Chapman and Cutler LLP

Chapman Client Alert

May 23, 2018 Current Issues Relevant to Our Clients

House Passes Bank Deregulation Bill

On May 22, 2018, the House passed Senate bill S. 2155, which would amend certain Dodd-Frank provisions and, primarily for smaller banks and credit unions, provide additional regulatory relief. Although House members originally suggested the House would pass a modified form of S. 2155, which would have required a conference committee to agree to a compromise version, the House ultimately voted on the unchanged Senate bill to avoid a new vote in the Senate. President Trump is expected to sign the bill, so that it will take effect as law.

As noted in press reports, the bulk of the new law will provide regulatory relief to smaller banks and credit unions (i.e., those with assets less than $10 billion). As news reports also noted, however, the bill includes more controversial provisions affecting larger banks. The most controversial of those provisions, contained in Article IV, would (1) change the Dodd-Frank "enhanced prudential standards" (EPS) requirements for bank holding companies (BHCs) with assets less than $250 billion (and their subsidiary banks) and (2) for a "custodial bank" remove certain Federal Reserve Bank balances from the bank's assets in computing the supplemental leverage ratio. The other Article IV provision, Section 403, would instruct the federal banking agencies to treat "investment grade, liquid, and readily marketable" municipal securities as "high quality liquid assets" (HQLA) under the liquidity coverage ratio.

This Client Alert describes aspects of these Article IV provisions of the bill.

Revised Asset Thresholds for Regulation YY standards (Section 401)

Section 401 of the bill increases asset thresholds in Dodd-Frank Section 165 that served as the basis for the Regulation YY EPS that currently apply, in varying degrees, to bank holding companies (BHCs) with $10 billion or more in assets. The threshold revisions can be divided into three categories:

1. **BHCs with at least $10 billion but less than $50 billion in assets:**

Existing Dodd-Frank treatment: Dodd-Frank Section 165 requires such BHCs to establish a risk committee if they are public companies and, whether public or private, to conduct annual stress tests if they have *more than* $10 billion in assets.[1]

New Dodd-Frank treatment: Section 401 of S. 2155 increases to $50 billion the Section 165 threshold for the risk committee requirement and to $250 billion the threshold for the annual stress test requirement.

Expected Regulation YY effects: Assuming the Federal Reserve does not attempt to maintain the risk committee or company run stress test requirement through more general supervisory practice,[2] both of these requirements should be eliminated by increasing to $50 billion or more the thresholds in Regulation YY for risk committees (Subpart C, 12 CFR §252.20-22) and for company run stress tests (Subpart B, 12 CFR §252.10-17).

2. **BHCs with at least $50 billion but less than $100 billion in assets:**

Existing Dodd-Frank treatment: Dodd-Frank Section 165 requires the Federal Reserve to impose (in some form) all Section 165 specified EPS on BHCs with at least $50 billion in assets.

New Dodd-Frank treatment: Aside from the risk committee requirement for publicly traded BHCs, which will continue to apply to publicly traded BHCs with at least $50 in assets, all other Section 165 EPS requirements will only apply to a BHC with at least $100 billion in assets (and, 18 months after the new law takes effect, only to those with at least $250 billion in assets unless the Federal Reserve orders otherwise, as described below). Section 401(d)(2) of the bill provides a special immediate effective date for the Section 401 provisions affecting BHCs with less than $100 billion in assets.

Expected Regulation YY effects: Again, assuming the Federal Reserve does not attempt to continue EPS through more general supervisory practice, all EPS requirements other than the risk committee requirements currently applicable to BHCs with $10 billion or more, but less than $50 billion, in assets (i.e., Subpart C of Regulation YY), should be eliminated for such BHCs. Subparts D-F of Regulation YY should no longer apply to BHCs with less than $100 billion in assets. The Subpart C risk committee requirement should instead be made applicable to such companies, although it is possible the Federal Reserve would continue the Subpart D (i.e., 12 CFR §252.33) requirement for such BHCs.

3. **BHCs with at least $100 billion but less than $250 billion in assets:**

Existing Dodd-Frank treatment: Same as described above for BHCs with at least $50 billion in assets.

