

Bank Regulatory Reform Arrives – Gingerly

by Joseph Lynyak and Nicholas A.J. Vlietstra

On May 24, 2018, President Trump signed the Economic Growth, Regulatory Relief and Consumer Protection Act (the “Reform Act”).¹

The bulk of reform in the Reform Act consists of the elimination of many technical and regulatory-overreach problems caused by the Dodd-Frank Act of eight years ago. The Reform Act is striking for what it does not do – it passes on dismantling the Consumer Financial Protection Bureau’s reach. Perhaps the most significant reform is that the Act prospectively raises the so-called “SIFI” (systemically important financial institution) level for enhanced prudential regulation from \$50 billion to \$100 billion immediately, and from \$100 billion to \$250 billion in 18 months. This change will reduce compliance costs for a large number of banks, and will likely inspire a wave of bank consolidation where such consolidation does not create SIFI status.

The Reform Act also provides a statutory exemption for small banks from the Volcker Rule. (With that statutory exemption in place, on May 30th the federal banking agencies issued a proposal to amend the Volcker Rule.) The Reform Act may pave the way for a great deal of regulatory relief through the administrative process.

This Alert provides: (a) a short history of the legislative process leading up to the Reform Act; (b) a summary by category of the Reform Act’s most significant provisions; and (c) an analysis of how financial regulatory reform may proceed over the next 12-month period.²

A. Short History

From an historical perspective, whenever Congress has adopted comprehensive financial legislation intended both to respond to and contain a financial crisis, numerous legislative drafting mistakes are made that require repair in subsequent legislation. This typically occurs two or three years after the comprehensive financial legislation becomes effective—and is usually deemed to be consensus legislation on the part of both the House and Senate and the two parties.

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In the case of the Reform Act, however, corrective legislation did not meet this time-frame because of the fear (possibly justified) on the part of Democrats that the Republican-controlled Congress would eviscerate the Consumer Financial Protection Bureau (the “CFPB”). Those fears were confirmed by the House when it adopted Chairman Hensarling’s Choice Act, which rolled back many of the prudential regulatory standards of the Dodd-Frank Act, and emphasized wholesale dismantling of the consumer protection authority of the CFPB (leaving it arguably less effective than its older cousin, the FTC).

Following the passage of the Choice Act in the House, Senate Democrats indicated that the Choice Act was a non-starter in that chamber. In response, Republican Senator Mike Crapo, the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, negotiated a small, moderate list of consensus Dodd-Frank Act corrective measures acceptable to the Democratic minority, which notably sidestepped dismemberment of the CFPB.

Subject to only one provision directed at assisting large banks, Senator Crapo was able to convince several moderate Senate Democrats to support the Reform Act by emphasizing regulatory relief aimed at smaller community banks. Notwithstanding the House view that more aggressive reform measures should be considered, the House leadership adopted the Senate version of the legislation and sent the enrolled bill to the President for his signature (thus avoiding the necessity of a conference committee).

B. The Reform Act as Adopted

As noted above, the Reform Act was carefully negotiated by Senator Crapo to achieve consensus with moderate Democrats in the Senate by adopting several small regulatory relief measures correcting several problems arising from the Dodd-Frank Act.

Accordingly, a fair reading of the range of reforms is that they consist primarily of the elimination of many technical and annoying overreach problems caused by the Dodd-Frank Act.

A summary of more significant provisions of the Reform Act – broken down into several categories – is as follows:

i. Regulatory Relief for Large Banks

Perhaps the most significant regulatory relief provision, Section 401 of the Reform Act prospectively raises the so-called “SIFI” (systemically important financial institution) level for enhanced prudential regulation from \$50 billion to \$100 billion immediately, and from \$100 billion to \$250 billion in 18 months. This change potentially saves smaller SIFIs no longer subject to enhanced prudential regulation collectively hundreds of millions of dollars in compliance costs (and reduces the number of SIFIs by approximately two-thirds).³

As discussed in greater detail below, this increase in the level at which enhanced prudential standards would now apply may result in a wave of bank consolidations—not

only among the SIFIs who will now fall well below the new minimum level, but among larger banks who have been hesitant to enter into consolidations lest they lose potential economies of scale due to increased compliance costs as the SIFI level is approached.

ii. Various Capital Calculations

The Reform Act includes several tailored modifications to capital calculations and related requirements for several categories of banks and holding companies, as follows:

