SULLIVAN & CROMWELL LLP

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Implementation of Financial Services Regulatory Reform Legislation

Federal Reserve Official Previews Risk-Based Regulatory Tailoring Agenda

SUMMARY

On October 2, the Senate Banking Committee held a hearing on the implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"), which was enacted earlier this year. The hearing featured testimony by FDIC Chairman Jelena McWilliams, Federal Reserve Board Vice Chairman for Supervision Randy Quarles, National Credit Union Administration Chairman Mark McWatters, and Comptroller of the Currency Joseph Otting.

In his opening statement, Committee Chairman Mike Crapo (R-ID) urged the regulators to implement the new law "expeditiously," to revise "all regulation and guidance [asset] thresholds" in light of the now "outdated" $50 billion asset threshold (often referred to as the "SIFI" threshold) originally established in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), above which the Federal Reserve is required to apply the "enhanced prudential standards" ("EPS") in Section 165 of Dodd-Frank to a bank holding company ("BHC"), and to tailor the imposition and application of EPS to "reflect[] actual systemic risk."

In Vice Chairman Quarles' testimony, he described the "detail work" the Federal Reserve is conducting to implement the Act and to otherwise tailor the prudential regulation of financial institutions based on risk.[1] One aspect of this work, which he described as one of the Federal Reserve's "top priorities in the next few months," is to tailor, on the basis of risk, the supervision and regulation of institutions with $100 billion or more in total assets that are not identified as globally systemically important bank holding companies ("G-SIBs"), with a particular focus on BHCs with between $100 billion and $250 billion in total consolidated assets.[2] His testimony suggests, however, that the Federal Reserve's risk-based regulatory

reform agenda is unlikely to result in much, if any, relief for G-SIBs or large foreign banking organizations with U.S. operations ("FBOs"), at least in the short term.

FDIC Chairman McWilliams, Vice Chairman Quarles, NCUA Chairman McWatters, and Comptroller of the Currency Otting also testified about their agencies' efforts to implement other modifications made by the Act to the post-crisis regulatory framework.

This Memorandum to Clients focuses on Vice Chairman Quarles' testimony. We address the other testimony by the Federal banking regulators in a separate Memorandum to Clients that was also published today. That Memorandum is available on our website or by following the instructions at the end of this document.

BACKGROUND

The Act, originally introduced in the Senate by Chairman Crapo and cosponsored by a bipartisan group of Senators, was approved by the Senate and the House of Representatives earlier this year and signed into law on May 24. As discussed in our Memorandum to Clients published on that date, the Act preserves the fundamental elements of the regulatory framework established after the 2010 enactment of Dodd-Frank, but includes a variety of measures that should result in meaningful regulatory relief for smaller and certain regional banking organizations. Of particular note, the Act automatically increased the Dodd-Frank SIFI threshold from $50 billion to $100 billion as of May 24, the date of the Act's enactment, with a further automatic increase to $250 billion to occur 18 months after the date of enactment.

Notably, the Act does not itself amend regulations promulgated by the Federal banking agencies based on asset thresholds, including regulations implementing EPS, as well as regulations that implement other post-crisis regulatory requirements established under (but not required by) Dodd-Frank or other legal authorities. Accordingly, the agencies must amend their existing regulations to account for the new asset thresholds in the Act and other statutory changes. The agencies may also consider amending regulations not directly affected by the Act to the extent they seek to render such regulations consistent with the Act.

VICE CHAIRMAN QUARLES' TESTIMONY

In implementing the Act and as part of a broader effort to "enhance th[e] efficiency" of the post-crisis regulatory framework, Vice Chairman Quarles said that one of the Federal Reserve's "top priorities in the next few months" will be to tailor, on the basis of risk, the supervision and regulation of non-G-SIB financial institutions with total consolidated assets of $100 billion or more, with a particular focus on BHCs with total consolidated assets of between $100 billion and $250 billion.[3]

