line” so long as other “compensating factors” make up for the amount of leverage.²³⁰ Additionally, the guidance gave banks the opportunity to adopt their own definitions of leveraged lending – such as to identify leveraged loans based on the borrower's leverage, based on the borrower's credit rating, based on the purpose of the loan, or based on the spread of the loan at origination.²³¹ Notwithstanding subsequent clarifications to the guidance, this ambiguity left banks unsure how to satisfy regulatory demands while also providing credit to clients. In essence, banks were left to wait until ex post facto regulatory review to get clarity on whether a leveraged loan would pass or fail supervisory review.

In addition to the ambiguity around the definition of leveraged lending, the guidance lacked clear penalties for noncompliance, which fueled further questions about its usefulness. As a general matter, failure to comply with guidance can result in increased supervisory scrutiny and potentially even a downgrade in the bank's supervisory rating.²³² Because the guidance lacked specificity, it led to uncertainty in the leveraged lending market, and ultimately, resulted in fewer leveraged loans by banks.²³³ However, the reduction in leveraged lending by banks did not necessarily lead to a reduction in risk in the financial system. Instead, a recent Federal Reserve staff paper found that leveraged lending migrated to less regulated nonbanks – a dynamic which makes it far less clear

229. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar 22, 2013).

230. Some industry engagement participants informed Treasury that bank regulators sometimes utilized leverage definitions of 3x or 4x senior debt divided by EBITDA.

231. Kim, Sooji, Plosser, Matthew, and Santos, Joao, *Macprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance*, Federal Reserve Bank of New York Staff Reports, Report No. 815, May 2017, at 2.

232. *Id.*

233. *Id.* at 4.

that the guidance actually diminished risks to financial stability, since nonbank lenders often originate leveraged loans using more aggressive and riskier credit structures.²³⁴ What is clear, however, is that the reduction in leveraged loans available from banks reduced access to credit by businesses.

Recommendations for Regulatory Reform

To address the concerns noted above, Treasury recommends the following:

- The 2013 leveraged lending guidance should be re-issued for public comment. Following the public comment process, the guidance should be refined with the objective of reducing ambiguity in the definition of leveraged lending and achieving consistency in supervision, examination and enforcement.
- Banks should be encouraged to incorporate a clear but robust set of metrics when underwriting a leveraged loan, instead of solely relying on a 6x leverage ratio discussed in the 2013 leveraged lending guidance. Encouraging banks to do so will help maximize the role that leveraged lending plays in the provision of capital to business.

Small Business Lending

Overview

Small businesses are an integral engine of economic growth and job creation in the United States.²³⁵ They employ almost half of the private sector workforce and create three out of five net new jobs in the United States as small businesses are typically more labor intensive than their larger peers.²³⁶ Ensuring adequate access to capital for this segment of the economy is critical to supporting robust and lasting growth.

Unlike large and medium-sized businesses, small businesses typically do not have access to capital markets to attract retail or institutional investors. As a result, small businesses rely heavily on personal savings, business profits, home equity loans, and friends and family as initial sources of capital. Financial institutions are the primary source of outside credit to small businesses. Among financial institutions, community banks issue 43% of small business loans.²³⁷

234. Sooji Kim, Matthew Plosser and João Santos, "Did the Supervisory Guidance on Leveraged Lending Work?" *Liberty Street Economics*. May 16, 2016, available at <http://libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html>. See also: Kim, Sooji, "Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance," at 4.

235. Traditionally, a small business is defined as an enterprise with fewer than 500 employees. Financial institutions tend to define small businesses as a client which produces between less than \$10-\$50 million in revenues per year.

236. Karen Mills & Brayden McCarthy. *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* (State of Small Business Lending), Working Paper 15-004. Harvard Business School, (June 22, 2014) available at: http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf.

237. *FDIC Quarterly* 2017. Vol. 11. No. 1. available at: www.fdic.gov/bank/analytical/quarterly. (FDIC Quarterly)

Small businesses were adversely affected by the contraction in the overall supply of credit during the financial crisis. Stricter lending standards, loans rates, and increased collateral requirements all deterred borrowing by small businesses. Deteriorating economic conditions, falling real estate values, and lethargic demand for small business products and services simultaneously impacted the creditworthiness of small business borrowers.

Structural Challenges with Small Business Credit and Credit Markets

Small business lending poses unique challenges to lenders and certain aspects of the business will not be remedied by changes to existing regulation. Given the high transaction costs, the often incomplete data on small business loan performance, and extreme heterogeneity of small businesses, underwriting small dollar loans is inherently expensive. Given the relatively higher due diligence and loan review costs for small business loans, they are less attractive for lenders than loans to larger, well-established businesses.²³⁸ As a result, underwriting costs associated with small business borrowers can be seen as outsized given the potential returns.

Due in part to their size and scale, large financial institutions generally maintain highly structured credit evaluation processes to ensure consistency across the institution. These assessment methods tend to focus on quantitative methods of analysis, frequently placing great emphasis on evaluating the collateral securing the loan. Credit assessment methods employed by large financial institutions favor more automated products for small business borrowers, such as business credit cards, which require lower upfront transaction costs to deploy. Unfortunately, these automated products may not always meet the credit needs of the borrower.

Increased Regulatory Scrutiny

Additional regulatory scrutiny in the wake of the financial crisis has limited the willingness or ability of some banks—large and small—to make loans to small businesses. Regulatory developments, such as increased capital requirements and a larger focus by the banking agencies on concentration risk, have increased the “cost of doing business” with small businesses for regulated banks.²³⁹ Increased regulatory focus on pricing has also challenged the ability of banks to price additional risk for lower credit loans, further reducing the availability of bank credit to small business borrowers.

The Ultimate Cost of Small Business Credit

Certain structural aspects inherent in lending to small businesses and in the banking sector more broadly continue to affect the cost and availability of small business credit. A recent study concluded that, in general, “low income consumers and small businesses, which generally have fewer or less effective alternatives to bank credit, have paid the largest price for increased bank regulation” in the years following the passage of Dodd-Frank. This same analysis went on to state that funding costs for small businesses have increased by approximately 175 basis points more than for larger

238. Mills, *State of Small Business Lending*.

239. Ryan Nash & Eric Beardsley. *The Future of Finance: Part 1, The Rise of the New Shadow Bank*. Goldman Sachs Equity Research. (Mar. 3, 2015).

businesses when compared with the pre-crisis period.²⁴⁰ These facts suggest that heightened regulatory and compliance costs in the wake of recent financial regulatory reform have had a direct and adverse impact on small business lending.

Recommendations for Regulatory Reform

Minimizing the adverse impact of financial regulation on small business lending is not necessarily a function of changing a few specific regulations but rather reducing the aggregate burden of regulatory compliance on those institutions serving the financing needs of small businesses.

Predominantly, the nature of lending to small businesses—which often lack established and consistent cash flow, access to worthy collateral, diversified sources of revenue, and sophisticated operations and controls—is riskier than lending to their larger counterparts. The banking agencies should be mindful of this reality.

Simplify, adjust, or change certain financial regulations for community financial institutions serving small businesses

The cost of doing business for community banks, which provide approximately 43% of small business loans and 90% of agricultural loans, has increased under the current regulatory framework.²⁴¹ The section in this report on community financial institutions discusses ways that existing regulations can be better tailored for community banks and credit unions. Many of these recommendations would also alleviate burdens to small business lending by these institutions, including improvements to complex capital requirements and reducing the examination and reporting burdens. Moreover, additional changes to leverage lending guidance could help promote capital access for small and mid-sized businesses.

Reduce regulation and reconsider guidance regarding real estate collateral

Real estate is often the most useful collateral to leverage to gain access to business and start-up credit. This is particularly true for small business owners where personal and business finances are highly intertwined and retaining full equity and management control is a high priority. Alleviating regulatory burdens that directly impact access to credit collateralized by property would directly contribute to closing critical gaps in credit that supports small businesses.

In particular, as businesses grow and expand, commercial real estate (CRE) owned by small businesses often becomes the collateral pledged to obtain credit. CRE lending is a highly bank-intensive business that has historically been a key source of risk for banks during periods of distress.

Over the past few years, prudential regulators have increasingly warned financial institutions that there will be a renewed focus on the management of concentration risk in CRE lending. Prudential regulators focus on three measures of CRE exposure: (1) total loans reported for construction, land development, and other land representing 100% or more of the institution's total capital;

240. Steve Strongin & Sandra Lawson et. al. *Who Pays for Bank Regulation?* Goldman Sachs Market Institute (June 2014), available at: <http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/who-pays-for-bank-regulation-pdf.pdf>.

241. *FDIC Quarterly 2017*. This was also regularly voiced during Treasury's consultation with stakeholders.

(2) total CRE loans representing 300% or more of the institution's total capital; and (3) whether the outstanding balance of the institution's CRE loan portfolio has increased by 50% or more during the prior 36 months. This elevated regulatory scrutiny combined with a renewed focus on concentration risk has had the greatest impact on small business loans secured by CRE.²⁴²

CRE guidance, such as that discussed above, does not provide for sufficient flexibility where there may be very strong collateral. Regulators should consider alternatives to assessing concentration risk to allow banks engaged in CRE lending to maximize access to credit for small businesses and optimize balance sheet usage while still maintaining safety and soundness.

Consider addressing the calibration of the SLR for lines of credit to small and mid-sized businesses

Small, unrated corporate loans (commercial and industrial, or C&I, loans) are almost entirely underwritten by banks. The SLR has a direct effect on the cost of working capital loans and specifically unfunded lines of credit. Recalibrating the leverage ratio requirement would likely help banks to provide additional access to working capital lines for small businesses.

