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# Regulatory Rollback or Rightsizing?

*A review of regulatory developments*

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# Agenda

- During today's webcast we will discuss:
  - The current approach to regulatory rollback
  - Banking agency proposals
  - Proposed amendments to the Volcker Rule
  - Changes to the designation of entities subject to the enhanced prudential supervision provisions and other elements of the Crapo Act
  - Securities law provisions of the Crapo Act

# Administration Priorities & the Road to Reg Reform . . .

- February 2017 – Administration's "Core Principles" for Financial Regulation
- June 2017 – Treasury Report, Banks and Credit Unions
  - Improve capital and liquidity regulation by raising threshold for Dodd-Frank enhanced prudential standards and better tailoring regulations to a bank's complexity and risk
  - Improve regulatory engagement model and more appropriately define the role and responsibility of bank boards for regulatory oversight and governance
  - Encourage foreign bank investment and participation in the US financial markets
  - Improve the Volcker Rule, including reducing burden on smaller institutions and those with limited trading activities
  - Reduce regulatory burden for community banks

# The Road to Reg Reform . . .

- Many of the changes that we will discuss today emanate from the banking agencies rather than from legislation
  - Change in leadership at the banking agencies
  - Change in personnel
  - Difficulties associated with reaching consensus for legislative changes

# BANKING AGENCY ACTIONS

# Enhanced Supplementary Leverage Ratio

- In an April 2018 joint NPR, the OCC and the Fed proposed changes to the enhanced supplementary leverage ratio (eSLR) applicable to US G-SIBs
- Currently, US G-SIBs are subject to the supplementary leverage ratio (SLR) that requires advanced approaches by banking organizations to maintain a Tier 1 capital to total leverage exposure ratio of at least 3%. In addition to the 3%, US G-SIBs must maintain a 2% leverage buffer under the eSLR
- The proposal would change the 2% leverage buffer to 50% of the G-SIB's risk-based capital surcharge under the G-SIB surcharge rule

# Enhanced Supplementary Leverage Ratio, *cont'd*

- US G-SIB subsidiary insured depository institutions (IDIs) that are currently subject to the eSLR must maintain an SLR of at least 6% in order to qualify as "well capitalized"
- The proposal would change this requirement and replace it with an SLR threshold equal to 3% plus 50% of the risk-based G-SIB surcharge applicable to the parent G-SIB BHC

# TLAC

- The eSLR changes would impact the TLAC requirements
  - There are two separate external TLAC buffers, the TLAC leverage buffer and the TLAC RWA buffer
  - The NPR proposes that the current TLAC leverage buffer, which requires a US G-SIB to maintain a buffer of at least 2% of its total leverage exposure in addition to satisfying the 7.5% leverage-based TLAC requirement, would be replaced with a buffer equal to 50% of the US G-SIB's risk-based G-SIB surcharge
- Under the current rule, a US G-SIB is required to maintain eligible long-term debt (eLTD) of 4.5% of total leverage exposure

# TLAC, *cont'd*

- The 4.5% requirement was calculated by subtracting a 0.5% balance sheet depletion allowance from the 5% amount required to satisfy the eSLR
- With eSLR changing, now the leverage-based eLTD requirement would change to 2.5% (3% minus the 0.5% allowance for balance sheet depletion) plus 50% of the US G-SIB's risk-based G-SIB surcharge
- The proposal also would make technical changes in the calculation of eLTD so that the eLTD is calculated in a consistent manner for all TLAC requirements
- The proposal clarifies that newly covered IHCs have three years to conform to the TLAC requirements

# Stress Capital Buffer

- The Fed proposed in April an “integrated” capital requirement, which is called a stress capital buffer (SCB) and a new Tier 1 leverage buffer
- Applicable to the 39 CCAR firms
- The fixed capital conservation buffer of 2.5% would be replaced with an SCB.  The SCB would be tailored annually based on an institution’s projected losses under the CCAR severely adverse stress scenario subject to a 2.5% floor

