Insight

A Measure of Regulatory Relief for Mid-Size Banks

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Executive Summary

– In two notices of proposed rulemaking announced on October 31, the Federal Reserve is at last grappling with the reform for mid-size banks promised in the Economic Growth, Regulatory Relief, and Consumer Protection Act.

– The notices propose easing the capital regulation standards that apply to mid-sized banks, but not reforming the stress testing process, and the largest banks will not see any relief from capital or liquidity enhanced restrictions.

– The two proposals (one of the Federal Reserve, the other interagency) are both open for public comment until January 22, 2019. Federal Reserve Vice Chairman Quarles is to testify before Congress twice in November.

Introduction

In May 2018, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155), a landmark financial services deregulatory bill aimed at scaling back and addressing some of the most burdensome aspects of the Dodd-Frank Act. The Act sought to reform the prudential regulatory landscape, including reform of banking capital requirements, and was primarily aimed at community and mid-tier banks. (For more on the "tiering" of banks and the capital standards that apply please see a primer here.)

In particular, S.2155 raised the threshold for systemically important financial institutions from $50 billion to $250 billion while also empowering the Federal Reserve to articulate a new regulatory approach to supervising banks with assets exceeding $100 billion. Relief measures contained within S.2155, however, require implementation by the Fed, which finally held an open meeting on October 31 to discuss how it plans to execute the law.

A New Regulatory Approach

The Fed is fundamentally restructuring the hierarchy by which it considers banks with assets exceeding $100 billion. The Fed has articulated four new categories and outlined the regulatory relief that each category would expect to see.

Category	Definition	Impacted Banks
I	Domestic Global Systemically Important Banks (G-SIBs)	Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley, State Street, Wells Fargo
II	Banks with total assets exceeding $700 billion or exceeding $75 billion in cross-border activity	Northern Trust

III	Banks with total assets exceeding $250 billion or exceeding $75 billion in non-bank assets, weighted short-term wholesale funding, or off-balance sheet exposure	Capital One, Charles Schwab, PNC Financial, U.S. Bancorp
IV	All other banks with total assets between $100 billion and $250 billion	Ally Financial, American Express, BB&T Corp., Citizens Financial, Discover, Fifth Third, Huntington, KeyCorp, M&T Bank, Regions Financial, SunTrust

Category I banks would not see any regulatory relief. Category II banks (in this case simply Northern Trust) would also not see any changes in capital or liquidity requirements.

Category III banks would see regulatory relief relating to bank capital requirements. Restrictions relating to the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) would be eased following the Fed's proposal. Category III banks would see the LCR and NSFR requirements reduced to between 70 and 85 percent. Relief for banks in this category would relate only to bank capital requirements, but Category III banks would also be able to opt out of "accumulated other comprehensive income" (AOCI) reporting.

Category IV banks would see the most sweeping regulatory relief. The LCR and NSFR requirements for these banks will be removed entirely. The Comprehensive Capital Analysis and Review (CCAR) stress testing requirements would still apply to these banks, but the annual stress testing requirement would shift to a biennial requirement, although banks would still need to provide an annual capital plan. Category IV banks would also be able to opt out of not just AOCI reporting but also the countercyclical capital buffer.

Analysis

At the hearing announcing the proposal, Fed Vice Chairman Randal Quarles noted, "the character of regulation should match the character of a firm." The Fed's proposals would release almost all domestic banks from the "advanced approaches," i.e. regulatory and supervisory programs governing bank risk. In further sub-dividing medium-tier banks, the Fed has demonstrated its understanding that banks of different sizes and asset make-ups require different regulation and that, as Quarles noted, mid-size banks do not exhibit "meaningful complexity." The Fed's approach, however, is still keyed specifically to bank size; commentators hoping to see international regulators move from size as the key determinant of regulatory supervision to an activities-based approach will have to wait a little longer.

Details remain scarce on the annual capital plans required by banks in Category III and IV as these banks move to a biennial stress testing cycle. In a welcome step, however, the Fed has indicated that it will be providing firms with greater flexibility in the creation of these plans, taking into account the idiosyncratic risks of a particular firm. The degree of tailoring here appears to represent a more nuanced approach to regulation and capital setting. Quarles also indicated that the Fed will likely move to consider 2019 an off-cycle year.

What do the Fed's proposals not cover, in addition to the details on annual capital plan requirements? Several key reforms are noticeable in their absence. Perhaps most telling is the lack of real reform for banks in Category I, the G-SIBs. Some commentators expected the Fed to review the G-SIB surcharge. As AAF has written about previously, the G-SIB surcharge has not been altered since the financial crisis, despite the significant derisking of the world's largest banks. Given the greatly different risk profiles of the domestic G-SIBs between 2008 and today, this surcharge must have been inappropriate either then or now. A lack of reform in this area is indicative that the Fed does not consider regulatory relief for the G-SIBs a priority.

The other key omission is review of regulations covering a firm's living will or recovery and resolution plan.

One of the key elements of enhanced supervisory requirements, the living will represents a significant compliance cost for banks, and banking interest groups are calling for the process to be streamlined. The stress testing regime also remains largely intact. As of now it seems that the Fed's reform efforts are focused on regulatory capital.

Next Steps

Implementation of S.2155 and the Fed's reforms efforts are realized in the form of two proposed rules: first a Fed-alone proposed rule on Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, and the other an interagency proposal of changes to applicability thresholds for regulatory capital and liquidity requirements. Both proposed rules are open for public comment until January 22, 2019.

Both Senate and House Republicans have sent letters to the Fed (in August and September) encouraging the Fed to drop all enhanced prudential standards for banks under $250 billion in assets. Vice Chairman Quarles is set to testify before Congress twice in November. He will likely face significant challenge from lawmakers who believe the Fed's proposals have either gone too far or not far enough.

Conclusions

The Fed has taken the first steps in realizing the regulatory relief for mid-size banks promised by S.2155. Enhanced tailoring in regulatory approach is a welcome indication that the Fed will be applying higher degrees of nuance, recognizing that not all banks are the same or face the same risk. Although the proposals represent real capital relief for mid-size banks, the Fed has postponed both reform for the domestic G-SIBs and analysis of the non-capital aspects of enhanced supervision.