Repeal the Application of Section 1071 of Dodd-Frank to Small Business Lending

Section 1071 of Dodd-Frank requires the CFPB to establish regulations and issue guidance for small business loan data collection. The purposes of section 1071 include enabling creditors to identify the needs of small, minority-owned, and women-owned businesses, and to facilitate enforcement of fair lending laws.²⁴³ Although financial institutions are not currently required to gather such information, many lenders have expressed concern that this requirement will be costly to implement, will directly contribute to higher small business borrowing costs, and reduce access to small business loans. The provisions in this section of Dodd-Frank pertaining to small businesses should be repealed to ensure that the intended benefits do not inadvertently reduce the ability of small businesses to access credit at a reasonable cost.

242. FDIC. *Managing Commercial Real Estate Concentrations*. 7 Dec. 2007, available at: www.fdic.gov/regulations/examinations/supervisory/insights/siwin07/article02_real_estate.html.

243. 15 U.S.C. § 1691c-2(a).

Appendix A

Participants in the Executive Order Engagement Process



Many organizations and individuals participated in the engagement process in connection with this report, including the following list as of June 12, 2017.

Government Entities, Offices, and Related Entities

California Public Employees' Retirement System	Financial Services Agency, Japan
Conference of State Bank Supervisors	Independent Member with Insurance Expertise, FSOC
Consumer Financial Protection Bureau	National Credit Union Administration
Delegation of the European Union to the United States of America	New York State Common Fund
Federal Deposit Insurance Corporation	Office of Financial Research
Federal Housing Finance Agency	Office of the Comptroller of the Currency
Federal Reserve Bank of Chicago	Teacher Retirement System of Texas
Federal Reserve Bank of New York	U.S. Commodity Futures Trading Commission
Federal Reserve Board	U.S. Securities and Exchange Commission

Consumer Advocates

AARP	National Community Reinvestment Coalition
Americans for Financial Reform	National Consumer Law Center
Center for Responsible Lending	National Council of La Raza
Consumer Action	National Disability Institute
Consumer Federation of America	National Urban League
Consumers Union	U.S. Public Interest Research Group
Leadership Conference on Civil and Human Rights	
National Association for the Advancement of Colored People	

Academics

Adi Sunderam Harvard Business School	Lawrence White New York University
Anat Admati Stanford University	Mark Willis New York University
Arnold Kling Independent Scholar	Richard Herring University of Pennsylvania
Arthur Wilmarth George Washington University	Roberta Romano Yale University
David Skeel University of Pennsylvania Law School	Robin Greenwood Harvard Business School
Jay Rosengard Harvard Kennedy School	Sanjai Bhagat University of Colorado
John Taylor Stanford University	

Think Tanks

American Enterprise Institute	Heritage Foundation
Aspen Institute	Hoover Institution
Better Markets	Mercatus Center at George Mason University
Bipartisan Policy Center	New America
Brookings Institution	Pew Charitable Trust
CATO Institute	R Street Institute
Committee on Capital Markets Regulation	Urban Institute
Competitive Enterprise Institute	

Industry and Trade Groups

1st University Credit Union	American Express Company
Aegon N.V. (Transamerica)	American Institute of Certified Public Accountants
Aflac Inc.	American International Group, Inc.
Allegacy Federal Credit Union	American Investment Council
AllianceBernstein L.P.	Amerifirst Financial, Inc.
Allstate Corporation	Angel Oak Home Loans
American Airlines Federal Credit Union	AQR Capital Management
American Bankers Association	Arlington Community Federal Credit Union
American Council of Life Insurers	Association for Enterprise Opportunity

Appendix A • Participants in the Executive Order Engagement Process

Association for Financial Professionals	BOK Financial Corporation
Association of Institutional Investors	Boston Consulting Group
Association of Mortgage Investors	Bridgewater Associates, LP
Autonomous Research	Caliber Home Loans
AXA	Cape Cod Five Mutual Company
Bank of America Corporation	Capital Group Companies, Inc.
Bank of America Merrill Lynch	Capital One Financial Corporation
Bank of Bennington	Cardinal Bank
Bank of Montreal	Carnegie Cyber Policy Initiative
Bank of New York Mellon Corporation	Cedar Rapids Bank and Trust Company
Bank of the West	Center for Financial Services Innovation
Barclays US LLC	Central Bank of Kansas City
Barksdale Federal Credit Union	Centric Financial Corporation
Bayview Asset Management	Centris Federal Credit Union
BB&T Corporation	Century Bank and Trust Company
BBVA Compass Bancshares, Inc.	Chiropractic Federal Credit Union
BlackRock	Chubb
Blackstone Group L.P.	CIT Group Inc.
BNP Paribas SA	Citadel LLC
Boeing Credit Union	Citigroup Inc.

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Citizens Financial Group, Inc.	Discover Financial Services
City First Bank of DC	District Government Employees Credit Union
City National Bank of New Jersey	Dupont Community Federal Credit Union
Clayton Holdings, LLC	EagleBank
Cleary Gottlieb Steen & Hamilton LLP	Eastern Bank
CLS Group Holdings AG	Eby-Brown
CME Group Inc.	EKap Strategies LLC
CMG Financial Inc.	Emergent Biosolutions
Columbia Investment Management	Equipment Leasing and Finance Association
Comerica, Inc.	Equity Prime Mortgage, LLC
Community Development Bankers Association	Fairfax County Federal Credit Union
Consumer Bankers Association	Fifth Third Bank
Credit Suisse Group AG	Financial Executives International
Credit Union National Association	Financial Industry Regulatory Authority, Inc.
Cullen/Frost Bankers, Inc.	Financial Services Roundtable
Cypress Group	First National Bank of Elkhart
Davis Polk & Wardwell LLP	First State Bank
Depository Trust & Clearing Corporation	First Tech Federal Credit Union
Deutsche Bank AG	FirstCapital Bank of Texas

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Fitch Ratings Inc.	Institute of International Bankers
Flagstar Bank	Institute of International Finance
FMR LLC	Intercontinental Exchange
Ford Foundation	International Council of Shopping Centers
Franklin Templeton Investments	International Franchise Association
Futures Industry Association	International Swaps and Derivatives Association
GEICO Corporation	Invesco Ltd.
German American Bancorp	Investment Company Institute
Goldman Sachs Group, Inc.	Jones Walker
Goldstein Policy	JPMorgan Chase & Co.
Grand Rapids State Bank	Keefe, Bruyette & Woods
Guaranteed Rate, Inc.	KeyCorp
Hancock Whitney Bank	Latham & Watkins
HomeBridge Financial Services Inc.	Law Office of William J. Donovan
HSBC North America Holdings	LCH.Clearnet Group Ltd
Hunt Consolidated, Inc.	Levy Group
Huntington Bancshares, Inc.	Liberty Mutual Group, Inc.
IBERIABANK Corporation	Lincoln Financial Bancorp, Inc.
ICF International, Inc.	LivWell
Independent Community Bankers of America	Loan Syndications & Trading Association
Industrial Bank of DC	

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Loomis, Sayles & Co	National Bankers Association
Lower East Side People's Federal Credit Union	National Conference of Insurance Guaranty Funds
M&T Bank	National Federation of Community Development Credit Unions
MainStreet Bancshares, Inc.	National Federation of Independent Business
Managed Funds Association	National Organization of Life and Health Guaranty Associations
Manulife Financial Corporation	National Restaurant Association
Marvin F. Poer and Company	National Retail Federation
Massachusetts Mutual Life Insurance Company	Nationstar Mortgage Holdings Inc.
MB Financial, Inc.	Nationwide Mutual Insurance Company
McGuireWoods LLP	Navy Federal Credit Union
McKinsey & Company	New York Life Insurance Company
MetLife, Inc.	New York University Federal Credit Union
MidFirst Bank	Northern Trust Corporation
Mid-Size Bank Coalition of America	Northwest Bancshares, Inc.
Moody's Corporation	Northwestern Mutual Life Insurance Company
Morgan Stanley	Och-Ziff Capital Management Group
Mortgage Bankers Association	
Municipal Employees Credit Union	
National Association of Federally-Insured Credit Unions	
National Association of Home Builders	

Appendix A • Participants in the Executive Order Engagement Process

Old National Bancorp	Roosevelt Management Company
Oliver Wyman Group	Royal Bank of Canada
Options Clearing Corporation	Runbeck Election Services
Patelco Credit Union	Sandler O'Neill + Partners, L.P.
PennyMac Financial Services, Inc.	Santander
PentAlpha Capital, LLC	Securities Industry and Financial Markets Association
People's United Bank, NA	Security Bancorp, Inc.
PHH Mortgage Corporation	Service Credit Union
PIMCO Investments LLC	Small Business & Entrepreneurship Council
PNC Financial Services Group, Inc.	Small Business Majority
Primary Residential Mortgage, Inc.	SMW 104 Federal Credit Union
Progressive Corporation	Standard & Poor's Financial Services LLC
Property Casualty Insurers Association of America	State Employees' Credit Union
Prudential Financial, Inc.	State Farm Mutual Automobile Insurance Company
Pulte Mortgage LLC	State Street Corporation
Quicken Loans Inc.	Stearns Lending, LLC
Redwood Trust Inc.	Sterling Bancorp
Regions Financial Corporation	Structured Finance Industry Group
Rock Financial Corporation	Sullivan & Cromwell LLP
	Sunrise Banks, NA

