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STRATEGIC PERSPECTIVES—Will 2016 banking developments see their full conclusion in 2017?

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The year 2016 for banking will be remembered for the latest round by Congressional Republicans to either repeal or dismantle various aspect of the Dodd-Frank Act; the legal setback for the Financial Stability Oversight Council to designate non-bank companies as significantly important financial institutions; the steps the banking agencies took to set boundaries on "responsible innovation;" final action by the banking agencies to implement the various requirements of the Basel capital framework; and a plan to end "too big to fail." This Strategic Perspectives will examine these developments and analyze how these developments may be impacted by the election of Donald J. Trump as the 45th President of the United States.

1. Demise of Dodd-Frank?

Since it was enacted in July 2010, the Dodd-Frank Act has had a "bull's eye" with Congressional Republicans seeking to repeal the Act in its entirety or weaken many of its provisions.

Financial CHOICE Act. In a June speech before the Economic Club of New York, House Financial Services Committee Chairman Jeb Hensarling (R-Texas) sketched the contours of a "new legislative paradigm" for banking and the capital markets that will allow strongly capitalized banks to opt-out of burdensome regulations, end too-big-to-fail, and impose greater accountability on regulatory agencies. The plan, the Financial Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs (CHOICE) Act, also would repeal Dodd-Frank's controversial Volcker Rule while instituting a raft of proposals for fostering capital formation.

Hensarling said the Financial CHOICE Act rests on the belief that bank capital is the most basic element in a healthy and resilient financial system. Although U.S. banks have raised hundreds of billions in new capital since the financial crisis, capital standards that were already complex have become even more complex with the latest iteration of the Basel capital accords, Hensarling said. In the place of these "growth-strangling" regulations, the Republican plan will offer financial institutions a "market-based, equity financed Dodd-Frank off-ramp" in exchange for meeting higher, yet simple, capital requirements (see *Banking and Finance Law Daily*, June 7, 2016).

The Financial CHOICE Act was formally introduced as H.R. 5983 and approved by the House Financial Services Committee in September 2016. The 30-to-26 vote was along party lines. At the time of the vote groups representing the banking industry and pro-reform groups also advocated for and against the bill (see *Banking and Finance Law Daily*, Sept. 13, 2016).

Financial CHOICE Act 2.0. Hensarling is expected to introduce a new version of the Financial CHOICE Act once the 115th Congress convenes in January 2017. The newer version would appear to contain changes based on input from financial services industry groups that Hensarling received after reportedly meeting with the groups in mid-December 2016.

2016 election. After winning the presidential election, the Financial Services Policy Implementation team, which is part of the Trump presidential transition, said the "Dodd-Frank economy does not work for working people." The team added it will be working "to dismantle the Dodd-Frank Act and replace it with new policies to encourage economic growth and job creation." Steven Mnuchin, the nominee for Treasury Secretary, said the incoming Trump Administration will strip back parts of Dodd-Frank that prevent banks from lending.

Although Republicans control both houses of Congress, the entirety of the Dodd-Frank Act will probably not be repealed once the Trump Administration takes office. Total repeal on "Day 1" probably will not occur due to the small majority the Republicans hold in the Senate. For any legislation to move forward, roughly eight Democrat senators will need to side with the Republican senators. It is possible that Senate Majority Leader Mitch McConnell (R-Ky) could remove the 60-vote cloture rule for legislation to move forward, but he is also deemed to be an "institutionalist" and may retain the cloture rule.

However, total repeal of Dodd-Frank may be a possibility following the 2018 mid-term elections. At that point in time, Democrats will have to defend 25 of the 33 seats being contested.

Staffing of agencies. Even if Congress is not successful in making changes to the Dodd-Frank Act, the incoming president's appointments to various independent financial regulatory agencies could, as noted by Justin Schardin, director of the Bipartisan Policy Center's Financial Regulatory Reform Initiative, provide "wide latitude to reinterpret or roll back new rules and regulations." Although some of the agencies may be headed up by members that could reinterpret or roll back regulations, any type of action would still need to go through the normal proposal and comment process. It was also observed with the various agency appointments that the role of FSOC could change, with the new Treasury Secretary using FSOC's statutory mandate as a means for coordinating regulators to streamline existing regulations.

