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POINT OF VIEW

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WHERE DOES US FINANCIAL REGULATION GO FROM HERE?

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Recent weeks have brought some clarity to where US financial regulation is going, although there remains a high level of uncertainty. The greater clarity comes from a combination of new appointments, a US Treasury report in June 2017 with detailed suggestions on financial regulation and related legislation, and some other statements by key political figures. Implications of the Trump Administration for Financial Regulation, our paper from January 2017 on financial regulation under the new Administration continues to serve as a solid base, so this report will focus on what is new since then:

- Legislation has gone from difficult to nearly impossible, with some modest exceptions. This blocks regulatory changes that require amending Dodd-Frank or other laws.
- It still appears that a major loosening of financial regulation will occur, however, outside of legislation.
- Smaller banks are still going to benefit disproportionately, but big banks are in a considerably more favorable position than expected in January:
  - Announced appointments have been universally from the pool of candidates with whom big banks are comfortable.
  - The Administration is promoting an approach to regulatory oversight that may increase the ability of banks to have more influence on final regulations and supervisory guidance.
  - The Treasury report from June largely aligns with the positions of the banking industry on prudential regulation.
- The Treasury report is surprisingly positive for foreign banks operating in the US.
- The emerging landscape is also favorable for other financial institutions:
  - The initial expectation of favorable treatment for insurers and asset managers is carrying through into reality.
- There are some caveats regarding the overall loosening of financial regulation:
  - There are areas where the Administration may take a less favorable approach to the banking industry (such as "Modern Glass-Steagall" or "Basel IV").
  - There are uncertainties outside the Administration that could put the brakes on the emerging balance of powers (the outcome of mid-term elections; the possibility that independent agencies move away from Administration positions, etc.).
- Implications of this emerging landscape:
  - It may be time for foreign banks to consider ramping up US operations.
  - Big banks may want to resume organic growth.
- Open questions remain, key ones include:
  - The future of recovery and resolution planning.
  - The potential for adoption of the Net Stable Funding Ratio in the US.

WHAT'S NEW?

Legislation has gone from difficult to nearly impossible, with modest exceptions. This blocks regulatory changes that require amending Dodd-Frank or other laws. *Nothing* appears likely to pass that requires Democratic votes, rather than just very little. Further, it is less clear that the few items where Senate procedures allow Republicans to pass a bill without Democratic votes will happen. This is due to the broader political environment that has encouraged Democrats to resist all Republican initiatives, combined with difficulties for the Republicans in holding their own coalition together. (Please see Implications of the Trump Administration for Financial Regulation for an explanation of Senate filibuster procedures that give the Democrats the power to block most legislation despite being in a minority.)

The biggest casualty may be the move to raise the $50 billion threshold for banks to automatically be considered systemically important and thereby subject to "enhanced prudential supervision." This had seemed a near certainty and now looks much less likely with this Congress. This could have knock-on effects as the Treasury report calls for the use of the same increased limit in a number of different contexts. It also appears that Title II of Dodd-Frank, which has special procedures for the resolution of systemically important financial institutions, may survive despite longstanding and vehement opposition from Congressional Republicans. At a minimum, it still seems likely restrictions will be placed on how the special features will be used, especially the Orderly Liquidation Fund, but the rest of the Title may live on.

The political environment also means that much of what drove the "Trump Rally", including the anticipation of reflation and tax reform, is significantly less certain. This has important impacts on financial institutions, but is outside the scope of this Point of View.

But, it still appears that a major loosening of financial regulation will occur, outside of legislation. As described in January, there is a great deal that regulators can do to change regulation and supervision in ways that will benefit the financial institutions, even without legislation. This appears even more positive for the banks now than in January, as described below.

The big banks are in a considerably more favorable position than expected, as evidenced by announced appointments and recommendations from the Treasury Report. It was clear from the beginning that the election was a significant net positive for banks of all sizes. However, as of January, there appeared to be a number of ways that populist sentiment could harm the big banks or keep them from reaping many of the benefits of deregulation that would be available to smaller banks. Instead, the populist wing of the Administration seems to have lost all the battles to date in this area. This could change, but the trend has been striking.

Announced appointments have been universally from the pool of candidates with whom big banks are comfortable, and it appears that FDIC Vice Chair Thomas Hoenig, the regulator most concerning to the big banks, may be boxed completely out of a job, despite being a serious candidate for several of the top roles. Some key appointments went to former lawyers from major New York firms and others to Republican Congressional staff or current regulators respected by the big banks.