Appendix A • Participants in the Executive Order Engagement Process

SunTrust Banks, Inc.	Union State Bank of Everest
SVB Financial Group	United Bank
SWBC Mortgage Corporation	United Community Bank
Swiss Re Ltd.	United States Automobile Association
TCF Financial Corporation	Vanguard Group
TD Group US Holdings	VantageScore Solutions, LLC
Teachers Credit Union	Venable LLP
Teachers Insurance and Annuity Association of America	Virtu Financial Inc.
The Clearing House	Waddell & Reed
The Peoples Bank Co.	Wellington Management Company
Travelers Companies, Inc.	Wells Fargo & Company
U.S. Bancorp	Wilmington Trust Corporation
U.S. Chamber of Commerce	Windsor Federal Savings Bank
UBS Group AG	Wintrust Financial Corporation
UMB Financial Corporation	Wright-Patt Credit Union, Inc.
Union Home Mortgage Corporation	Zions Bancorporation

Appendix B

Table of Recommendations



Regulatory Structure

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
REGULATORY OVERLAP AND DUPLICATION			
<ul style="list-style-type: none"> • Congress should take action to reduce regulatory fragmentation, overlap, and duplication. 	Congress		E, G
<ul style="list-style-type: none"> • FSOC’s statutory mandate should be broadened so that it can assign a lead regulator as primary regulator on issues where agencies have conflicting or overlapping jurisdiction. • FSOC should be reformed to further facilitate information sharing and coordination among member agencies. 	Congress		B, F
<ul style="list-style-type: none"> • Congress should reform the structure and mission of the Office of Financial Research to improve its effectiveness and to ensure greater accountability. • OFR should become part of the Treasury, with its Director subject to appointment by the Secretary, without a fixed term and subject to removal at will, and that the budget of the OFR come under the control of the Treasury appropriations and budget process. 	Congress		E, G
CYBER SECURITY			
<ul style="list-style-type: none"> • Treasury recommends that federal and state financial regulatory agencies establish processes for coordinating regulatory tools and examinations across sub-sectors. <ul style="list-style-type: none"> • Financial regulatory agencies should work to harmonize regulations, including using a common lexicon. • Financial regulators should work to harmonize interpretations and implementation of specific rules and guidance around cybersecurity. 		Federal and State Financial Regulatory Agencies	E, G

Note: each “policy responsibility” above is a preliminary assessment and is not intended to indicate whether other authorities may exist to implement the relevant recommendation.

Capital and Liquidity

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
APPROPRIATELY TAILORED RULES FOR BANKS			
<ul style="list-style-type: none"> • Appropriate tailoring of DFAST, CCAR, LCR, and SCCL 			
<ul style="list-style-type: none"> • DFAST Threshold: The threshold for participation for company-run DFAST should be raised to \$50 billion in total assets (from the current threshold of more than \$10 billion). The banking regulators should be granted authority to further calibrate this threshold on an upward basis by reference to factors related to the degree of risks and complexity of the institution. 	Congress	FRB, OCC, FDIC Regulation	C, D, F
<ul style="list-style-type: none"> • DFAST Process: The mid-year DFAST cycle should be eliminated, and the number of supervisory scenarios should be reduced from three to two—the baseline and severely adverse scenario. Further, as a company-led process, leeway should be granted for banks to determine the appropriate number of models that are sufficient to develop appropriate output results, aligned with the scale and complexity of the banking organization and nature of its asset mix. 	Congress	FRB, OCC, FDIC Regulation	C, D, F
<ul style="list-style-type: none"> • Enhanced Prudential Standards and CCAR Thresholds: The threshold in Section 165 of Dodd-Frank for enhanced prudential standards should be raised to be better tailored to the complexity of bank holding companies. The Federal Reserve should also revise the threshold for the application of CCAR to match the revised threshold for the application of the enhanced prudential standards. 	Congress	FRB Regulation	C, D, F
<ul style="list-style-type: none"> • LCR: The scope of application of the LCR should be narrowed to apply only to internationally active banks: the U.S. LCR should be limited to G-SIBs and a less stringent standard (i.e., an LCR that is not “super-compliant”) should be applied to internationally active bank holding companies that are not G-SIBs. 		FRB, OCC, FDIC Regulation	C, D, F
<ul style="list-style-type: none"> • SCCL: The scope of application of the SCCL should apply only to banks that are subject to the revised threshold for the application of the enhanced prudential standards. 		FRB Regulation with FSOC	C, D, F
<ul style="list-style-type: none"> • Creating an “off-ramp” for well-capitalized banks: Consider establishing a “regulatory off-ramp” from all capital and liquidity requirements, nearly all aspects of Dodd-Frank’s enhanced prudential standards, and the Volcker Rule for depository institution holding companies and IDIs. This approach would require the institution to elect to maintain a sufficiently high level of capital, such as a 10% non-risk-weighted leverage ratio. 	Congress		C, D, F

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Appendix B • Table of Recommendations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
REDUCE UNNECESSARY BURDENS AND IMPROVE TRANSPARENCY			
<ul style="list-style-type: none"> • Improve capital and liquidity supervisory process and guidance 			
<ul style="list-style-type: none"> • CCAR: The Federal Reserve should (i) reassess assumptions in the CCAR process that create unrealistically conservative results, such as the assumption that firms continue to make capital distributions and grow their balance sheets and risk-weighted asset exposure in severely adverse scenarios; (ii) improve its modeling practices by better recognizing firms' unique risk profiles; and (iii) consider changing the CCAR process to a two-year cycle (with more frequent reviews permitted to allow revisions to capital plans in the case of extraordinary events). 		FRB Supervisory and Regulation	C, D, E, G
<ul style="list-style-type: none"> • Pending Rules: U.S. banking regulators should delay adoption of the Net Stable Funding Ratio and Fundamental Review of the Trading Book standards until U.S. regulators can appropriately assess and calibrate them. 		FRB, OCC, FDIC Supervisory	C, D, E, G
<ul style="list-style-type: none"> • Simplifying the capital regime: Treasury recommends keeping the standardized approaches for calculating risk-weighted assets but reducing reliance upon the advanced approaches for calculating firms' overall risk-based capital requirements. However, U.S. regulators should consider where it would be appropriate to introduce more appropriate risk sensitivity such as in the measurement of derivative and securities lending exposures for the standardized approaches and the proposed SCCL. 		FRB, OCC, FDIC Regulation	C, D, E, G
<ul style="list-style-type: none"> • CECL: U.S. prudential regulators should review the potential impact of the CECL standard on banks' capital levels and formulate recommendations to harmonize the application of the standard with regulators' supervisory efforts. 		FRB, FDIC, OCC Supervisory	C, D, F
<ul style="list-style-type: none"> • Improving the transparency of the CCAR and other supervisory processes 			
<ul style="list-style-type: none"> • Improving CCAR transparency: The Federal Reserve should subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies. 		FRB Regulation	C, E, G
<ul style="list-style-type: none"> • CCAR qualitative assessment: The qualitative CCAR element should no longer be the sole basis for the Federal Reserve's objection to capital plans for all banks subject to CCAR. The qualitative assessment should be adjusted to the horizontal capital review for all banking organizations (as the Federal Reserve has already implemented for non-complex banks with less than \$250 billion in assets). 		FRB Regulation	C, D, F
<ul style="list-style-type: none"> • Other CCAR transparency modifications: The CCAR process could also be modified to provide management with greater control of capital distribution planning by providing firms an accurate understanding of the capital buffers they would have after considering the projected results of the Federal Reserve's supervisory models under the severely adverse scenario. This additional certainty about the size of a firm's capital cushion could be achieved through (i) changing the sequence of the CCAR process; or (ii) integrating the risk-based capital and CCAR stress testing regimes, without increasing post-stress capital requirements. 		FRB Supervisory	C, D, F

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Appendix B • Table of Recommendations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
<ul style="list-style-type: none"> • Countercyclical capital: Any countercyclical capital measures should be implemented through the existing CCAR and DFAST stress testing processes rather than through the countercyclical capital buffer (currently included in the risk-based capital rules). 		FRB Supervisory and Regulation	C, D, F
<ul style="list-style-type: none"> • Operational risk capital requirements: The method of calculating operational risk capital requirements under the advanced approaches should be made more transparent as compared to the current approach. 		FRB, FDIC, OCC, Supervisory and Regulation	C, D, F
IMPROVING REGULATORY COHERENCE TO IMPROVE THE FUNCTIONING OF CAPITAL MARKETS			
<ul style="list-style-type: none"> • Addressing the impact of the SLR: Significant adjustments should be made to the calculation of the SLR. In particular, deductions from the leverage exposure denominator should be made, including for: (i) cash on deposit with central banks; (ii) U.S. Treasury securities; and (iii) initial margin for centrally cleared derivatives. 		FRB, FDIC, OCC Regulation	B, C, D, F
<ul style="list-style-type: none"> • Changing liquidity requirements: There should be expanded treatment of certain qualifying instruments as HQLA. This would include categorizing high-grade municipal bonds as Level 2B liquid assets (rather than generally not being counted as HQLA currently). In addition, improvements should be made to the degree of conservatism in cash flow assumptions incorporated into calculations of the LCR to more fully reflect banks' historical experience with calculation methodologies. 		FRB, FDIC, OCC Regulation	C, D, F
RECALIBRATING U.S. IMPLEMENTATION OF CERTAIN INTERNATIONAL FINANCIAL REGULATORY STANDARDS			
<ul style="list-style-type: none"> • U.S. rules implementing international standards that should be revisited include (i) the G-SIB risk-based surcharge for U.S. G-SIBs, including the short-term wholesale funding component; (ii) the mandatory minimum debt ratio included in the Federal Reserve's TLAC and minimum debt rule; and (iii) the calibration of the eSLR for G-SIBs. 		FRB, FDIC, OCC Regulation	C, D, F
APPROACH TO INTERNATIONAL STANDARD SETTING PROCESSES			
<ul style="list-style-type: none"> • Treasury generally supports efforts to finalize remaining elements of the international reforms at the Basel Committee, including establishing a global risk-based capital floor to promote a more level playing field for U.S. firms and strengthen the capital adequacy of global banks. The banking agencies should carefully consider the implications on U.S. credit intermediation and systemic risk from the implementation in the United States of a revised standardized approach for credit risk under the Basel III capital framework. 		FRB, FDIC, OCC Supervisory	B, C, D, E, F
<ul style="list-style-type: none"> • Treasury recommends that the United States lead efforts to narrow the scope of SSBs' initiatives, specifically by streamlining their mandates and eliminating existing overlapping objectives. In addition, Treasury recommends increased transparency and accountability, so that the views and concerns of external stakeholders are appropriately and timely considered and accounted for. Finally, Treasury recommends that the U.S. members continue to advocate for and shape international regulatory standards that are in alignment with domestic financial regulatory objectives. 		FRB, FDIC, OCC, SEC, CFTC Supervisory	C, D, E, F