# Stress Capital Buffer, *cont'd*

- The SCB would be recalibrated as an add-on to an institution's minimum required standardized approach risk-based capital ratios and would include: the maximum projected decline in its CET1 capital ratio under the DFAST severely adverse stress scenario and its planned common stock dividends for the fourth through seventh quarters of the nine-quarter CCAR plan (as a percentage of projected risk-weighted assets for such quarters)
- The SCB would be incorporated into a standardized capital conservation buffer (SCCB) that would be the aggregate of:
  - the SCB
  - any countercyclical capital buffer
  - the greater of the G-SIB surcharge under method 1 and method 2

# Stress Capital Buffer, *cont'd*

- If an institution's SCCB level falls below the minimum CET1 risk-based, Tier 1 risk-based and total risk-based minimum capital requirements, it would be subject to restrictions on discretionary payments
- The proposal also introduces a stress leverage buffer (SLB) that would be recalibrated annually as an add-on to the minimum required Tier 1 leverage ratio and that would be equal to:
  - the maximum projected decline in the institution's Tier 1 leverage ratio under the DFAST severely adverse scenario, and
  - its planned common stock dividends for the fourth through the seventh quarters of the nine-quarter CCAR planning horizon (expressed as a percentage of the firm's projected leverage ratio denominator (average balance sheet assets) for such quarters)

# Stress Capital Buffer, *cont'd*

- CCAR banks would be required to maintain the SLB above their 4% minimum Tier 1 leverage requirement or be subject to limitations on discretionary payments

# THE VOLCKER RULE

# Introduction

- The five Agencies have developed a common proposal to amend the regulations
- Between May 30 and June 5, the Agencies each acted to approve the release of the proposal
- The proposed regulation was published in the Federal Register on July 17, and the public comment period will end on September 17, 2018

# Objectives of the Agencies

- Clarify the requirements of the regulation
- Adopt a more risk-based approach
- Make the regulation more “efficient” and thereby reduce the regulatory burden
- Reflect experience gained with the existing regulation
- Tailor compliance burden to the size and complexity of trading operations
- In addition to specific revisions in the proposal, seek public comment on a wide variety of other potential changes
  - Top to bottom review
  - More than 330 multipart questions

# Categorization of Banking Entities for Compliance Purposes

- "Significant trading assets and liabilities"— consolidated gross trading assets and liabilities of at least $10 billion (excluding US government and agency obligations)
  - Foreign banking organizations (FBOs) make this determination on the basis of assets and liabilities of their combined US operations
- "Limited trading assets and liabilities" — consolidated trading assets and liabilities of less than $1 billion (excluding US governments and agencies)
  - FBOs make this determination on the basis of global assets and liabilities
- "Moderate trading assets and liabilities" — falling between significant and limited categories

# Compliance Programs

- Eliminate the enhanced minimum standards for compliance programs
- Banking entities with significant trading assets would be subject to a comprehensive compliance program requirement including CEO attestation and metrics reporting and recordkeeping
- Banking entities with moderate trading assets would be subject to a simplified compliance program requirement but also the CEO attestation
- Banking entities with limited trading assets would have a presumption of compliance subject to regulator authority to impose a compliance program if the banking entity engages in prohibited activities

# Proprietary Trading – Key Proposals

- Revised definition of "trading account" used for determining what is prop trading
- Trading desk presumption of compliance
- Broadened exclusion from prop trading for liquidity management activities
- New exclusion from prop trading for correcting trading errors
- Liberalized exemptions for underwriting, market making, hedging and prop trading outside the United States

# Proprietary Trading – Trading Account Definition

- Eliminate the short term intent prong but keep the market risk capital and "dealer" prongs
  - Add an "accounting prong" — any account used to purchase or sell a financial instrument that is recorded at fair value on a recurring basis under GAAP or other appropriate accounting standards
  - Add a prong for the purchase or sale of financial instruments by non-US banking entities that are subject to capital requirements under a non-US market risk framework implementing the Basel Committee on Banking Supervision's market risk framework
- Eliminate the 60-day rebuttable presumption

# Proprietary Trading – Trading Desk Presumption of Compliance

- An individual trading desk would have a presumption of compliance if the absolute values of the daily net gain and loss figures for the preceding 90-day calendar period do not exceed $25 million
- If the activity exceeds the threshold, the banking entity must demonstrate that the trading desk is in compliance
- This presumption is only available for trading desks operating under the accounting prong definition, not those operating under the market risk capital or dealer prongs