Randal Quarles, former co-head of Davis Polk's financial institutions practice and a former Undersecretary of Treasury, is the nominee for Federal Reserve Vice Chair for Supervision. He is a high quality pick with real expertise and experience in both the private sector and government and is well thought of by bankers.

The SEC Chair is now Jay Clayton, a long-time partner at Sullivan & Cromwell, a major New York law firm. Among the former Republican staff members: James Clinger, former chief counsel of the House Financial Services Committee, was appointed FDIC Chair, although he has since withdrawn for personal reasons, and Chris Campbell, majority staff director on the Senate Finance Committee, was appointed Assistant Secretary of Treasury for Financial Institutions. J. Christopher Giancarlo was nominated as CFTC Chair, having initially been appointed CFTC commissioner in 2014 to fill a Republican slot. All of these are people with whom the big banks are quite comfortable.

The downside for banks is that the appointment process has been extremely slow, meaning that deregulation may not really begin in earnest until the end of this year or the start of next. That said, there are already effects. Indeed, regulatory agencies altered some of their behavior shortly after the election, but this has mostly consisted of slowing down or halting moves to further regulation, rather than rolling anything back.

The balance of power between supervisors/regulators and the banks is shifting. A common theme from the Administration and Congressional Republicans, which is highlighted in the Treasury report, is a belief that regulators have been trying to micromanage banks through regulation and supervision. The Treasury report makes a number of recommendations to change this balance. Treasury wants the CCAR process to be more transparent, to be subject to "notice and comment" requirements, to apply to fewer banks, and to have fewer implications, such as by largely eliminating the "qualitative" CCAR tests and moving such assessments to the regular supervisory process. Treasury also wants some of the Recovery and Resolution Plan requirements to be subject to notice and comment requirements. Across the board, Treasury is also pushing hard for a more systematic and comprehensive provision of cost/benefit analyses in financial regulation. Further, many Congressional Republicans want to expand the actual use of the Congressional Review Act, which gives Congress extensive authority to roll back regulations. All of these changes would be likely to reduce the level and detail of regulations and supervisory requirements, make it easier for banks to push back, and introduce a more serious threat of a Congressional override of regulations that banks strongly oppose.

The Treasury report from June largely aligns with the positions of the banking industry on prudential regulation. This is especially important, as there are elements of the Republican Party that would like to see a much higher capital burden on the largest banks. The Treasury report agreed with them in a few smaller ways, including a modest reference to relying more on standardized risk weightings rather than those based on internal models.

However, the great bulk of the recommendations on capital and liquidity would be as favorable to the big banks as the small ones, or even more favorable in the case of rolling back the use of CCAR, which has often been the binding capital constraint for the largest banks but does not affect small banks.

The Treasury report is quite positive for foreign banks, as opposed to the "America First" rhetoric that raised concerns earlier that foreign banks would be handicapped. Instead, US operations of foreign banks may be exempted from a number of burdensome requirements that had been based on their global size, rather than their US footprint. The Treasury report even talked about giving some deference to foreign regulatory supervision without insisting on US standards. This has always been done to some extent, but the earlier "America First" rhetoric makes it notable that Treasury highlighted the point.

The expectation of favorable treatment for insurers and asset managers is carrying through into reality. There is a rollback of efforts by the Obama Administration and regulators to impose new standards in order to combat perceived systemic risks from these industries. For one, it is clear that the Financial Stability Oversight Council will move to de-designate non-banks that have been named as systemically important financial institutions if Congress does not roll this back through legislation.

The one partial exception to the rollback is that the Department of Labor felt unable to completely halt the new Fiduciary Rule promulgated by the Obama Administration. This appears to have been an isolated situation in which the rule was so recent that it would have been difficult for the Department to defend a rollback in court at this point, as there were essentially no new facts to cite for such a change and too little time to create a new administrative record that would justify it on other grounds. Most observers still expect the Department of Labor to make important changes before some of the key features take effect at the end of this year.

However, there are areas where the Administration may take a less favorable approach to the banking industry. One ongoing regulatory threat to the big banks is the continued momentum for a "Modern Glass-Steagall." So far, Treasury seems to be trying to define this in a quite limited way that could be accomplished with relatively technical adjustments with which the big banks could probably live comfortably. However, Treasury may not win this battle within the Administration and, even if they did, Congress might take the concept much further if such legislation ever advances. If the Administration backs legislation for a Modern Glass-Steagall, this could turn out to be one of the few initiatives to gain bipartisan support, although perhaps at the expense of agreeing with Democratic demands for a greater separation of investment and commercial banking.