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Community Financial Institutions

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
RECOMMENDATIONS FOR COMMUNITY BANKS			
<ul style="list-style-type: none"> • Simplifying the capital regime for community banks: Treasury recommends that bank regulators explore exempting community banks from the risk-based capital regime implementing the Basel III standards. In addition, if required, Dodd-Frank’s Collins Amendment should be amended (Dodd-Frank Section 171). Regulators should simplify and improve the calculation of capital requirements for MSAs, as well as simplify and clarify the definition of HVCRE loans to avoid the application of higher risk-weights for loans where it would be unnecessary. 	Congress	FRB, FDIC, OCC Regulation	A, C, F
<ul style="list-style-type: none"> • Raising the Small Bank Holding Company Policy Statement asset threshold: Treasury recommends raising the asset threshold of the Federal Reserve’s Small Bank Holding Company and Savings and Loan Holding Company Policy Statement to \$2 billion (from the current \$1 billion). 	Congress	FRB Regulation	A, C, F
RECOMMENDATIONS FOR COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS AND MINORITY DEPOSITORY INSTITUTIONS			
<ul style="list-style-type: none"> • It may be appropriate to grant CDFI banks and MDIs additional flexibility in utilizing subordinated debt or capital, particularly capital that is borrowed by the holding company and injected into the bank. Such capital may include program-related investments received from foundations or impact investors. 		FRB, FDIC, OCC Regulation	A, C, F
RECOMMENDATIONS FOR FEDERALLY-INSURED CREDIT UNIONS			
<ul style="list-style-type: none"> • Easing the NCUA regulations relating to credit union capital and stress-testing requirements: NCUA should revise the risk-based capital requirements to only apply to credit unions with total assets in excess of \$10 billion or eliminate altogether risk-based capital requirements for credit unions satisfying a 10% simple leverage (net worth) test. 		NCUA Regulation	A, C, F
<ul style="list-style-type: none"> • Raising the scope of application for stress-testing requirements for credit unions to \$50 billion: In line with the tailoring of capital regulations for banks, Treasury recommends generally raising the scope of application for stress testing of federally-insured credit unions to \$50 billion in assets (from the current \$10 billion threshold). 		NCUA Regulation	A, C, F
<ul style="list-style-type: none"> • Allowing appropriate supplemental capital: Treasury supports allowing credit unions to rely in part on appropriately designed supplemental capital to meet a portion of their risk-based capital requirements. Such supplemental capital instruments, if required to have essential prudential features (e.g., noncumulative perpetual preferred stock and subordinated debt with long-maturity and lack of early event acceleration) will allow credit unions to increase their capital from investors rather than relying solely on retained earnings. 	Congress	NCUA Regulation	A, C, F

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Appendix B • Table of Recommendations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
ENCOURAGING DE NOVO ACTIVITY			
<ul style="list-style-type: none"> Treasury recommends implementing changes to the existing regulatory capital requirements and other burdensome rules for community banks and a critical review of capital requirements applicable to de novo banks. The application process of obtaining deposit insurance should be significantly streamlined, and Treasury supports the FDIC's recent efforts to encourage de novo charters. 		FDIC Regulation	A, C, F
REGULATORY REPORTING			
<ul style="list-style-type: none"> Treasury recommends that the regulators continue to streamline current regulatory reporting requirements for all community financial institutions. Treasury recommends that the regulators focus their efforts on applicability of each line item. 		FRB, FDIC, OCC Supervisory and Regulation	A, E, G
EXAMINATIONS			
<ul style="list-style-type: none"> Reviewing examination overlap and duplication: Treasury recommends that: (i) Congress consider raising the current asset threshold for smaller banks eligible for an 18 month examination cycle; (ii) the NCUA implements parallel changes to extend examination cycles for smaller credit unions; and (iii) all regulators expand upon current efforts to further coordinate and rationalize their examination and data collection procedures to promote accountability and clarity. 	Congress	FRB, FDIC, OCC, NCUA, CFPB Supervisory	A, E, G
AGRICULTURAL AND RURAL CREDIT			
<ul style="list-style-type: none"> Minimizing compliance burdens for rural and agriculture lenders: Providing banking services in rural areas is particularly difficult given the scarcity of key service providers, such as appraisers and other legal and compliance staff. As such, the regulators need to recognize these circumstances and provide special consideration to agriculture and rural banks' compliance challenges. 		FRB, FDIC, OCC Supervisory	A, E, G
INCREASING THRESHOLD FOR MAKING SMALL CREDITOR QUALIFIED MORTGAGE (QM) LOANS			
<ul style="list-style-type: none"> Reforming mortgage requirements: A detailed evaluation of mortgage requirements is addressed in the Residential Mortgage section. 		FRB, FDIC, OCC, CFPB Regulation	A, E, G

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Improving the Regulatory Engagement Model

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
REASSESSING REGULATORY REQUIREMENTS ON A BANKING ORGANIZATION'S BOARD OF DIRECTORS			
<ul style="list-style-type: none"> Treasury recommends an inter-agency review of the collective requirements imposed on Boards in order to reassess and better tailor these aggregate expectations and restore balance in the relationship between regulators, Boards, and bank management. 		Interagency regulators	C, E, G
ENHANCED USE OF REGULATORY COST-BENEFIT ANALYSIS			
<ul style="list-style-type: none"> Federal financial regulatory agencies should follow the principles of transparency and public accountability by conducting rigorous cost-benefit analyses and making greater use of notices of proposed rulemakings to solicit public comment. In particular, Treasury recommends that financial regulatory agencies perform and make available for public comment a cost-benefit analysis with respect to at least all “economically significant” proposed regulations, as such term is used in Executive Order 12866. Such analysis should be included in the administrative record of the final rule. 		Federal Financial Regulatory Agencies	E, G
IMPROVING THE PROCESS FOR REMEDIATING IDENTIFIED REGULATORY ISSUES			
<ul style="list-style-type: none"> Treasury recommends an interagency reassessment of the volume and nature of matters requiring attention (MRAs), matters requiring immediate attention (MRIAs), and consent orders (COs) to evaluate impact, consistency and overlap and to establish consistent interagency standards. 		Interagency regulators	C, E, G
<ul style="list-style-type: none"> Treasury recommends that regulators and banking organizations develop an improved approach to addressing and clearing regulatory actions. 		Interagency regulators	C, E, G
COMMUNITY REINVESTMENT ACT			
<ul style="list-style-type: none"> It is very important to have the benefits arising from banks’ CRA investments better align with the interest and needs of the communities that they serve and to improve the current supervisory and regulatory framework for CRA. Treasury expects to comprehensively assess how the CRA could be improved to achieve these goals, which will include soliciting input from individual consumer advocates and other stakeholders. Aligning the regulatory oversight of CRA activities with a heightened focus on community investments will become a high priority for the Secretary. 	Congress	Treasury, Interagency	A, F

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Living Wills

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
RAISE THRESHOLD FOR LIVING WILL REQUIREMENTS			
<ul style="list-style-type: none"> Treasury recommends changing the threshold for compliance with living will requirements from current level of \$50 billion to match the revised threshold for application of enhanced prudential standards. 	Congress	FRB Regulation with FSOC	B, C, D, F
ADJUST LIVING WILL SUBMISSION FREQUENCY			
<ul style="list-style-type: none"> Agencies should formalize a change of the living will process to a two-year cycle. The agencies could require firms to provide notice of material events that occur between living will submissions. 		FRB, FDIC Regulation	B, F
IMPROVE LIVING WILL GUIDANCE			
<ul style="list-style-type: none"> The agencies should be held accountable to develop specific, clear, and accountable guidance for living will submissions as well as the assessment framework for determining deficiencies in living will submissions (including remediation procedures). All assessment framework and guidance should be subject to a public notice and comment process. 		FRB, FDIC Supervisory and Regulation	B, C, E, G
CONSOLIDATE REGULATORY OVERSIGHT AND IMPROVE TIMELINESS OF FEEDBACK			
<ul style="list-style-type: none"> Treasury recommends that section 165(d) of Dodd-Frank be amended to remove the FDIC from the living wills process. The Federal Reserve should be required to complete its review and give feedback to firms on their living wills within six months. 	Congress	FRB Supervisory	B, E, G