# Proprietary Trading – Liquidity Management Exclusion

- The current liquidity management exclusion is only available with respect to trading securities for liquidity management purposes
- The proposal would permit certain other financial instruments to be traded under this exclusion for liquidity management purposes:
  - Foreign exchange forwards
  - Foreign exchange swaps
  - Physically settled cross-currency swaps

# Proprietary Trading – Exclusion for Errors

- For purchases or sales of financial instruments that were made in error while the banking entity was engaged in a permitted or excluded activity (such as agency, custodial or other activities) or are necessary in order to correct such an error
- To monitor the use of this exclusion, purchases would have to be transferred to a separately managed trade error account for disposition by personnel independent of the traders who made the error

# Proprietary Trading – Reservation of Authority

- The Agency would have the authority to determine on a case-by-case basis that the purchase or sale of a financial instrument was done for the trading account despite the apparent availability of an exclusion, etc.
- The Agency would be required to give notice to the banking entity that would have an opportunity to provide a response before a final determination was made

# Proprietary Trading – Changes to the Underwriting and Market Making Exemptions

- The proposal would simplify the RENTD requirement (positions under these exemptions cannot exceed the "reasonably expected near term demands" of clients, customers and counterparties)
- The proposal would provide a presumption that the trading desk is in compliance with RENTD if the banking entity maintains and enforces internal risk limits for each trading desk
- The proposal would establish specific elements to be addressed in the internal risk limits
- Banking entities in the "significant trading" category would be required to have a specific compliance program for these exemptions under subpart D
  - The "moderate" category would have to adopt the internal limits but without a specific compliance program under subpart D

# Proprietary Trading –Required Internal Risk Limits

- Underwriting
  - amount, types, and risk of its underwriting positions
  - level of exposures to relevant risk factors arising from its underwriting positions
  - period of time a security may be held
- Market making
  - amount, types, and risk of its market making positions
  - amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes
  - level of exposures to relevant risk factors arising from its financial exposure
  - period of time a financial instrument may be held

# Proprietary Trading – Status of Loan-Related Swaps

- Request comment on whether loan-related swaps should rely on the market making exemption or if the agencies should consider establishing a new exclusion or exemption for loan-related swaps
- Such swaps would be covered by the new accounting prong because derivatives transactions would be recorded at fair value on a recurring basis under applicable accounting standards

# Proprietary Trading – Risk Mitigating Hedging

- Eliminate the requirement to show that a hedge demonstrably reduces or significantly mitigates an identifiable risk
- Eliminate the correlation requirement
- Only banking entities in the significant trading category will be required to have a specific compliance program for this exemption under subpart D
- Certain documentation requirements in the existing regulation will be eliminated

# Proprietary Trading – Amendments to TOTUS

- Eliminate the requirement that the purchase or sale not be conducted with or through a US entity
- Eliminate the requirement that US personnel not be involved in arranging, negotiating or executing trades
- Eliminate the requirement that no financing for the non-US banking entity’s purchase or sale be provided by any US branch or US affiliate
- Retain the requirements that the personnel engaged in making the decision to do the trade be located outside the United States and that the trade be booked outside the United States

# Proprietary Trading – Modifying the Metrics

- Limit certain metrics requirements to the market making and underwriting desks
- Replace various existing metrics with new more precise requirements
- Require qualitative information concerning the types of trading activities and the legal entities holding the trades, descriptive information concerning the reported metrics and a narrative statement describing changes in trading desk operations
- Eliminate duplicative and unnecessary requirements

# Treatment of Controlled Funds as Banking Entities

- The Volcker Rule excludes covered funds from the definition of banking entity
- A major issue with the implementation of the Volcker Rule has been the potential treatment of controlled foreign excluded and other non-covered funds as banking entities
- The Agencies requested comment on these issues but did not propose any specific changes in the regulations at this time
- The current one year exemption of qualifying foreign excluded funds from the definition of banking entity is being extended to July 21, 2019

# Proposed Amendment to Covered Fund Rules – Risk-Mitigating Hedging Exemption

- Amendment intended to facilitate banking entities' ability to offer clients fund-linked note products where the reference fund is a covered fund
- Proposal would expand the hedging exemption to permit a banking entity to acquire an ownership interest in a covered fund as a hedge when acting as an intermediary on behalf of a client to provide the client with exposure to the profits and losses of the covered fund
  - Only available with respect to a client that is not itself a banking entity

