

April 18, 2018

## Federal Reserve Regulatory Agenda

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### Vice Chairman for Supervision Quarles Outlines Key Principles and Specific Initiatives

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#### SUMMARY

On April 17, 2018, Federal Reserve Board Vice Chairman for Supervision Randal Quarles described a comprehensive regulatory agenda in his first semi-annual testimony before the House Financial Services Committee.<sup>1</sup> This agenda includes both several key guiding principles and a broad range of specific regulatory initiatives.

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#### KEY PRINCIPLES

Vice Chairman Quarles emphasized what is, in effect, a dual regulatory mandate to promote: (i) safety and soundness and (ii) an efficient financial system. He explained that these two objectives are not in conflict but are “mutually reinforcing.”<sup>2</sup>

A second key principle endorsed by Vice Chairman Quarles is transparency. He explained that transparency will promote the two key regulatory objectives, and noted that transparency will be promoted through regulatory measures that are clear and simple as opposed to needlessly complex.

Vice Chairman Quarles cited numerous metrics that confirm the robustness of the post-financial crisis financial system and thereby support the conclusion that efficiency can coexist as a regulatory objective with safety and soundness. These metrics include an increase of more than \$700 billion in equity capital held by the largest banking organizations, a 120% increase in common equity capital ratios, a decrease of more than 50% in reliance on short-term debt, and a 60% increase in high-quality liquid assets.<sup>3</sup> Indeed, as discussed below, this robustness of the financial system enabled the Vice Chairman to focus his specific discussion of recent and planned initiatives on enhancing efficiency and transparency. At the same time, he noted “[i]t is critical that we continue to monitor for emerging risks affecting the financial

system. This calls for better analysis and more agility by supervisors in identifying emerging risks, as well as vigilance against complacency.”<sup>4</sup>

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### KEY INITIATIVES

**eSLR.** Vice Chairman Quarles noted the recent proposal<sup>5</sup> by the Federal Reserve and the Office of the Comptroller of the Currency to recalibrate the enhanced supplementary leverage ratio (“eSLR”) for global systemically important bank holding companies (“G-SIBs”) and their lead insured depository institution subsidiaries. Importantly, although the two agencies propose to retain the eSLR, he described the appropriate role of leverage capital requirements as “generally serv[ing] as a *backstop* to risk-based capital requirements”,<sup>6</sup> and noted that “[w]hen the leverage ratio acts as a primary constraint, it can actually encourage excessive risk-taking behavior because it does not distinguish between the capital cost of safer and that of riskier assets.”<sup>7</sup>

**Qualitative CCAR Evaluations.** The Federal Reserve is considering whether to expand the elimination of a separate qualitative evaluation conducted as part of its Comprehensive Capital Analysis and Review (“CCAR”) process for “large and noncomplex” firms (those that are not G-SIBs and that have between \$50 billion and \$250 billion in total consolidated assets and less than \$75 billion in nonbank assets) “to a broader range of firms”.<sup>8</sup>

**Liquidity.** As part of the tailoring considerations, Vice Chairman Quarles suggested “concrete steps” towards a “gradation” for liquidity regulation that would distinguish between G-SIBs and non-G-SIBs.<sup>9</sup>

**Living Wills.** The Vice Chairman proposed a two-year cycle for all resolution plan filings and a reduction in information requirements for firms with less significant systemic footprints.

**Examination Process and Ratings.** The Vice Chairman noted the Federal Reserve’s initiatives to simplify and reduce burden in the examination process, especially for small institutions, and to simplify its ratings system.

**Applications.** The banking industry has for some time expressed concern about a substantial elongation of the application process for many transactions. Vice Chairman Quarles said the Federal Reserve has begun a broad review to identify ways to increase the efficiency of the applications process, which he expects to reduce processing times for certain types of applications.