2. FSOC SIFI setback

The ability of FSOC to designate non-bank financial companies as systemically important financial institutions under the Dodd-Frank Act was setback in 2016 when a federal district court revoked FSOC's designation of MetLife, Inc., as a non-bank SIFI. Under the Dodd-Frank Act and its guidance, FSOC can designate a non-bank financial company as a SIFI if the financial company's leverage, liquidity risk, and maturity mismatch will make it vulnerable to financial distress. FSOC is also required to conduct an impact analysis evaluating size, substitutability, and interconnectedness to determine the potential effect of distress.

SIFI tag revoked. In her unsealed court opinion, Judge Rosemary Collyer, U.S. District Court for the District of Columbia, ruled that MetLife's SIFI designation was arbitrary and capricious and that FSOC acted contrary to its published guidance without explaining, or even acknowledging, the deviation. Collyer also ruled that FSOC refused to consider the costs that the SIFI designation imposed on MetLife. The district court relied on the 2015 U.S. Supreme Court case *Michigan v. EPA*, which held that the Environmental Protection Agency unreasonably interpreted provisions of the Clean Air Act when it deemed cost irrelevant to the decision to regulate power plants (see *Banking and Finance Law Daily*, April 7, 2016).

"Fairly exudes deference." FSOC appealed to U.S. Court of Appeals for the District of Columbia arguing that the lower court "read into the guidance an obligation to assess the likelihood that MetLife would experience financial distress and a requirement to identify with precision the impact that distress would have on the broader financial system during a hypothetical future crisis." FSOC also contends that the lower court misapplied the holding in *Michigan v. EPA*, since the provisions of the Dodd-Frank Act have "no resemblance to the statute at issue in *Michigan v. EPA*." It added that Dodd-Frank's focus on risk to the nation's financial stability, rather than on costs to large financial companies, and its use of language that "fairly exudes deference," thereby preclude the district court's imposition of its own, very different, interpretation (see *Banking and Finance Law Daily*, June 17, 2016).

Support for FSOC. Shortly after FSOC filed its brief, a number of *amici curiae* briefs were filed to support FSOC's position. One *amicus* brief was filed by a group of 20 current and former members of Congress, led by former Rep. Barney Frank and former Sen. Christopher J. Dodd. The second brief was filed by former Fed Chairmen Ben S. Bernanke and Paul A. Volcker. The final *amicus* brief was filed by the non-profit, non-partisan, and independent organization Better Markets (see *Banking and Finance Law Daily*, June 24, 2016).

The congressional members brief argued that "FSOC's determinations should be subject to highly deferential 'arbitrary and capricious' review in court" and that the district court erred by imposing a requirement that FSOC consider the costs that the SIFI designation imposed on MetLife. They noted that cost requirement was not "warranted" by the Dodd-Frank Act and would "meaningfully hamstring FSOC's ability to play the critical role Congress assigned it."

MetLife's arguments. MetLife's appellate brief generally claims that the FSOC failed to follow its own rules and to consider factors required by the Dodd-Frank Act, and that it violated both separation of powers and due process requirements when it designated the company as a SIFI to be supervised by the Fed (see *Banking and Finance Law Daily*, Aug. 17, 2016).

In its reply brief, Metlife laid out five reasons why the company's SIFI designation should be rejected:

1. By refusing to consider whether MetLife is vulnerable to material financial distress—the criterion relied on for the designation—the FSOC disregarded its own regulation and interpretive guidance. The FSOC was required to assess whether the company was vulnerable to material financial distress, but instead it assumed not only vulnerability but also "extreme degrees of distress."

2. The FSOC did not apply the stated standard for determining whether material financial distress at MetLife actually could destabilize the economy. The FSOC also failed "to specify plausible, objectively defined scenarios under which to evaluate the risks posed by MetLife," and it assumed that responses by state insurance regulators would aggravate, rather than ameliorate, financial distress.
3. The FSOC did not consider whether the consequences of the designation actually could weaken the company and make it more likely to experience financial distress.
4. Reasonable alternatives recommended by MetLife, such as system-wide regulation of risky activities, were not considered.
5. During the review and decision-making process, the FSOC refused to give MetLife access to the full administrative record or to information on previous SIFI designations of other companies. It also used an "administrative apparatus" under which the same individuals wrote the rules, prepared the case, proposed the SIFI designation, and made the final decision. This denied the company an opportunity to defend itself, which violated the company's due process rights and separation of powers principles.