# Proposed Amendment to Covered Fund Rules – SOTUS Exemption

- Proposal would make two minor changes to the exemption for covered fund investments solely outside the United States ("SOTUS")
  - Eliminate from the SOTUS exemption the requirement that no financing for the banking entity's purchase or sale of a covered fund ownership interest is provided by any US branch or affiliate of the banking entity
  - Incorporate (without change) the Agencies' February 2015 FAQ guidance regarding the scope and content of the US marketing restriction into the regulation
    - SOTUS only available for a covered fund with respect to which no foreign bank entity participates in an offer or sale to US persons
    - Organizing and offering a covered fund or acting as investment adviser or manager constitutes participation in any US marketing that occurs

# Proposed Amendment to Covered Fund Rules – Underwriting and Market-Making Exemptions

- Proposal would amend covered fund rules so that ownership interests in a third-party covered fund acquired/held in an underwriting or market-making capacity would not count toward a banking entity's 3% aggregate covered fund limit and would not be subject to the regulation's capital deduction requirement
  - Underwriting and dealing entities can more efficiently underwrite /distribute and make markets in securities issued by third-party covered funds

# Extensive Requests for Industry Comment on Covered Fund Rules

- No specific proposal to amend the definition of covered fund or any exclusions; no proposal to amend Super 23A prohibition
  - Comments requested on a broad range of questions concerning the definitions of covered fund, including the consequences of adopting "characteristics-based" definitions of private equity funds and hedge funds
  - Comments also requested on the scope of the existing exclusions from the definition of covered fund, in particular with respect to foreign public funds, securitizations, and joint ventures
  - Proposal also requests comment on fund vehicles not specifically addressed in the current exclusions, including family wealth management vehicles, certain small business investment companies, and municipal tender option bond vehicles
  - Request comment on whether to add the exemptions in section 23A of the Federal Reserve Act and Regulation W into Super 23A provision

# THE CRAPO ACT

# Financial Reform Legislation

- Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Crapo Act”)
  - Recalibration and tailoring of thresholds for Enhanced Prudential Standards
  - Stress testing, capital and liquidity reforms
  - Limited Volcker Rule reforms
  - Community bank relief

# Crapo Act: Recalibration & Tailoring of EPS Thresholds

- The Act amends Section 165 of the Dodd-Frank Act to recalibrate the application of Enhanced Prudential Standards to US BHCs
  - Increases general threshold for application of EPS from $50 billion to $250 billion in total consolidated assets
    - FRB retains discretion to apply EPS on a case-by-case basis to BHCs with $100 billion to $250 billion in total consolidated assets
  - Increases thresholds for company-run and supervisory stress tests from $10 billion and $50 billion in total consolidated assets, respectively, to $250 billion
  - Increases threshold for risk committee from $10 billion to $50 billion

# Crapo Act: Recalibration & Tailoring of EPS Thresholds, *cont'd*

- Implementation and Knock-On Effects of the Act
  - Foreign Banking Organizations
    - The Act does not affect application of current Enhanced Prudential Standards regulations, including the IHC requirement, to FBOs with more than $100 billion in global total consolidated assets
    - Implementation of revised thresholds as applied to FBOs yet to be determined
  - Impact on Non-EPS Regulations
    - Applicability of CCAR
    - FDIC resolution plan requirement for IDIs with $50 billion in assets

# Crapo Act: Limited Volcker Rule Reforms

- Community Bank Exemption
  - Applies to banking groups with (i) $10 billion or less in total consolidated assets and (ii) total trading assets and trading liabilities that are five percent or less of their total consolidated assets
- Asset Management Exemption Name-Sharing Relief
  - Restriction under the Volcker Rule asset management exemption will no longer apply to a covered fund that shares a name or variation of a name with an investment adviser if that investment adviser: (i) is not an IDI, a parent of an IDI or a FBO; (ii) does not share a name or variation of a name with an IDI, a parent of an IDI or an FBO; and (iii) does not have the word "bank" in its name
  - Query the practical impact on banking entities that have already invested in and completed re-branding efforts to accommodate prior restrictions