Vice Chairman Quarles noted that the Act requires the Federal Reserve and the other Federal banking agencies to "further tailor[] regulation to better reflect the character of the different banking firms" they supervise.[4] Based on the Act's "underlying" principle of "tailoring regulation to risk," Vice Chairman Quarles pledged to engage in the "thoughtful detail work" required to "improve the efficiency" by which the "core objectives" of the post-crisis regulatory framework—higher and better quality capital, stronger liquidity, and increased resolvability—are achieved.[5] He stated that, in light of the Federal Reserve's "many years of experience with the body of post-crisis regulation," risk-based tailoring would enable the agency to better "align the nature of [its] regulations with the nature of the firms being regulated."[6] In so doing, he stressed that the Federal Reserve should move beyond its previous approach of tailoring post-crisis regulations, which he described as having been "principally calibrated according to the asset size of an institution," and instead consider asset size as only one of several factors relevant to risk-based tailoring.[7]

In light of the impending increase in the SIFI threshold mandated under the Act, Vice Chairman Quarles said the Federal Reserve "has placed [its] highest priority on issuing a proposed rule on tailoring enhanced prudential standards for banking firms with assets between $100 billion and $250 billion," observing that "the legislation gives [the Federal Reserve] more flexibility to tailor or eliminate certain requirements that, under Dodd-Frank, were mandatory" for these firms. He noted, however, that the Federal Reserve is "independently considering" how non-G-SIBs with more than $250 billion in total assets "could be more efficiently regulated by applying more tailored standards."[8] He also briefly addressed how the Federal Reserve's risk-based tailoring efforts may affect the regulation of G-SIBs and FBOs with U.S. operations.

Non-G-SIB BHCs with total consolidated assets of between $100 billion and $250 billion. As noted above, effective 18 months after the Act's date of enactment, BHCs with between $100 billion and $250 billion in total consolidated assets will no longer be automatically subject to EPS. During this 18-month "off-ramp" period, the Federal Reserve is authorized to exempt, by order, any BHC with between $100 billion and $250 billion from any EPS requirement.[9] After the SIFI threshold increase becomes effective, the Act grants the Federal Reserve the discretionary authority to apply any EPS to any BHC or BHCs with between $100 billion and $250 billion in total consolidated assets that would otherwise be exempt under the legislation. To exercise this discretionary authority, however, the Federal Reserve must (1) act by order or rule promulgated pursuant to Section 553 of the Administrative Procedure Act (requiring public notice and comment) and (2) determine that the application of the EPS is "appropriate . . . to prevent or mitigate risks to [U.S.] financial stability" or "to promote the safety and soundness of the [BHC] or [BHCs]," taking into consideration the BHC's or BHCs' capital structure, riskiness, complexity, financial activities, size, and "any other risk-related factors that the [Federal Reserve] deems appropriate."[10]

As noted above, Vice Chairman Quarles said the Federal Reserve's "highest priority" is the issuance of a notice of proposed rulemaking on "tailoring enhanced prudential standards" for BHCs with between $100 billion and $250 billion in total consolidated assets.[11] Notwithstanding the forthcoming increase in the SIFI threshold for these firms, Vice Chairman Quarles described the Act as requiring the Federal Reserve to "tailor, but . . . not to eliminate prudential regulation[]" of these BHCs and said the Federal Reserve "will continue to be focused on capital and liquidity for institutions in [this] size and complexity range." He noted that he expects that, "[w]hile the statute sets an 18-month deadline for this regulatory process,"[12] a proposed rule on tailoring stress tests and other EPS for these institutions will be released "certainly before the end of the year" and hopefully "well before that." This proposal, according to Vice Chairman Quarles, will provide a framework that "describe[s] in a principled way when future institutions may expect enhanced regulation and why."[13] He noted that the framework would be tailored to institutions based on a number of factors, including size, "using objective measures that account for the relative complexity and interconnectedness among large banks."[14]

He said the forthcoming proposed rule will also address the application of the Federal Reserve's capital and liquidity rules, resolution planning requirements, and supervisory stress testing to these BHCs. As required by the Act, the "annual" supervisory stress tests that applied to these BHCs under Dodd-Frank will be replaced by "periodic" supervisory stress tests. Vice Chairman Quarles observed that the change from "annual" to "periodic" "recognizes the value of stress testing but requires a more tailored frequency and requires [the Federal Reserve] to think more carefully about the burden of these tasks."[15] He stressed that, even though the Act will make stress testing less frequent for these institutions, it will remain "consistent with the Federal Reserve's long standing expectations that all banking organizations, regardless of size, should employ internal risk-management practices that appropriately assess their capital needs and vulnerabilities under a range of reasonably anticipated stress scenarios."[16]