Another area in which the Administration might favor tougher requirements on the big banks is what the industry calls "Basel IV". The Treasury report explicitly endorses concluding the negotiations successfully when it could easily have avoided the topic or emphasized concerns that must be addressed. At the same time, it seems unlikely that the Federal Reserve, for its part, would be comfortable endorsing an agreement prior to the confirmation of Randal Quarles. This could take several more months. If a deal is reached, I expect that there would be an “output floor” of 70%, with some national adjustments allowed for areas such as residential mortgages under certain circumstances. (The output floor places a limit on how much lower capital requirements can be based on advanced internal models as compared to standardized methods under the Basel Capital Accords. It matters greatly, but is too technical for a complete explanation here.)

Finally, there are additional caveats to keep in mind. If the politics get even worse for the Administration and the new regulatory team, or if there is a new bank scandal, there is still the potential for some of the changes to be stymied. The worst case for the big banks would be if there are further massive delays and then the Democrats win one or both Houses of Congress in the mid-term elections. Investigative committees, led by Democrats, that actively looked into regulatory activities could create a substantially more cautious approach from the new appointees. No regulator likes to be hauled before a Congressional committee, even to defend actions with which they are intellectually comfortable. Beyond that, once independent regulators are appointed, they may diverge over time from the initial expectations represented in the Treasury report. For that matter, the Treasury report was done in consultation with the agencies, but definitely represents the Administration’s views and not necessarily those of the agencies, at least under current leadership. And, of course, there could be a resurgence of populism within the Administration and Congress that could lead to a true resumption of something like a Modern Glass-Steagall or other actions that would harm big banks.

SOME IMPLICATIONS

It may be time for foreign banks to consider ramping up US operations, rather than slimming them down. The combination of a more favorable US banking environment and a reduction in the special burdens being placed on foreign banks could change the game for them. This is a strategic decision with many facets, but the increasing regulatory burden had been a major source of pressure for shrinkage and it appears to be reversing.

Big banks may want to resume organic growth. Pressures to shrink are waning and the potential rewards from expansion are increasing. This still leaves the issue of how to profitably expand, but the mindset already appears to be changing to fit the new environment.

OPEN QUESTIONS

What will happen with Resolution and Recovery plans (RRP) in the US? This process, sometimes known as "living wills," is at something of a crossroads, but it is difficult to know which way it will go. Broadly speaking, the new team could view regulatory RRP mandates as being akin to CCAR, which they believe has been far too intrusive, binding, and opaque. This could lead to a major rollback, since virtually all of the requirements come from rules and supervisory guidance, not law. Or, concerns about Too Big to Fail banks could lead the team to allow a continuation of the trend towards increasingly detailed requirements. The argument would be that TBTF is unacceptable and the only way to avoid it is to have detailed, workable, and comprehensive plans that are overseen carefully by supervisors.

The Treasury report took a middle ground. It endorsed the RRP process, but called for the plans to be submitted on a biennial basis; to allow more flexibility to take account of global planning for foreign banks; and to re-evaluate requirements that would raise total liquidity needs above those determined by other regulatory tests. (Treasury also called for getting the FDIC out of the process, leaving it to the Federal Reserve, but this would require legislation that is extremely unlikely to pass.) Depending on what the independent regulators eventually decide, this might not result in much change in current trends or could spur a larger change in direction. Even if we knew the future direction, there are real questions about the timing of any changes, especially given the slowness of the appointment process.

Will the Net Stable Funding Ratio be applied in the US? It now looks like only perhaps a one in two chance that the NSFR will become binding in the US. The Federal Reserve and other agencies proposed implementing such regulations prior to the election. The comment period has passed and there is no legal obstacle to the independent agencies putting the rules in place. However, there is a strong reluctance to do this until it is clear how the new Trump appointees will view the rule. This reluctance was likely increased by the call in the Treasury report to reconsider the appropriateness of the rule. The two most likely outcomes would appear to be (a) that the rule effectively dies for at least the next few years or (b) that it is reworked quite substantially and then applied in a form that is not very binding on the US banks. There is very strong opposition to the NSFR from the banks and it is one of the easiest rules to undo, since it is not already in place. It is also associated with what many Republicans see as over-reach by the Basel Committee, making it politically easier to block.

Given all this, why is there even a one in two chance? First, because the regulatory agencies do like to abide by globally agreed standards. Second, because the staff and the carry-over appointees are quite supportive. Third, it is possible to make a number of detailed implementation choices that would make it considerably less binding in practice, reducing the degree of opposition. With the right changes, regulators might believe they could get the benefits of adhering to a global standard without spending too much political and bureaucratic capital fighting the opponents of the rule.

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