Oral arguments were held before a three judge panel in October 2016. It is of interest to note that the three judges hearing the oral arguments were appointed by Democrat Presidents. This may give FSOC a sympathetic ear. A decision by the court will probably be handed down in first half of 2017.

3. FinTech

After a nearly year's long process, the Office of the Currency is posed to allow financial technology companies or FinTech, the opportunity to apply for special purpose national bank charters.

Innovation white paper. The process began in March 2016 with the release of a white paper entitled "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective," discussing the principles that will guide the development of the agency's framework for evaluating new and innovative financial products and services. The framework builds upon the OCC's mission to ensure that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations (see *Banking and Finance Law Daily*, March 31, 2016).

Receiverships rule. The next step in the process was the September 2016 proposed rule that would establish a framework to address the conduct of receiverships for national banks that are not insured by the Federal Deposit Insurance Corporation.

The OCC issued a final receivership rule in December 2016. The final rule, which incorporates the framework set forth in the National Bank Act for the Comptroller to appoint a receiver for an uninsured bank and clarifies certain powers held by the receiver, as well as describing the receiver's duties in winding up the affairs of the uninsured bank, becomes effective Jan. 19, 2017 (see *Banking and Finance Law Daily*, Dec. 19, 2016).

Office of Innovation. In October 2016, the OCC created the Office of Innovation as part of the agency's "Recommendations and Decisions for Implementing a Responsible Innovation Framework,"

which will be the blueprint that the agency will use to support the ability of national banks and federal savings associations to fulfill their role of providing financial services to consumers, businesses, and their communities through responsible innovation that is safe and sound, consistent with applicable law, and protective of consumer rights. Commenting on the Office of Innovation, Comptroller of the Currency Thomas J. Curry noted, "By establishing an Office of Innovation, we are ensuring that institutions with federal charters have a regulatory framework that is receptive to responsible innovation and the supervision that supports it" (see *Banking and Finance Law Daily*, Oct. 27, 2016).

The final piece of OCC's action was the early December release of a paper, entitled "Exploring Special Purpose National Bank Charters for Fintech Companies" that discusses several important issues associated with the approval of a national bank charter.

The paper discussed:

- features and attributes of a national bank charter;
- baseline supervisory expectations; and
- the chartering process.

In deciding to move forward with the chartering process, Curry stated there were "a few basic reasons" to do so, with the public interest being the "first and foremost reason." Curry cited the choice to become a national bank as another reason. A third reason was to provide a "clear process, criteria, and standards" that ensures regulators and companies openly vet risks so that FinTech companies "have a reasonable chance of success, appropriate risk management, effective consumer protection, and strong capital and liquidity" (see *Banking and Finance Law Daily*, Dec. 2, 2016).

4. Capital and liquidity

In the area of capital and liquidity, 2016 saw the banking agencies move closer to implementing various aspects of the Basel III capital framework that were issued to address practices that gave rise to the global financial crisis.

U.S. progress. In its progress report on the adoption of the Basel III capital framework, the Basel Committee on Banking Supervision reported on the progress of its 27 member jurisdictions in adopting Basel III risk-based capital standards, leverage ratio, liquidity coverage ratio (LCR), net stable funding ratio (NSFR), standards for global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs), Pillar 3 disclosure requirements, and large exposure framework.

The progress report indicated that the United States has yet to issue any type of rulemaking for the following aspects of the Basel III risk-based capital requirements:

- capital requirements for equity investment in funds;
- a standardized approach for measuring counterparty credit risk exposures;
- strengthen the capital standards for securitization exposures held in the banking book; and
- capital requirements for bank exposures to central counterparties.

Under the Basel III framework's liquidity standards, the report noted that the U.S. has proposed regulations to implement the net stable funding ratio and the NSFR disclosure requirements (see *Banking and Finance Law Daily*, Oct. 20, 2016).