New Dodd-Frank treatment: Although Section 401 of the bill generally increases the EPS threshold to $250 billion in assets, the new threshold for BHCs with at least $100 billion in assets only takes effect 18 months after the bill becomes law (i.e., approximately December 2020, depending upon when President Trump signs the bill into law).

Even after December 2020, the Federal Reserve will retain the discretion to continue any EPS requirement for a BHC with at least $100 billion in assets if it determines (following public notice and comment) applying such EPS requirement to an identified BHC or BHCs is “appropriate” to “prevent or mitigate risks to the financial stability” of the US or “to promote the safety and soundness” of the BHC or BHCs. Federal Reserve Chairman Powell has stated the Federal Reserve is prepared to take such action.[3]

Section 401(e) of the bill imposes a new requirement that the Federal Reserve conduct periodic supervisory stress tests of BHCs with at least $100 billion, but less than $250 billion, in assets to evaluate whether such BHCs have sufficient capital “to absorb losses as a result of adverse economic conditions.”

Expected Regulation YY effects: After the effective date in 2020, Regulation YY should be modified the same as for BHCs with at least $50 billion but less than $100 billion in assets, subject to Subpart E possibly serving as the required “periodic” supervisory stress test, but individual BHCs or classes of BHCs with less than $250 billion, but at least $100 billion, in assets could be subjected to Subpart D-F standards through a Federal Reserve order or rule issued under Section 401(a)(1)(C) of the bill.

Outside of Regulation YY, the Federal Reserve separately mandates the Regulation Y (12 CFR 225.8) “Comprehensive Capital Analysis and Review (CCAR) program for any BHC with $50 billion or more in assets. Commentators have noted that S. 2155 does not directly affect CCAR, because CCAR is not an EPS requirement imposed under Dodd-Frank. Commentators, however, expect the Federal Reserve to increase the CCAR asset threshold consistent with S. 2155 after it becomes law. That could easily mean the CCAR threshold could be raised to $100 billion rather than $250 billion in assets, with CCAR serving as the new law’s Section 401(e) requirement for periodic supervisory stress tests (and BHCs with $100 billion, but less than $250 billion, in assets therefore being freed from the Regulation YY Subpart E stress test requirement).

The new law should not affect how EPS requirements apply to BHCs with at least $250 billion in assets.[4]

Regulation YY currently imposes EPS on foreign banking organizations (FBOs) with a US office or subsidiary and worldwide assets of $50 billion or more. Regulation YY deals separately with such FBOs if their US offices and subsidiaries have less than $50 billion in assets. The bill does not address the treatment of FBOs, but Section 401(g) states nothing in the bill affects the Federal Reserve’s authority to regulate FBOs with worldwide assets of $100 billion or more. Although this might suggest Regulation YY can only regulate FBOs with at least $100 billion in consolidated worldwide assets, as a practical matter all FBOs currently regulated by Regulation YY probably exceed that asset threshold.

Exclusion of Reserves from Custodial Bank SLR computation (Section 402)

Section 402 of bill excludes from assets in the supplemental leverage ratio (SLR) calculation balances held by a “custodial bank” at a Federal Reserve bank (or certain other central banks[5]) to the extent those balances “are linked to fiduciary or custodial and safekeeping accounts.”

Because the SLR only applies to BHCs using the “advanced approaches” (generally those with at least $250 billion in assets or at least $10 billion in foreign assets) the special rule will only apply to a few large BHCs that meet the restrictive definition of “custodial bank” (i.e., are “predominantly engaged in custody, safekeeping, and asset servicing activities”).[6]

Treatment of municipal securities as HQLA (Section 403)

Section 403 of the bill directs the federal banking agencies to treat as level 2B high quality liquid assets (HQLA) any municipal security that meets the “investment grade” and “liquid and readily-marketable” criteria that currently apply to corporate debt for purposes of determining its eligibility as level 2B HQLA.

Since 2016 the Federal Reserve has permitted general obligation municipal securities to qualify as level 2B HQLA subject to special limits. The bill will require all three federal banking agencies to permit municipal securities, including revenue bonds, to be included as level 2B HQLA, so long as they meet the Section 403 investment grade and liquidity requirements.