Non-G-SIB BHCs with total consolidated assets of $250 billion or more. Although the Act does not directly affect the application of EPS to BHCs with total consolidated assets of $250 billion or more, it did amend Section 165 of Dodd-Frank to require, rather than merely permit, the Federal Reserve to "differentiate among companies on an individual basis or by category" in prescribing EPS, taking into consideration capital structure, riskiness, complexity, financial activities, size, and "any other risk-related factors that the [Federal Reserve] deems appropriate."[17] Vice Chairman Quarles said the Federal Reserve is reviewing and will seek to tailor, on the basis of risk, the requirements applicable to non-G-SIBs with total consolidated assets of $250 billion or more. He explained that, although certain requirements apply to all BHCs with $250 billion or more in total consolidated assets, he saw "reason to apply a clear differentiation" between BHCs that are G-SIBs and those that are not.[18] Further, in response to a question regarding the application of the liquidity coverage ratio ("LCR") rules, Vice Chairman Quarles noted that specific tailoring of those rules, as they apply to non-G-SIB BHCs with more than $250 billion in total consolidated assets, is viewed as a "priority" and will be addressed "promptly."

U.S. G-SIBs. In Vice Chairman Quarles' prepared testimony, he did not identify U.S. G-SIBs as being among the institutions for which the Federal Reserve is prioritizing risk-based tailoring of the post-crisis regulatory framework. He stressed that the current capital surcharge imposed on G-SIBs is "part of a complex of regulations that apply to our largest firms," which includes the Federal Reserve's capital framework, liquidity rules, and stress testing requirements, and that, accordingly, the G-SIB surcharge will "inevitably be part of considering whether [the Federal Reserve] ha[s] appropriately calibrated this complex of rules to ensure that [it] ha[s] . . . protected the safety and soundness of those firms, . . . protected the stability of the financial sector in the United States, and . . . ensure[d] that we have a level playing field internationally." Asked specifically about the Federal Reserve's willingness to consider a recalibration of the G-SIB surcharge, he stressed that he would not "prejudge what the outcome of an honest consideration of that whole complex of rules will be," but said he believes that, as they apply to the G-SIBs, the existing "capital levels, the total loss absorbency capital capacity in our system is roughly about right" and noted that Federal Reserve Board Chairman Powell shares this view.

FBOs. FBOs are treated as BHCs for purposes of Section 165 of Dodd-Frank.[19] Accordingly, the Act's increase in the SIFI threshold for domestic BHCs also nominally applies to the application of EPS to FBOs, but, because total consolidated assets are measured on a global basis for this purpose, the practical effect is minimal. Certain stress test and risk management requirements as applied to FBOs adopted the Dodd-Frank $50 billion asset test based on combined U.S. assets, and the requirement that certain FBOs establish an intermediate holding company, which is subject to a set of EPS similar to those that apply to the largest domestic BHCs, applies if an FBO has $50 billion or more in U.S. non-branch assets.[20] Nonetheless, observing that FBOs with significant U.S. operations have total global consolidated assets well in excess of $250 billion, Vice Chairman Quarles said the Federal Reserve is "not including any changes to the FBO regulatory scheme for FBOs with more than $250 billion in global assets as part of our implementation of tailoring mandated by the Act." He specifically noted that the Act "does not require the Board to change the U.S. asset threshold for establishment of an intermediate holding company, which is currently at $50 billion in U.S. non-branch assets." He did pledge, however, that the Federal Reserve will "continue, as [it] always ha[s], to review [its] regulatory framework to improve the manner in which [it] deal[s] with the particular risks of FBOs in light of the distinct characteristics of such institutions."[21]

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ENDNOTES

[1] Statement by Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, at 1 (Oct. 2, 2018) [hereinafter Quarles Statement].

[2] *Id.* at 1-2.

[3] *Id.*

[4] *Id.* at 1.

[5] *Id.*

[6] *Id.* at 2.

[7] *Id.* at 1.

[8] *Id.* at 6.

[9] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 401(d)(3).

[10] *Id.* § 401(a).

[11] Quarles Statement, at 6.

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.* at 7.

[16] *Id*.

[17] 12 U.S.C. § 5365(a)(2)(A).

[18] Quarles Statement, at 7.

[19] *See* 12 U.S.C. § 5311(a)(1).

[20] *See* 12 C.F.R. Part 252, Subpart O.

[21] Quarles Statement, at 8.

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