# Crapo Act: Community Bank Relief

- IDIs and holding companies with less than $10 billion in assets
  - Community Bank Leverage Ratio
    - Banks and BHCs with less than $10 billion in total consolidated assets that maintain a community bank leverage ratio of $\left[\frac{\text{tangible equity capital}}{\text{average total consolidated assets}}\right]$ at least 8%–10% are no longer subject to Basel III US risk-based capital rules and leverage ratio requirements
    - Banking agencies retain discretion to disqualify entities from this relief based on their risk profiles
  - Volcker Rule exemption
- Federal savings associations with less than $20 billion in assets
  - "Opt in" to national bank rules
- Expansion of Small Bank Holding Company Policy Statement from $1 billion BHCs/SLHCs to $3 billion BHCs/SLHCs

# Supplementary Leverage Ratio

- Federal agencies must amend the Supplementary Leverage Ratio $\left[\frac{\text{Tier 1 Capital}}{\text{Total Leverage Exposure}}\right]$ to exclude from the SLR denominator funds on deposit with certain central banks for BHCs and their subsidiaries that are primarily in the custody business
- Amounts in excess of the total value of deposits of the custodial bank that are linked to custodial accounts will be taken into account for the SLR denominator
- This change for custody banks will cause the US SLR to deviate from the Basel leverage framework

# Liquidity Coverage Ratio

- The liquidity coverage ratio would be required to be amended by banking agencies to permit municipal bonds that are liquid, readily marketable and investment grade to be treated as Level 2B high-quality liquid assets (HQLAs)
- Level 2B HQLAs are subject to a 50% haircut on their fair value and Level 2B HQLAs are capped at 15% of total HQLAs
- The Federal Reserve already had taken action on municipal bonds in 2016, but the OCC and the FDIC had not done so

# SECURITIES-RELATED PROVISIONS

# Encouraging Employee Ownership

- Rule 701 under the Securities Act provides an exemption from the registration requirements of the Securities Act for securities issued in compensatory circumstances to specified investors by companies that are not subject to the reporting requirements under the Exchange Act
- Currently, Rule 701(e) requires that if the aggregate sales price or amount of securities sold in a consecutive 12-month period exceeds $5 million, the company must deliver specified disclosures to investors within a reasonable period of time before the date of sale
- Section 507 of the Crapo Act requires that the SEC increase the threshold from $5 million to $10 million for the maximum amount of securities that can be sold in a 12-month period under Rule 701 without triggering the additional disclosure requirements
- Section 507 also requires that the SEC index this amount every five years to reflect changes to the Consumer Price Index for All Urban Consumers, rounding to the nearest million
- The SEC is to amend Rule 701(e) by July 23, 2018

# Improving Access to Capital

- Regulation A under the Securities Act provides an exemption from the Securities Act registration requirements in connection with companies raising capital in securities offerings of up to $50 million in a 12-month period, provided that the disclosure and other requirements of Regulation A are satisfied
- Regulation A currently is available only to companies that are not subject to the reporting obligations of the Exchange Act
- Section 508 of the Crapo Act expands the availability of Regulation A by requiring the SEC to remove the requirement that the company issuing securities not be subject to the Exchange Act's reporting requirements immediately before such offering

# National Securities Exchange Regulatory Parity

- Section 18 of the Securities Act exempts securities listed on national securities exchanges from registration or qualification under state securities laws and regulations
- Originally, the Section 18 exemption applied automatically to securities of the exchanges that were expressly designated under that statutory provision
- For securities on other exchanges to be entitled to the exemption from state registration requirements, the SEC had to determine by rule that the exchange had listing standards substantially similar to the listing standards of the statutorily designated exchanges

# National Securities Exchange Regulatory Parity, *cont'd*

- Section 501 of the Act amended Section 18(b) of the Securities Act to eliminate differences between exchanges in the applicability of the federal preemption of state registration of securities offerings
- As amended, Section 18 exempts from state registration requirements securities that are designated by the SEC as qualified for trading in the national market system and authorized to be listed on a national securities exchange

# Closed-End Fund Parity

- Section 509 of the Crapo Act provides that closed-end funds listed on a national securities exchange and certain interval funds should benefit from the same securities offering and other provisions available to operating companies
- The SEC is required to amend the securities offering, communications and other provisions in order to meet this objective