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Foreign Banking Organizations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
APPLYING ENHANCED PRUDENTIAL STANDARDS FOR FBOs BASED UPON THEIR U.S. FOOTPRINTS RATHER THAN GLOBAL CONSOLIDATED ASSETS			
<ul style="list-style-type: none"> The application of enhanced prudential standards and living will requirements to FBOs should be based on their U.S. risk profile (using the same revised threshold as is used for the application of enhanced prudential standards to U.S. bank holding companies) and should not be based on global consolidated assets. 	Congress	FRB Regulation	C, D, F
RECALIBRATING IHC REQUIREMENTS			
<ul style="list-style-type: none"> Consistent with the thresholds recommended for U.S. BHCs, the threshold for IHCs to comply with U.S. CCAR should be raised from the current \$50 billion level to match the revised threshold for enhanced prudential standards, subject to the ability of the Federal Reserve to impose these requirements on smaller IHCs in cases where the potential risks posed by the firm justify the additional requirements. 		FRB Regulation	B, D, F
<ul style="list-style-type: none"> Other IHC regulatory standards, such as resolution planning and liquidity, should also be recalibrated. In considering such a recalibration, greater emphasis should be given to the degree to which home country regulations are comparable to the regulations applied to similar U.S. BHCs. Where regulations are sufficiently comparable, FBOs should be allowed to meet certain U.S. requirements through compliance with home country regimes. 		FRB Regulation	B, D, F
RECALIBRATING THE FEDERAL RESERVE'S LONG-TERM DEBT AND TLAC RULE			
<ul style="list-style-type: none"> Treasury recommends the Federal Reserve consider recalibration of the internal TLAC requirement. In assessing the appropriate calibration, the Federal Reserve should consider the foreign parent's ability to provide capital and liquidity resources to the U.S. IHC, provided arrangements are made with home country supervisors for deploying unallocated TLAC from the parent, among other factors. 		FRB Regulation	B, C, D, F

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Improving the Volcker Rule

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
EXEMPT SMALLER INSTITUTIONS FROM THE VOLCKER RULE			
<ul style="list-style-type: none"> Exempt banking entities with \$10 billion or less in assets from the Volcker Rule. Exempt banking entities with over \$10 billion in assets that are not subject to the market risk capital rules from the proprietary trading prohibitions of the Volcker Rule. 	Congress		D, F
IMPROVE REGULATORY COORDINATION			
<ul style="list-style-type: none"> Agencies should ensure their guidance and enforcement of the Volcker Rule is consistent and coordinated. 		FRB, FDIC, OCC, SEC, CFTC Supervisory	C, E, G
SIMPLIFY THE DEFINITION OF PROPRIETARY TRADING			
<ul style="list-style-type: none"> Eliminate the 60-day rebuttable presumption from the definition of proprietary trading. 		FRB, FDIC, OCC, SEC, CFTC Regulation	F
<ul style="list-style-type: none"> Assess whether to eliminate the purpose test from the definition of proprietary trading. 	Congress		C, D, F
PROVIDE INCREASED FLEXIBILITY FOR MARKET-MAKING			
<ul style="list-style-type: none"> Regulators should give banks additional flexibility to adjust their determinations of the reasonable amount of market-making inventory: for illiquid securities, banks should have greater leeway to anticipate changes in markets; for over-the-counter derivatives, regulators should focus more on ensuring that banks appropriately hedge the positions they maintain; banks that have not yet established a market-making presence in a particular asset class should have more discretion to meet the RENTD condition; banking entities should be able to enter into block trades even if they involve a trading volume outside of historical averages. 		FRB, FDIC, OCC, SEC, CFTC Supervisory/Regulation	D, F
<ul style="list-style-type: none"> Policymakers should evaluate the benefits of other potential modifications to the RENTD framework, including an ability for banking entities to opt out of the RENTD requirement altogether if they adopt enhanced trader mandates or hedge all significant risks. 	Congress		D, F
REDUCE THE BURDEN OF HEDGING BUSINESS RISKS			
<ul style="list-style-type: none"> Banks should not be required to maintain ongoing calibration of a hedge over time. 		FRB, FDIC, OCC, SEC, CFTC Regulation	D, F

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Appendix B • Table of Recommendations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
<ul style="list-style-type: none"> Eliminate the requirement to maintain documentation of the specific assets and risks being hedged. 		FRB, FDIC, OCC, SEC, CFTC Regulation	D, F
REDUCE THE BURDENS OF THE VOLCKER RULE'S COMPLIANCE REGIME			
<ul style="list-style-type: none"> The existing “enhanced” compliance program under the regulations should apply only to those banking entities with at least \$10 billion in trading assets and liabilities on a consolidated basis (current application is to all banking entities with over \$50 billion in total consolidated assets). 		FRB, FDIC, OCC, SEC, CFTC Regulation	C, D, F
<ul style="list-style-type: none"> Banks should be given greater ability to tailor their compliance programs to the particular activities engaged in by the bank and the particular risk profile of that activity. 		FRB, FDIC, OCC, SEC, CFTC Regulation	C, D, F
<ul style="list-style-type: none"> Agencies should eliminate any required metrics for reporting that are not necessary for effective supervision. 		FRB, FDIC, OCC, SEC, CFTC Regulation	C, D, F
FOCUS AND SIMPLIFY COVERED FUNDS RESTRICTIONS			
<ul style="list-style-type: none"> Regulators should adopt a simple definition of covered funds that focuses on the characteristics of hedge funds and private equity funds with appropriate additional exemptions as needed. 		FRB, FDIC, OCC, SEC, CFTC Regulation	D, F
<ul style="list-style-type: none"> The exemptions in Section 23A of the Federal Reserve Act should be restored in the Volcker Rule so that they apply to banking entities’ transactions with their covered funds. 	Congress	FRB, FDIC, OCC, SEC, CFTC Regulation	D, F
<ul style="list-style-type: none"> The initial “seeding period” exemption from the covered funds investment restriction should be extended to three years, rather than one year, to provide banking entities with additional time to stand up new funds and allow them to establish the track records they need to attract investors. 	Congress		D, F
<ul style="list-style-type: none"> Banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor, provided that the separate identity of the funds is clearly disclosed to investors. 	Congress		D, F
<ul style="list-style-type: none"> An exemption of the Volcker Rule’s definition of “banking entity” should be provided for foreign funds owned or controlled by a foreign affiliate of a U.S. bank or a foreign bank with U.S. operations. 	Congress	FRB, FDIC, OCC, SEC, CFTC Regulation	D, F
CREATE AN OFF-RAMP FOR HIGHLY CAPITALIZED BANKS			
<ul style="list-style-type: none"> Consideration should be given to permitting a banking entity that is sufficiently well-capitalized, such that the risks posed by its proprietary trading are adequately mitigated by its capital, to opt out of the Volcker Rule altogether, if the institution remains subject to trader mandates and ongoing supervision and examination to reduce risks to the safety net. 	Congress		D, F

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Consumer Financial Protection Bureau

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
ADOPTING STRUCTURAL REFORMS TO MAKE THE CFPB MORE ACCOUNTABLE TO THE PRESIDENT, CONGRESS AND THE AMERICAN PEOPLE			
<ul style="list-style-type: none"> • The for-cause removal protection for the CFPB Director impermissibly limits the President’s authority, disperses executive power, and renders the CFPB less politically accountable than other agencies. The most straightforward remedy is to make the Director removable at-will by the President. As an alternative, the CFPB could be restructured as an independent multi-member commission or board, which would create an internal check on the exercise of agency power. 	Congress		A,G
<ul style="list-style-type: none"> • The CFPB should be funded through the annual congressional appropriations process to enable Congress to exercise greater oversight and control over how taxpayer dollars are spent. 	Congress		A,G
<ul style="list-style-type: none"> • The CFPB should be subject to OMB apportionment. 	Congress		A,G
<ul style="list-style-type: none"> • CFPB’s other funding mechanism, the Consumer Financial Civil Penalty Fund, should be reformed to permit the CFPB to retain and use only those funds necessary for payments to the bona fide victims of activities for which the CFPB has imposed civil money penalties. The CFPB should remit to the Treasury any funds in excess of payments to victims. 	Congress		A,G
ENSURING THAT REGULATED ENTITIES HAVE CERTAINTY REGARDING CFPB INTERPRETATIONS OF THE LAW BEFORE SUBJECTING THEM TO ENFORCEMENT ACTIONS			
<ul style="list-style-type: none"> • The CFPB should issue rules or guidance subject to public notice and comment procedures before bringing enforcement actions in areas in which clear guidance is lacking or the CFPB’s position departs from the historical interpretation of the law. 		CFPB Regulation	A, C, E, G
<ul style="list-style-type: none"> • The CFPB should adopt regulations that more clearly delineate its interpretation of the UDAAP standard. The agency should seek monetary sanctions only in cases in which a regulated party had reasonable notice—by virtue of a CFPB regulation, judicial precedent, or FTC precedent—that its conduct was unlawful. The CFPB could implement this reform administratively through issuance of a regulation limiting the application of monetary sanctions to cases that satisfy this notice standard. 		CFPB Supervisory and Regulation	A, C, E, G