Currently, the Federal Reserve limits municipal obligations to 5% of a bank’s HQLA in addition to the general restriction that all level 2B assets are limited to 15% of HQLA (and all level 2 assets are limited to 40% of HQLA).

As mentioned above, most of the bill’s provisions affect smaller banks and credit unions. The Independent Community Bankers of America (ICBA)[7] and the Credit Union National Association (CUNA)[8] supported the bill and issued descriptions of how it would affect community banks and credit unions.

Although most S. 2155 provisions outside of Article only apply to smaller BHCs (such as the Section 203 exemption from the Volcker Rule for BHCs with assets less than $10 billion), various non-Article IV Sections also apply to larger BHCs.[9]

For More Information

If you would like further information concerning the matters discussed in this alert, please contact your primary Chapman attorney or visit us online at chapman.com.

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1 Section 165(h)(2)(A) imposes the risk committee requirement on a BHC that is “publicly traded company” and that has at least $10 billion in assets. Section 165(i)(2) imposes the annual stress test requirement on any BHC with *more than* $10 billion in assets, so that it would not apply to such a company with *exactly* $10 billion in assets.

2 This should not be an issue, because the Federal Reserve (including through Chairman Powell in public testimony) has generally supported increases in the $50 billion threshold. Chairman Powell has stated that generally BHCs with less than $250 billion in assets do not raise the systemic risk concerns addressed by Section 165, and that (as referenced in note 3 below) the Federal Reserve is prepared to address specific exceptions.

3 “Fed Chair Says 'Fully Prepared' To Reach Banks Below $250B,” Law360. March 22, 2018. https://www.law360.com/articles/1025046/fed-chair-says-fully-prepared-to-reach-banks-below-250b

4 By amending Dodd-Frank Section 155 to establish a $250 billion threshold for BHCs to pay assessments to cover the expenses of the Office of Financial Research, Section 401(e)(1)(D) increases the financial burden on BHCs with assets of $250 billion or more by eliminating assessments on BHCs with at least $50 billion, but less than $250 billion, in assets.

5 The European Central Bank or any other OECD member central bank if that country has a 0% risk weight under the US risk-based capital rules and has not defaulted on sovereign debt during the preceding five years.

6 Since the federal banking regulators first established formal leverage guidelines in 1981, the US leverage limits for banks have always included all bank assets, including reserves. The exclusion of reserves (or other “cash”) from bank assets for testing leverage is not a new idea, however. Before 1981, particularly during World War II and through the 1950s, US bank regulators used capital to “risk asset” ratios to monitor bank capital adequacy and excluded both “cash” and government securities from “risk assets.” Since 1989, however, only the risk-based capital rules have been used to measure capital against risk. Some commentators have criticized Section 402 for introducing a risk element into the SLR or for providing custodial banks with a special exemption from the SLR.

7 “ICBA Thanks Senate for Passing S. 2155,” Independent Community Bankers of America. March 14, 2018. https://www.icba.org/news/press-releases/2018/03/14/icba-thanks-senate-for-passing-s.-2155

“Final Push Underway as House Plans Reg Relief Vote,” Independent Community Bankers of America. May 17, 2018. http://www.icba.org/news/news-details/2018/05/17/final-push-underway-as-house-plans-reg-relief-vote

8 "S. 2155 passes Senate in major reg relief win for CUNA, CUs," Credit Union National Association. March 14, 2018. http://news.cuna.org/articles/113881-s-2155-passes-senate-in-major-reg-relief-win-for-cuna-cus

"House expected to vote on S. 2155 next week," Credit Union National Association. May 15, 2018. http://news.cuna.org/articles/114199-house-expected-to-vote-on-s-2155-next-week

9 For example, in Article II, Section 202 would exempt up to $5 billion in reciprocal deposits from the definition of brokered deposits, Section 204 would permit a Volcker Rule fund to share a name or variant with the fund's advisor even though the advisor is a "banking entity" under the Volcker Rule, and Section 214 mandates that the 150% US Basel III standardized approach risk weight for a "high volatility commercial real estate" (HVCRE) loan be limited to an "HVCRE AD loan" as defined in Section 214.

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