**Control.** For many years, the process for determining whether an investment constitutes “control” has been opaque and the relevant standards highly restrictive. The Vice Chairman noted that the Federal Reserve is “in the process of developing a revised framework for determining ‘control’ under the Bank Holding Company Act.”<sup>10</sup> He predicted that the revised framework “would be more transparent, simpler to understand, easier to apply, and would liberalize some existing limitations.”<sup>11</sup>

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**Volcker Rule.** Noting that the existing implementing regulation is “exceedingly complex”, the Vice Chairman explained that the Federal Reserve is working actively with the other regulators “to further tailor implementation of the Volcker rule and to reduce burden, particularly for firms that do not have large trading operations and do not engage in the sorts of activities that may give rise to proprietary trading.”<sup>12</sup> In response to a question, the Vice Chairman maintained that it is “unarguable” that the Volcker Rule has been “detrimental” to the capital markets and that it has resulted in “excessive burden” and a “great deal of uncertainty [and] a great deal of cost.” In response to another question about more specific actions, he noted that the regulators could clarify what activities constitute “proprietary trading” and alter the “burden of proof in examinations” for certain institutions.<sup>13</sup>

**Expectations for Banking Organization Directors.** The Vice Chairman described the Federal Reserve’s August 2017 proposed guidance regarding supervisory expectations for banking organizations’ boards of directors as designed to “scale back some of the excessive micromanagement” of bank boards.<sup>14</sup> In response to a question, he noted that the Federal Reserve should recommend dismissal of a bank director only in “extremely rare cases”.<sup>15</sup>

**CRA.** The Vice Chairman described the current approach to enforcing the Community Reinvestment Act (“CRA”) as “formulaic and ossified”, described the Treasury Department’s recent recommendations for CRA regulatory reform as a “good map” and indicated that the three federal banking agencies are working on a joint proposal for revision of the existing CRA regulations designed to “mov[e] CRA off autopilot.”<sup>16</sup>

**Transparency and Simplicity.** Describing transparency as “central to the Federal Reserve’s mission, in supervision no less than monetary policy” and the “compliance burden that results from overly complex regulation”, the Vice Chairman outlined a number of initiatives that should promote transparency and simplicity.<sup>17</sup>

**International Engagement.** Vice Chairman Quarles described the Federal Reserve’s process of engagement with foreign bank regulators as “promoting global financial stability and a more level playing field for our supervised firms.”<sup>18</sup> In this international context, the Vice Chairman encouraged greater transparency and a “pivot focus . . . toward [an] evaluat[ion of] policies that have been implemented to ensure the reforms are efficient and effective and to address any unintended consequences.”<sup>19</sup>

**Internal TLAC and Tax Reform Legislation.** A major concern for a number of non-U.S. G-SIBs that have U.S. operations is the impact of the new base erosion anti-abuse tax (“BEAT”) on the regulatory requirements for internal total loss-absorbing capacity (“TLAC”) requirements, because the interest paid on the internal TLAC is not deductible for purposes of the BEAT. The Vice Chairman indicated that he has been discussing with the U.S. Department of the Treasury whether this issue should be addressed through Treasury or Federal Reserve rulemaking. He reiterated earlier comments by Treasury that, in

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order to help policymakers find a solution to this problem, it will be important for the affected non-U.S. banks to “quantify” its impact.<sup>20</sup>

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ENDNOTES

- <sup>1</sup> See *Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System*, 115th Cong. (Apr. 17, 2018), available at <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-rquarles-20180417.pdf> (written statement of Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System) [hereinafter, "Quarles Testimony"].
- <sup>2</sup> Quarles Testimony at 1.
- <sup>3</sup> Quarles Testimony at 2.
- <sup>4</sup> Quarles Testimony at 12.
- <sup>5</sup> For a discussion of the proposal, please see our Memorandum to Clients entitled *Bank Capital: Requirements: Federal Reserve and OCC Propose Amendments to the Enhanced Supplementary Leverage Ratio Requirements for U.S. G-SIBs* (Apr. 17, 2018), available at [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Bank\\_Capital\\_Requirements\\_04\\_17\\_18.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_04_17_18.pdf).
- <sup>6</sup> Quarles Testimony at 5 (emphasis added).
- <sup>7</sup> Quarles Testimony at 5.
- <sup>8</sup> Quarles Testimony at 6.
- <sup>9</sup> Quarles Testimony at 7.
- <sup>10</sup> Quarles Testimony at 9.
- <sup>11</sup> Quarles Testimony at 9.
- <sup>12</sup> Quarles Testimony at 10.
- <sup>13</sup> *Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System*, 115th Cong. (Apr. 17, 2018), available at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403293> (archived webcast) [hereinafter, "Hearing Webcast"].
- <sup>14</sup> Hearing Webcast.
- <sup>15</sup> Hearing Webcast.
- <sup>16</sup> Hearing Webcast.
- <sup>17</sup> Quarles Testimony at 8–9.
- <sup>18</sup> Quarles Testimony at 12.
- <sup>19</sup> Quarles Testimony at 12.
- <sup>20</sup> Hearing Webcast.

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