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Appendix B • Table of Recommendations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
<ul style="list-style-type: none"> The CFPB should make the requirements for CFPB no-action relief less onerous. The CFPB should align its policies for issuing no-action letters or analogous documents with the more effective policies of the SEC, CFTC, and FTC. To make the CFPB no-action letter policy a more useful tool for the providers and consumers of financial services, the CFPB should adopt the following changes: (a) expand the scope of the policy beyond “new” products; (b) require a consumer benefit, but not a “substantial” consumer benefit; (c) require some regulatory uncertainty to issue a no-action letter, but not “substantial” uncertainty; (d) address a broader number and range of UDAAP questions; and (e) revisit the requirement that applicants be required to share potentially proprietary data with CFPB, which the agency may not be able to adequately safeguard. 		CFPB Supervisory and Regulation	A, F, G
ADOPTING PROCEDURAL REFORMS TO CURB EXCESSES AND ABUSES IN INVESTIGATIONS AND ENFORCEMENT ACTIONS			
<ul style="list-style-type: none"> The CFPB should bring enforcement actions in federal district court rather than use administrative proceedings. To the extent CFPB continues to pursue some enforcement actions through administrative adjudications, it should promulgate a regulation specifying binding criteria that it will use when deciding whether to bring an action in federal court or before an ALJ in the first instance. 		CFPB Supervisory and Regulation	A, F, G
<ul style="list-style-type: none"> The CID process should be reformed to ensure subjects of an investigation receive the benefit of existing statutory protections, backed by judicial review. The CFPB should adopt guidance to ensure that all CIDs comply with the standard set forth by the D.C. Circuit in the <i>ACICS</i> case. In addition, the CFPB should adopt procedures to ensure that review of a CID appeal remains confidential if requested. Congress should amend the Dodd-Frank Act to permit persons who receive a CID to proactively file a motion in federal district court to modify or set aside a CID, rather than limiting recourse to an appeal to the Director. 	Congress	CFPB Supervisory	A, F, G
EXPANDING REGULATORY REVIEW REQUIREMENT			
<ul style="list-style-type: none"> The CFPB should promulgate a regulation committing it to regularly reviewing all regulations that it administers to identify outdated or otherwise unnecessary regulatory requirements imposed on regulated entities. 		CFPB Regulation	A, C, E, G
IMPROVING SAFEGUARDS FOR CONSUMER COMPLAINT DATABASE			
<ul style="list-style-type: none"> The CFPB’s Consumer Complaint Database should be reformed to make the underlying data available only to federal and state agencies, and not to the general public. 	Congress	CFPB Supervisory and Regulation	A, F, G
ELIMINATING CFPB’S DUPLICATIVE AND UNNECESSARY SUPERVISORY AUTHORITY			
<ul style="list-style-type: none"> Congress should repeal the CFPB’s supervisory authority. The responsibility to supervise banks should be entrusted to the prudential regulators. Supervision of nonbanks should be returned to state regulators. 	Congress		A, D, F

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Residential Mortgage Lending

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
MORTGAGE LOAN ORIGINATION			
<ul style="list-style-type: none"> • Adjust and Clarify the ATR Rule and Eliminate the “QM Patch”: The CFPB should engage in a review of the ATR/QM rule and work to align QM requirements with GSE eligibility requirements, ultimately phasing out the QM Patch and subjecting all market participants to the same transparent set of requirements. These requirements should make ample accommodation for compensating factors that should allow a loan to be a QM loan even if one particular criterion is deemed to fall outside the bounds of the existing framework, such as when a borrower has a high DTI ratio with compensating factors. 		CFPB Regulation	A, F
<ul style="list-style-type: none"> • Modify Appendix Q of the ATR Rule: Appendix Q should be simplified and the CFPB should make much clearer, binding guidance for use and application. The CFPB should review Appendix Q standards for determining borrower debt and income levels to mitigate overly prescriptive and rigid requirements. Review of these requirements should be particularly sensitive to considerations for self-employed and non-traditional borrowers. 		CFPB Regulation	A, F
<ul style="list-style-type: none"> • Revise the Points and Fees Cap for QM Loans: The CFPB should increase the \$103,000 loan threshold for application of the 3% points and fees cap, which would encourage additional lending in the form of smaller balance loans. The CFPB should scale points and fees caps in both dollar and percentage terms for loans that fall below the adjusted loan amount threshold for application of the 3% points and fees cap. 		CFPB Regulation	A, F
<ul style="list-style-type: none"> • Increase the Threshold for Making Small Creditor QM Loans: Raising the total asset threshold for making Small Creditor QM loans from the current \$2 billion to a higher asset threshold of between \$5 and \$10 billion is recommended to accommodate loans made and retained by small depository institutions. In order to maintain a level playing field across institution types, an alternative approach to this recommendation would be to undertake a rulemaking to amend the QM rule and related processes for all lenders regardless of type. 		CFPB Regulation	A, F
<ul style="list-style-type: none"> • Clarify and Modify TRID: The CFPB could resolve uncertainty regarding what constitutes a TRID violation through notice and comment rulemaking and/or through the publication of more robust and detailed FAQs in the Federal Register. The CFPB should allow a more streamlined waiver for the mandatory waiting periods, in consultation with all market participants, including both lenders and realtors. The CFPB should allow creditors to cure errors in a loan file within a reasonable period after closing. 		CFPB Regulation	A, F
<ul style="list-style-type: none"> • Improve Flexibility and Accountability of Loan Originator Compensation Rule: The CFPB should improve flexibility and accountability of the Loan Originator Compensation Rule, particularly in those instances where an error is discovered post-closing, in order to facilitate post-closing corrections of non-material errors. The CFPB should establish clear ex ante standards through notice and comment rulemaking, which will clarify its enforcement priorities with respect to the Loan Originator Compensation Rule. 		CFPB Regulation	A, F

Note: each “policy responsibility” above is a preliminary assessment and is not intended to indicate whether other authorities may exist to implement the relevant recommendation.

Appendix B • Table of Recommendations

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
<ul style="list-style-type: none"> • Delay Implementation of HMDA Reporting Requirements: The CFPB should delay the 2018 implementation of the new HMDA requirements until borrower privacy is adequately addressed and the industry is better positioned to implement the new requirements. The new requirements should be examined for utility and cost burden, particularly on smaller lending institutions. Consideration should be given to moving responsibility for HMDA back to bank regulators, discontinuing public use, and revising regulatory applications. 	Congress	CFPB Regulation	F
MORTGAGE LOAN SERVICING			
<ul style="list-style-type: none"> • Place a Moratorium on Additional Mortgage Servicing Rules: The CFPB should place a moratorium on additional rulemaking in mortgage servicing while the industry updates its operations to comply with the existing regulations and transitions from HAMP to alternative loss mitigation options. In addition, the CFPB should work with prudential regulators and state regulators to improve alignment where possible in both regulation and examinations. 		CFPB, FRB, OCC, FDIC, CSBS Regulation	F
PRIVATE SECTOR SECONDARY MARKET ACTIVITIES			
<ul style="list-style-type: none"> • Repeal or Revise Residential Mortgage Risk Retention Requirement: Repeal or substantially revise the residential mortgage risk retention requirement. If the requirement is revised rather than repealed, the legislation should designate one agency from among the six rule-writing agencies to be responsible for the interpretation of the risk retention rule. 	Congress	FRB, FDIC, HUD, FHFA, OCC, SEC Regulation	F
<ul style="list-style-type: none"> • Enhance PLS Investor Protections: Congress should consider legislation providing additional protections for investors in PLS. 	Congress		C
<ul style="list-style-type: none"> • Clarify Limited Assignee Liability for Secondary Market Investors: Secondary market investors, who do not exercise control over the loan origination process, should receive clear, authoritative guidance on their assignee liability under existing rules. 		CFPB Regulation	F
<ul style="list-style-type: none"> • Improve the Alignment of the Regulatory Capital Framework for Structured Mortgage Products: Prudential bank regulators should review the regulatory framework for risk-weighting and stress-testing applicable to securitization in order to better align the framework with the risk of the asset and with international standards for securitized products. 		FRB, OCC, FDIC Regulation	F
<ul style="list-style-type: none"> • Amend Reg AB II: The SEC should amend Reg AB II as it applies to registered securitizations to reduce the number of required reporting fields. 		SEC Regulation	F
<ul style="list-style-type: none"> • Evaluate Impact of Liquidity Rules on the PLS Market: U.S. banking regulators should consider the impact that capital and liquidity rules implementing Basel III standards would have on secondary market activity, and calibrate them to reduce complexity and avoid punitive capital requirements. 		FRB, FDIC, OCC Regulation	F

Note: each “policy responsibility” above is a preliminary assessment and is not intended to indicate whether other authorities may exist to implement the relevant recommendation.

Leveraged Lending

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
<ul style="list-style-type: none"> The banking regulators should re-issue the 2013 leveraged lending guidance for public comment. 		FRB, FDIC, OCC Supervisory	C, F
<ul style="list-style-type: none"> Banks should be encouraged to incorporate a clear but robust set of metrics when underwriting a leveraged loan, instead of solely relying on a 6x leverage ratio discussed in the 2013 leveraged lending guidance. 		FRB, FDIC, OCC Supervisory	D, F

Small Business Lending

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	
<ul style="list-style-type: none"> Simplify, adjust, or change certain financial regulations for financial institutions serving small businesses (as noted elsewhere in this report). 	Congress	FRB, FDIC, OCC Supervisory and Regulation	C, D, F
<ul style="list-style-type: none"> Reduce regulation and reconsider guidance regarding real estate collateral. Regulators should consider alternatives to assessing concentration risk to allow banks engaged in CRE lending to maximize access to credit for small businesses and optimize balance sheet usage while still maintaining safety and soundness. 		FRB, FDIC, OCC Supervisory and Regulation	C, D, F
<ul style="list-style-type: none"> Consider re-calibration of the SLR for lines of credit to small and mid-sized businesses. 		FRB, FDIC, OCC Regulation	C, D, F
<ul style="list-style-type: none"> Repeal the provisions of Section 1071 of Dodd-Frank pertaining to small businesses to ensure that the intended benefits of Section 1071 do not inadvertently reduce the ability of small businesses to access credit at a reasonable cost. 	Congress		C, F

Note: each “policy responsibility” above is a preliminary assessment and is not intended to indicate whether other authorities may exist to implement the relevant recommendation.

Appendix C

Capital and Liquidity



Capital and Liquidity

Introduction

In the wake of the financial crisis, U.S. regulators implemented significant changes to the capital and liquidity regulatory framework for U.S. banking organizations, particularly for the largest, most globally active banks. Higher capital and liquidity standards decrease the likelihood of the insolvency of a bank and the likely loss-given insolvency, and thus help to avoid the need for extraordinary government support or taxpayer assistance.