- **Capital Relief for Custodial Institutions.** Section 402 of the Reform Act provides capital relief for large custodial bank holding companies and their insured subsidiaries that “predominantly engaged in custody, safekeeping, and asset servicing activities.” For those entities, fiduciary and trust accounts will no longer be subject to the supplementary leverage ratio as calculated based upon Federal Reserve Board capital regulations.
- **Municipal Securities Deemed High Quality Assets.** Section 403 directs the federal banking agencies to amend their liquidity coverage ratio regulations to treat certain municipal securities as high quality assets—and thereby lower the capital risk retention requirement for banks holding those assets.

iii. Regulatory Relief for Smaller Banks

In order not to leave out smaller, community banks that have suffered by the trickle-down effect of enhanced prudential regulation imposed by bank regulators, the Reform Act adopts several provisions aimed at reducing the regulatory burden on smaller community banks, including the following:

- **New Community Bank Leverage Ratio.** Section 201 of the Reform Act requires that the federal banking agencies establish a community bank leverage ratio of tangible equity to average total consolidated assets of not less than eight percent and not more than ten percent. Banks with less than \$10 billion in total consolidated assets that maintain tangible equity in an amount that exceeds this new community bank leverage ratio will be deemed to be well capitalized and in compliance with risk-based capital and leverage requirements.
- **Elimination of the Volcker Rule to Smaller Banks.** Section 203 eliminates the application of the Volcker Rule for banks with assets below \$10 billion and total trading assets and trading liabilities that are not more than five percent of total consolidated assets.
- **Shortened Call Reports and Extended Examination Cycle.** Sections 205 and 210 modify two burdensome reporting requirements for smaller banks, by mandating that banks below a \$5 billion threshold in consolidated assets be allowed to use a shortened Call Report, and increased from a \$1 billion to a \$3 billion threshold below which the 18-month examination schedule would apply.⁴
- **Expanded Scope of the FRB’s Small Bank Holding Company Statement.** In a technical change that could assist many small banks, Section 207 raises the consolidated asset threshold of the Federal Reserve’s Small Bank Holding Company Policy Statement (the “Policy Statement”) from \$1 billion to \$3 billion.⁵

iv. Consumer Laws and Operations

The Reform Act is also noteworthy for what it does not broadly address—namely the

structure and authority of the CFPB. However, several industry-friendly provisions in the consumer arena and retail operations were adopted, as follows:

- **Mortgages Held in Portfolio by Smaller Banks and Credit Unions.** Because of the liability that arises by not making a mortgage loan that qualifies as a “qualified mortgage” or “QM” under the Truth-in-Lending Act and the CFPB’s implementing Regulation Z, smaller community banks have been extremely reluctant to originate non-QM mortgages. Section 101 corrects this problem by providing that certain mortgage loans that are originated *and* retained in portfolio by an insured depository institution or an insured credit union with less than \$10 billion in total consolidated assets will be deemed QMs.⁶
- **Modification of TILA’s 3-day Waiting Period.** Section 109 eliminates the TRID 3-day waiting period if the lender extends a second offer of credit that has a lower annual percentage rate.⁷
- **HMDA Reporting Relief.** Small volume mortgage loan originators (*i.e.*, originating less than 500 closed-end mortgage loans or 500 HELOCs in each of the two preceding years) are exempt from reporting the expanded HMDA disclosures created by the Dodd-Frank Act. This will exempt a large percentage of financial institutions on a go-forward basis.⁸
- **TILA Relief for Loan Originators.** Due to the time delay created when a loan originator (“LO”) switches employment, that individual was precluded from working in the capacity of an LO while his/her LO license was transferred (primarily through the NMLS registration system). Section 106 provides a 120-day period during which the LO may continue working while the subject license is processed.⁹
- **Online Banking and Identity Theft.** Section 213 allows banks and credit unions to utilize information from a driver’s license or an identification card when opening new accounts for customers when an application is made through the internet or a mobile banking application.
- **TILA Escrow Relief.** Section 108 exempts insured depository institutions and insured credit unions with less than \$10 billion in assets from TILA’s escrow requirements.
- **Manufactured Home Exemption.** Section 107 excludes from the definition of “mortgage originator” an employee of a retail manufactured home seller who does not receive compensation or gain for taking residential mortgage loan applications.
- **Preemption of State Credit-Freeze Laws.** Section 301 preempts state credit-freeze laws and adopts a national standard for placing and removing credit freezes, including a direction to the FTC to coordinate the process by creating a webpage to access credit reporting agencies.