LTD/TLAC requirements. One important piece in implementing the Basel III framework that was adopted in 2016 was a December 2016 final rule by the Federal Reserve Board requiring the eight U.S. GSIBs to establish long-term debt and total loss-absorbing capacity requirements, as well as restrictions on certain arrangements that could impede a resolution proceeding—clean holding, company requirements. The final rule, which is intended to enhance the resolvability of covered bank holding companies under the U.S. Bankruptcy Code and Title II of the Dodd-Frank Act, becomes effective Jan. 1, 2019 (see *Banking and Finance Law Daily*, Dec. 15, 2016).

At the Fed's Dec. 15, 2016, open meeting, Fed Chair Janet L. Yellen stated, "This meeting marks an important moment, because today we are putting into place one of the last critical safeguards that make up the core of our post-financial crisis reform efforts." She added, "Today's rule and the many other reforms we have put in place help keep our financial system strong and stable—not for its own sake—but for the sake of the workers, families and businesses who determine the long-run success of our economy." Fed Governor Lael Brainard stated, "Today's final rule helps to ensure that the largest and most complex banking institutions in America can be resolved without posing unacceptable risks to financial stability. The long-term debt requirement contained in the rule is a necessary counterpart to the Dodd-Frank Act requirement that firms construct credible plans to resolve themselves without endangering the stability of the financial system."

"Opportunity lost." Despite the progress made in the U.S. to implement the Basel III capital framework, Thomas M. Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation, cautioned that with momentum to undermine measures that could increase bank capital levels, and some jurisdictions threatening to walk away if the measures are thought too strict, the United States "should avoid joining this race to the bottom" (see *Banking and Finance Law Daily*, Nov. 10, 2016).

5. Ending TBTF

During his first speech as President and CEO of the Federal Reserve Bank of Minneapolis, Neel Kashkari offered his assessment of the current status and outlook for ending the problem of too big to fail banks. In that February 2016 speech, Kashkari noted that since the enactment of the Dodd-Frank Act, Kashkari observed, "significant progress has been made to strengthen our financial system," but he believes that Dodd-Frank "did not go far enough" and that the biggest banks are still too big to fail and continue to pose a significant, ongoing risk to our economy. He further indicated that "Now is the right time for Congress to consider going further than Dodd-Frank with bold, transformational solutions to solve this problem once and for all" see *Banking and Finance Law Daily*, Feb. 17, 2016).

To complete the work begun with the Dodd-Frank Act, Kashkari put forth a number of options which included:

- breaking up large banks into smaller, less connected, less important entities;
- turning large banks into public utilities by forcing them to hold so much capital that they virtually can't fail (with regulation akin to that of a nuclear power plant); and
- taxing leverage throughout the financial system to reduce systemic risks wherever they lie.

Kashkari's call for those bold, transformational solutions culminated in the release of the "Minneapolis Plan" in November 2016. The plan envisions four steps to strengthen the financial system:

1. Dramatically increase common equity capital for banks with assets exceeding $250 billion which would substantially reduce the chance of public bailouts relative to current regulations from 67 percent to 39 percent.
2. Call on the Secretary of the Treasury to certify that individual large banks are no longer systemically important or else subject those banks to extraordinary increases in capital requirements—up to 38 percent over time. This level of capital reduces the 100-year chance of a crisis to 9 percent.
3. Prevent future TBTF problems in the shadow financial sector by imposing a tax on the borrowings of shadow banks with assets over $50 billion. This tax rate will apply to shadow banks that are not systemically important as certified by the Treasury Secretary. A tax rate equal to 2.2 percent will apply to the shadow banks that the Treasury Secretary refuses to certify as not systemically important.
4. Reduce unnecessary regulatory burden on community banks while maintaining regulators' ability to identify and address bank risk-taking that threatens solvency.

Commenting on the plan, Kashkari stated, "We believe the Minneapolis Plan does a much better job of reducing risks at reasonable costs to society than current regulations. Ultimately, the public needs to make their own determination. We hope this process will equip them with the data and analyses they need to make an informed judgment."