Capital Regime

DFAST and CCAR stress tests

The Dodd-Frank Act Stress Test and the Comprehensive Capital Analysis and Review are used by the Federal Reserve to determine whether financial institutions subject to these tests have adequate capital to continue to operate through times of economic or financial stress. Though complementary, the two exercises are distinct.

CCAR is an annual supervisory assessment of the capital adequacy of the largest consolidated BHCs and their plans to distribute capital, primarily through dividend payments and stock repurchases. CCAR currently applies to the 34 largest U.S. BHCs (i.e., those with more than \$50 billion in assets). The CCAR exercise includes both (i) a quantitative “stress test” that evaluates a BHC’s capital levels over a nine-quarter, forward-looking horizon under three sets of assumptions of economic and financial stress ranging from a baseline set of assumptions to severely adverse assumptions; and (ii) a qualitative assessment of a BHC’s capital planning abilities. The Federal Reserve uses CCAR to review and approve a BHC’s capital plan, including planned distributions to shareholders (e.g., dividend payments or stock repurchases).¹ As of the 2017 CCAR cycle, the qualitative assessment no longer applies to 21 BHCs that have less complex operations.² These institutions, those with less than \$250 billion in assets and less than \$75 billion in nonbank assets, will now be subject to a horizontal capital review (HCR). Unlike with the qualitative assessment of CCAR, the HCR outcome is not a factor in the Federal Reserve’s approval of capital plans. Instead, matters arising from the HCR are reviewed as part of the normal supervisory process, with findings or concerns addressed through supervisory communications.

DFAST is a forward-looking exercise conducted by both the Federal Reserve and financial companies (i.e., company-run) to determine whether they have sufficient capital to absorb losses and support operations during adverse economic conditions.

The DFAST company-run stress tests apply to BHCs with more than \$10 billion in assets. The DFAST also is required of all financial companies that have assets greater than \$10 billion and are regulated by a primary financial regulatory agency. As a result, the OCC and FDIC also have a role

1. 12 C.F.R. § 225.8.

2. 82 Fed. Reg. 9308 (Mar. 6, 2017) (exempting 21 firms with less complex operations from complying with the qualitative requirements of CCAR), available at: www.federalreserve.gov/newsevents/pressreleases/bcreg20170130a.htm.

in issuing guidance and examining the company-run DFAST stress tests that are required of banks and savings associations of which they are the primary prudential regulator.

The Federal Reserve conducts the DFAST supervisory-run stress tests, which are required for BHCs with assets of \$50 billion or more. The quantitative methodologies, data, and processes used in the supervisory-run DFAST and CCAR are largely the same. However, in conducting the supervisory-run DFAST, each BHC and the Federal Reserve must assume capital distributions (e.g., dividends, stock buybacks) that are consistent with a BHC's prior capital distributions, which differ from the CCAR incorporation of a BHC's forward-looking capital plans.³

Supplementary Leverage Ratio (SLR) and Enhanced Supplementary Leverage Ratio (eSLR)

The Basel III capital standards that become effective in 2018 include a leverage ratio. The U.S. has implemented this Basel standard under the supplementary leverage ratio framework, which requires advanced approaches firms to hold a minimum SLR of 3%, calculated with a numerator of Tier 1 Capital and denominator of on-balance sheet assets and off-balance sheet exposures. This is referred to as a “supplementary” leverage ratio because U.S. banking regulators have long required U.S. banks to meet a U.S. leverage ratio, calculated with a numerator of Tier 1 Capital and a denominator of total on-balance sheet assets (reported on a GAAP basis).

In addition, U.S. G-SIBs and their insured depository institution subsidiaries are subject to an enhanced supplementary leverage ratio rule that also becomes effective in 2018.⁴ BHCs subject to the eSLR must maintain a leverage capital buffer greater than 2 percentage points above the minimum SLR requirement of 3%, for a total of more than 5%, to avoid restrictions on capital distributions and discretionary bonus payments. Insured depository institution subsidiaries of these BHCs must maintain at least a 6% SLR to be considered “well capitalized” under regulatory prompt corrective action frameworks.

Leverage capital requirements are not intended to adjust for real or perceived differences in the risk profile of different types of exposures. The Federal Reserve, OCC, and FDIC adopted the SLR and eSLR recognizing that the systemic impact of distress or failure of a global systemically important bank is in part a product of the volume of the firm's activities. As such, the leverage ratio requirements complement the risk-based capital requirements that are based on the composition of a firm's exposures.

Global Systemically Important Bank Surcharges: U.S. Methodology

In 2015, the Federal Reserve adopted a final rule establishing U.S. global systemically important bank capital surcharges for the eight U.S. BHCs qualifying as G-SIBs under the Federal Reserve's rule. The U.S. rule requires these G-SIBs to hold additional capital to account for the higher risk profile of these firms. The final rule resulted in estimated risk-based capital requirements that are higher than what would be required under the internationally-applicable Basel III surcharge

3. 12 C.F.R. Part 252, Subparts B, E, and F (Federal Reserve).

4. When issued, these standards applied to BHCs with more than \$700 billion in total consolidated assets or more than \$10 trillion in assets under custody and insured depository institution subsidiaries of the BHCs. When the Federal Reserve issued the G-SIB surcharge rule, it amended the eSLR standards to apply to G-SIBs and insured depository institution subsidiaries of G-SIBs.

methodology. The G-SIB capital surcharges are being phased in over a three-year period that began on January 1, 2016, and become fully effective on January 1, 2019.

The final U.S. rule requires G-SIBs to calculate their capital surcharges under two methods and use the higher of the two. The first is based on the Basel Committee’s assessment methodology, which considers a firm’s size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity (method 1). The second uses similar inputs, but is generally calibrated to result in a higher capital requirement, and replaces the substitutability category with a measure of the firm’s reliance on short-term wholesale funding (method 2).⁵ While as many as 30 or more U.S. BHCs are required to calculate a G-SIB score each year, only eight currently meet the qualifying score of 130 or more to be considered a U.S. G-SIB subject to the Federal Reserve’s G-SIB surcharge. Moreover, there is a clear separation in scores between the top eight G-SIBs and the remaining BHCs. The U.S. G-SIB risk-based capital surcharge was designed to have U.S. G-SIBs internalize the systemic costs of their activities in different ways, with the risk-based surcharge focusing on the type of activities and the leverage ratio focusing on their volume.

Total Loss-Absorbing Capacity

In December 2016, the Federal Reserve issued a final rule requiring that the eight U.S. G-SIBs and the U.S. operations of foreign G-SIBs meet a new long-term debt requirement and a new “total loss-absorbing capacity,” or TLAC, requirement. The Federal Reserve’s final rule is largely consistent with the international FSB TLAC standard. The Federal Reserve TLAC and long-term debt requirements, like the FSB TLAC standard, are designed to increase the loss-absorbing capacity of G-SIBs and reduce the systemic impact of the failure of a G-SIB. TLAC is defined as the sum of Tier 1 capital (other than minority interests) and the unpaid principal of eligible debt securities (which are subject to haircuts for amounts due to be paid within 2 years).

The Federal Reserve’s rule requires that covered institutions hold TLAC in an amount that is the greater of (1) 18% of risk-weighted assets plus certain buffers and (2) 7.5% of total leverage exposure (as defined in the Federal Reserve’s Basel III capital rule), plus a 2% buffer. In addition to the TLAC ratio, the rule requires that covered institutions issue eligible long-term debt in an amount that is the greater of (1) 6% of risk-weighted assets plus the G-SIB surcharge and/or (2) 4.5% of total leverage exposure (as defined in the Fed’s Basel III capital rule). Eligible long-term debt includes the unpaid principal of eligible debt securities, subject to haircuts for amounts due to be paid within 2 years. Compliance with the rule is required by June 1, 2019.⁶

The U.S. TLAC and long-term debt requirement differs from the FSB standard in that it (1) requires a higher minimum amount of long-term debt and (2) sets stricter criteria for such long-term debt. The Federal Reserve’s rationale for requiring long-term debt is that it can be used to help recapitalize the BHC’s operating subsidiaries in a resolution.

5. Press Release, Federal Reserve Board, Federal Reserve Board approves final rule requiring the largest, most systemically important U.S. bank holding companies to further strengthen their capital positions (July 20, 2015), available at: www.federalreserve.gov/newsevents/pressreleases/bcreg20150720a.htm.

6. 12 C.F.R. part 252, subpart G.

Basel III Risk-Based Capital

On July 2, 2013, the Federal Reserve issued a final rule implementing the U.S. Basel III regulatory reforms and certain changes required by Dodd-Frank.⁷ The U.S. adopted three final rules at this time: rules implementing Basel III capital standards and revisions to the standardized approaches (regulator-determined method of calculating risk-weighted assets) and advanced approaches (internal models based method of calculating risk-weighted assets) rules for risk-weighting of certain assets when calculating capital.

The U.S. rules implementing Basel III standards raised the quality and quantity of capital required of banking organizations in the United States. The provisions require banking organizations to hold more common equity tier 1 capital relative to risk-weighted assets, limit the qualifying instruments that can be included in additional tier 1 capital, and increase the deduction of certain assets (e.g., mortgage servicing assets) when calculating capital.

The revisions to the standardized approach rule generally increased the risk-weighting of certain assets (the denominator of the risk-based capital rule) to address asset exposures that created problems in the financial crisis (e.g., securitizations, commercial real estate) and improved the consistency and risk sensitivity of the capital rules.

The revisions to the advanced approaches rule apply to less than twenty internationally-active banks (i.e., those with assets of at least \$250 billion or on-balance sheet foreign exposures of at least \$10 billion) in the U.S. that use internal models to set risk weights.