v. Miscellaneous

In addition to the categories described above, the Reform Act has numerous individual provisions that are minor in nature, technical and non-controversial. They include, among others: (a) several reports required to be prepared by various federal agencies; (b) relief from the FDIC’s reciprocal deposit rule; (c) increasing the mutual saving association size to allow those institutions to operate as a national bank without switching charters; (d) expanding the definition of a 1-to-4 family dwelling for credit unions; (e) instructing the Social Security Administration to create a database to assist in preventing identity theft; (f) instructing that certain Acquisition, Development, and Construction (“ADC”) loans that meet specified criteria will not be subject to a heightened risk weighting under the banking agencies’ risk-based capital rules; (g) relieving some disclosure burdens for issuers that offer securities to employees through compensation plans; and (h) raising

from 100 to 250 the number of investors in a “qualified venture capital fund” that is exempt from SEC registration.

Finally, the Reform Act adopts several procedural protections for veterans and consumers, including: (1) modifying consumer reporting information on certain debt incurred by a veteran; (2) protecting veterans from predatory action relating to refinancings; (3) expanding for one year the stay on foreclosure for a veteran after the veteran’s service ends; (4) providing protections for whistleblowers for senior abuse; (4) permanently reinstating the Protect Tenants at Foreclosure Act; (5) requiring that Fannie Mae and Freddie Mac establish a process for validating credit scoring models; and (6) enhancing protections for student borrowers.

C. Observations

We offer the following initial observations:

First, in regard to regulatory reform going forward, virtually every corrective measure included in the Reform Act requires rule-making by the federal banking agencies. That is because in many instances the Reform Act’s provisions directly modify or negate existing regulations currently in effect that will require notice and comment. This process will likely take the remainder of 2018 (and probably extend well beyond).

However, the Reform Act is extremely compatible with the report issued by the Department of the Treasury in June of 2017, in which numerous administrative actions were identified that could significantly ease the compliance burden on banks and their affiliates.¹⁰

The Reform Act, therefore, could be a prism through which rulemaking might be accelerated. For example, joint agency rulemaking is extremely difficult—modifying existing joint agency rules seemingly impossible. However, with the statutory exemption for small banks from the Volcker Rule now in place, the federal banking agencies announced a proposal to amend the Volcker Rule. The Reform Act may ultimately have a similar salutary effect on regulatory relief through the administrative process.¹¹

Second, we note that the most significant statutory change—the increased SIFI floor—may occasion a wave of merger activity in the banking sector. Over the past several years, medium to larger-sized bank holding companies and banks have been reluctant to make strategic acquisitions of other larger-sized institutions because of the regulatory penalty associated with exceeding the SIFI level (and incurring enhanced prudential scrutiny). As a result of the SIFI asset floor increase, the opportunity may be available for expanded interstate acquisitions and enhanced economies of scale— with diminished risk management obligations.

¹ S.2155

² Although most of the provisions of the Reform Act are immediately effective, due to the necessity of modifying or issuing new regulations, it will be incumbent upon the banking

agencies to provide guidance regarding compliance as soon as possible.

³ Foreign banks with greater than \$100 billion in total assets will not qualify for this expanded relief.

⁴ The 18-month exam cycle would only apply to community banks that are well managed and well capitalized.

⁵ The Policy Statement permits small bank holding companies and saving and loan holding companies to hold a higher level of debt than is generally permitted for holding companies (and facilitates acquisition strategies).

⁶ Certain documentation and other requirements are necessary.

⁷ In a criticism of the CFPB's former leadership, Section 109 also includes a statement urging the CFPB to issue reliable guidance in this complicated area.

⁸ Note that the data will still be required to be gathered by exempted entities, and the exemption is lost if the institution's CRA rating is "needs to improve."

⁹ Section 106 also extends civil liability protection to government officials who make good faith errors related to the collection, furnishing, or dissemination of information with respect to people registered with the NMLS.

¹⁰ A Financial System That Creates Economic Opportunities—Banks and Credit Unions—A Report to President Donald J. Trump.

¹¹ With the confirmation of the Administration's nominee to head the FDIC, President Trump's financial services leadership is now completely in control. The Administration now owns regulatory relief, and excuses for delays based upon Obama hold-overs in key agency positions no longer apply.