Section 171 of Dodd-Frank, often referred to as the Collins Amendment, requires all banking organizations and nonbank financial companies designated by the FSOC to satisfy the “generally applicable” risk based and leverage capital requirements applicable to banking organizations of all sizes. In practical effect, this means that large banking organizations subject to the advanced approaches rule and relying on internal models must calculate their risk-based capital ratios and meet regulatory minimum capital requirements under the higher of requirements calculated using: (1) risk weighted assets as calculated under Advanced Approaches (models) and (2) risk weighted assets under Standardized Approaches (regulator determined).

Countercyclical Capital Buffer

The countercyclical capital buffer (CCyB) is a risk-based capital buffer that applies to internationally-active banks included in the revised capital rules the U.S. banking regulators adopted in 2013. The CCyB provides for an increase in such banks’ risk-based capital requirements by as much as 2.5% of risk-weighted assets when the risk of above-normal losses is elevated, as determined by the Federal Reserve. In September 2016, the Federal Reserve finalized a policy statement that detailed the framework it would use to determine the amount of the CCyB, which is currently set at zero.⁸ The Federal Reserve said it expects that it will activate the CCyB gradually when systemic

7. Press Release, Federal Reserve Board, Federal Reserve Board approves final rule to help ensure banks maintain strong capital positions (July 2, 2013), available at: www.federalreserve.gov/newsevents/pressreleases/bcreg20130702a.htm.

8. 12 C.F.R. § 217.

vulnerabilities are meaningfully above normal and will remove or reduce the CCyB when conditions abate or lessen and such action would support financial stability.⁹

Operational Risk Capital

Operational risk describes the potential for losses from inadequate or failed internal processes, people and systems, including legal risks, and from external events.¹⁰ The current Basel standard sets out three different approaches for institutions to calculate their required capital for operational risk.¹¹ These include a basic indicator approach based on a firm's gross income; a standardized approach based on the business units of a firm; and an "advanced measurement approach" which allows for the use of internal models subject to supervisory approval. In 2007, the U.S. banking regulators adopted only the advanced measurement approach for application to banks that utilize the advanced approaches.¹²

Because of the nature of modeling events that are rare and uncertain, the current advanced measurement approach can lead to excessive variability, and therefore is being revisited by the Basel Committee. On March 4, 2016, the Basel Committee released for comment a paper recommending that the advanced measurement approach be removed from the regulatory framework and be replaced with a non-model-based estimation of operational risk capital needs.¹³ The comment period for this revision ended June 3, 2016, and a final standard has not been issued.

Fundamental Review of the Trading Book (FRTB)

After six years of work to improve market-risk-modeling practices and eliminate inconsistencies in the measurement of trading risk capital, the Basel Committee finalized the FRTB standard in 2016. The FRTB is comprised of two components: (i) a new standardized approach for measuring trading book capital requirements for banks' trading activities, which would serve as a credible fallback to internal models and (ii) new standards to strengthen internal modeling practices. Based upon a Basel Committee study, the final FRTB results in a trading book minimum capital requirement that may be as much as 40% higher than the current capital requirements for such trading book exposures on a weighted-average basis and 22% higher for the median bank (about two dozen U.S. banks are subject to the trading book standard).¹⁴

Current Expected Credit Losses (CECL)

The Financial Accounting Standards Board (FASB) has finalized new accounting standards that will substantially affect how banks reserve for credit losses. FASB replaced the current accounting

9. 12 C.F.R. § 217, App. A §4.

10. 12 C.F.R. §3.101(b).

11. Basel Committee on Banking Supervision. Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework. Nov. 2005. available at: <http://www.bis.org/publ/bcbs107b.pdf>

12. Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II, 72 Fed. Reg. 69287 (Dec. 7, 2007).

13. Basel Committee on Banking Supervision. Standardised Measurement Approach for operational risk - consultative document. Mar. 2016, available at: <http://www.bis.org/bcbs/publ/d355.htm>.

14. Basel Committee on Banking Supervision. Fundamental review of the trading book – interim impact analysis. Nov. 2015, available at: <http://www.bis.org/bcbs/publ/d346.htm>.

model for bank loans known as the “incurred loss model,” which recognizes losses only generally as they are incurred, with an alternative “current expected credit loss model,” or CECL. This model aims to recognize expected lifetime losses upon the underwriting or purchase of loans. FASB’s old incurred loss model was criticized during the crisis as being pro-cyclical and leading banks to understate losses in good times and overstate them in bad times. The new CECL standard is set to become effective in 2020 for SEC-registered banks and 2021 for all other banks.

Liquidity Regime

Liquidity Coverage Ratio

The FDIC, OCC, and Federal Reserve jointly issued a final Liquidity Coverage Ratio rule in September 2014 that was designed to strengthen the ability of U.S. banking organizations to withstand short-term liquidity stress. The final rule, which constituted the U.S. adoption of the international Basel III liquidity standard, requires firms to hold high-quality liquid assets to cover net cash outflows over a 30-day stressed scenario. There are three categories of such high-quality liquid assets defined by regulators: Level 1, which is the most liquid and includes assets such as U.S. Treasury securities, central bank reserves, certain debt issued by foreign entities that meets certain requirements and cash; Level 2A, which includes assets such as agency MBS and securities or foreign entity debt not included in Level 1; and Level 2B, which includes certain qualifying corporate equity and debt. Banks with \$250 billion or more in assets or \$10 billion or more of on balance sheet foreign exposure and their depository institution subsidiaries with \$10 billion or more in assets are subject to the final LCR rule, while bank holding companies with assets in excess of \$50 billion are subject to a modified, less stringent version of the rule.¹⁵

U.S. banks have generally met the LCR through a combination of increasing the amount of high quality liquid assets held (e.g., by adding cash or U.S. Treasury securities) or changing their funding mix (e.g., by extending their funding maturities, which would reduce the amount of cash needed to withstand a 30-day stress scenario).

Net Stable Funding Ratio

In October 2014, the Basel Committee finalized another key liquidity standard, the Net Stable Funding Ratio. In 2016 the FDIC, OCC, and Federal Reserve proposed a U.S. rule implementing the international standard. The objective of the NSFR is to mitigate the potential effects of a firm’s loss of funding and create strong incentives for a firm to lengthen the maturity of its funding sources. The proposed U.S. NSFR is tailored to the size of the organization, with more stringent requirements for holding companies with \$250 billion or more in assets or \$10 billion or more in foreign exposure and their depository institution subsidiaries with \$10 billion or more in assets, and less stringent requirements for holding companies with less than \$250 billion in assets and less than \$10 billion in total on-balance sheet foreign exposure but in excess of \$50 billion in assets. As proposed, the rule does not apply to institutions with less than \$50 billion in assets. The proposed U.S. NSFR would require covered institutions to maintain a sufficient level of “available stable funding” (e.g., regulatory capital and long-term debt) to meet their “required stable funding”

15. 12 C.F.R. part 249.

(based on a calculation that accounts for its mix of assets, derivative exposures, and lending commitments) over a one-year time horizon. Less liquid positions (e.g., exposures with weaker credit quality and/or shorter maturities, and derivatives generally) would require greater accompanying levels of stable funding than more liquid positions such as cash and U.S. Treasury holdings.¹⁶

Comprehensive Liquidity Assessment Review (CLAR) and Internal Liquidity Stress Testing

In 2012 the Federal Reserve launched the Comprehensive Liquidity Assessment and Review process for firms in the Large Institution Supervision Coordinating Committee (LISCC) portfolio.¹⁷ Like CCAR, CLAR is an annual horizontal forward-looking assessment, with quantitative and qualitative elements, overseen by a multidisciplinary committee of liquidity experts from across the Federal Reserve System.¹⁸ This team assesses the adequacy of LISCC portfolio firms' liquidity positions relative to each company's unique risks and tests the reliability of each firm's approach to managing liquidity risk. Unlike CCAR, CLAR does not include a specific quantitative post-stress minimum.

In addition, as part of the enhanced prudential standards framework, U.S. BHCs that have in excess of \$50 billion in assets and FBOs that have over \$50 billion in U.S. assets are subject to internal liquidity stress testing and liquidity buffer requirements.¹⁹

Single-Counterparty Credit Limits

In March 2016, the Federal Reserve, as required by section 165 of Dodd-Frank, proposed a single-counterparty credit limit rule to address risks associated with excessive credit exposures of banking organizations to a single counterparty.²⁰ The rule would apply to bank holding companies with assets of \$50 billion or more, and the rule's credit limits increase in stringency with a firm's systemic importance. For internationally active banks (i.e., those with \$250 billion or more in assets or \$10 billion or more in on balance sheet foreign exposure), the proposal would limit aggregate net credit exposure to a single-counterparty and its subsidiaries on a consolidated basis to 25% of a bank's tier 1 capital. G-SIBs would also be subject to a limit of 15% of tier 1 capital if the counterparty is another systemically important financial institution. Non-internationally active banks with \$50 billion or more in total assets would be subject to a 25% limit against the bank's regulatory capital, which is a larger measure than tier 1 capital. The proposed rule is similar to the Basel Committee's large exposure standard.

16. Proposed Rule: Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed. Reg. 35123 (June 1, 2016).

17. OFR, Financial Stability Report (Dec, 2015) at 98, available at: https://www.financialresearch.gov/financial-stability-reports/files/OFR_2015-Financial-Stability-Report_12-15-2015.pdf. The current list of the firms in the LISCC portfolio is provided at: www.federalreserve.gov/bankinfo/reg/large-institution-supervision.htm.

18. Id.

19. 12 CFR §§ 252.35, 252.157.

20. Proposed Rule: Single-Counterparty Credit Limits for Large Banking Organizations, 81 Fed. Reg. 14328 (Mar. 16, 2016).

