Insight

The Good, the Bad, and the Ugly in Treasury's Report on Financial Regulation

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Last month, in response to an Executive Order from February, the U.S. Department of the Treasury released the first of four reports aimed at identifying any "laws, treaties, regulations, guidance, reporting and record keeping requirements, and other Government policies that inhibit Federal regulation of the U.S. financial system in a manner consistent with the Core Principles." This first report covers the depository system, including banks, savings associations, and credit unions, and the following three will cover capital markets, asset management and insurance industries, as well as non-bank financial companies, fintech and financial innovation.

Introduction

Recall that at the center of the Executive Order were seven core principles which the administration believes to be guideposts for any future financial regulation or any reform thereof. Those core principles are as follows:

1. Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
2. Prevent taxpayer-funded bailouts;
3. Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;
4. Enable American companies to be competitive with foreign firms in domestic and foreign markets;
5. Advance American interests in international financial regulatory negotiations and meetings;
6. Make regulation efficient, effective, and appropriately tailored; and
7. Restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

Treasury's report was a 150 page discussion of what parts of the current financial regulatory regime contradict these principles and what's missing from the regime in order for it to adhere to these principles. Some recommendations mirrored those in the Financial CHOICE Act, the bill out of the House Financial Services Committee that recently passed the House but faces a standoff in the Senate, and some were out of left field. What follows is a discussion of those recommendations that were good, those recommendations that were bad, and those recommendations that were just plain ugly.

The Good

There's a lot of good in the Treasury report. In fact, the report itself is a step in the right direction in having a real conversation about what is needed and what is doable in the world of financial regulatory reform. Without burrowing down into the minutia of the good recommendations, the best parts of the report can be broken out

into four categories: capital off ramps, CFPB reform, regulatory streamlining, and community bank relief.

Capital Off Ramps

Mirroring language from the CHOICE Act, the Treasury report recommends establishing a regulatory off-ramp "from all capital and liquidity requirements, nearly all aspects of Dodd-Frank's enhanced prudential standards, and the Volcker Rule for depository institution[s] holding companies and [insured depository institutions]." Treasury suggests a 10 percent non-risk weighted leverage ratio as an appropriate level of capital to qualify for the off ramp.

As the House Financial Services Committee has explained, a 10 percent non-risk weighted leverage ratio is more stringent than Basel III which requires a common equity tier 1 risk-based capital ratio of 4.5 percent, a tier 1 risk-based capital ratio of 6 percent, a total risk-based capital ratio of 8 percent, and a leverage ratio of just 4 percent.

It remains to be seen how many, if any, large banks will opt for the higher leverage ratio in exchange for a lighter regulatory burden, but providing an opportunity for financial institutions to make an informed business decision between multiple capital and regulatory structures is a very good thing.

CFPB Reform

The Treasury report also mirrors CHOICE Act language in its recommendations for CFPB reform. Most importantly, it recommends that either the CFPB Director be removable at will by the President or that CFPB leadership be restructured as an independent multi-member commission, much like the SEC. It also removes the CFPB's direct funding draw from the Federal Reserve and puts it under annual congressional appropriations which would subject it to greater oversight.

Since its inception, the CFPB has been a textbook example of government unaccountability and overreach. In just the last five years, it has finalized 25 new rules resulting in a $2.8 billion and 17 million paperwork hour burden on consumers. It has written rules that attempt to tell Americans what they can and can't afford. And it has written regulations governing financial entities that are already regulated by a multitude of other federal agencies. Not to mention the fact that its originally-approved $21 million budget for a new headquarters building is now going to cost taxpayers over $216 million. Treasury's recommendations of added accountability and transparency should be implemented as quickly as possible.

Community Bank Relief

Perhaps the most easily-achievable set of recommendations in the Treasury report are those aimed at easing the regulatory burden on small and community banks. Among others, Treasury suggests exempting community banks from Basel III standards, raising asset thresholds at which a number of filings are required, and streamlining many of the regulatory processes.

When Dodd-Frank became law, there were 7,658 banks in the United States. By the end of 2016 there were only 5,980, and credit unions had decreased similarly. Similarly, although overall lending has largely recovered since the crisis, small business lending, most of which comes from small and community banks, continues to lag. Easing up on the regulations that constrain these vital banks should be a top priority for this administration. Community bank relief is also a component of CHOICE, and, by most accounts, is seen as having the most

bipartisan support of any of the bill's major provisions.

Community Reinvestment Act (CRA) Reform

Specifically, Treasury stated in its report that "[i]t is very important to have the benefits arising from banks' CRA investments better align with the interest and needs of the communities that they serve and to improve the current supervisory and regulatory framework for CRA. Treasury expects to comprehensively assess how the CRA could be improved to achieve these goals, which will include soliciting input from individual consumer advocates and other stakeholders. Aligning the regulatory oversight of CRA activities with a heightened focus on community investments will become a high priority for the Secretary."

This is all good. When the CRA was passed forty years ago, its intended purpose was to encourage banks to meet the credit and deposit needs in the specific communities in which they operate, including low and moderate-income neighborhoods. This was to be achieved by incentivizing banks to locate in lower income neighborhoods, and punish those that refused to do so. This, however, has backfired, with a lack of synchronization in data used to determine exactly which banks are serving exactly what type of neighborhood.

This recently came to light in a Wall Street Journal article explaining that old data leads regulators to believe that some of the wealthiest neighborhoods in Manhattan and San Francisco qualify as low income neighborhoods and thereby incentivize banks to open branches there. However, on the flip side, the same old data led to a rural Mississippi bank having its CRA rating downgraded and eventually having to delay two mergers. That this will be a high priority for the Secretary is encouraging.

The Bad

Though there was a lot of good in the report, there was also some bad – most notably Treasury's attempts at "improving the Volcker Rule." The report spends close to eight pages outlining recommended changes to the Volcker Rule. For example, Treasury suggests exempting smaller institutions from the Volcker Rule, giving banks greater flexibility in deciding what is a reasonable amount of market-making inventory, reducing the burdens of Volcker Rule compliance by allowing banks to tailor their compliance programs to specific activities, and simplifying the definition of a "covered fund."

To be sure, these reforms are all theoretically good. The reason they are bad, in this case, is that Congress and regulators should not spend all their time enacting detailed reforms to the Volcker Rule. Instead, they should repeal the Volcker Rule in its entirety. It's long been settled that proprietary trading had nothing to do with the crisis, yet Volcker's restrictions thereof resulted in $4.3 billion in annual costs and over 2 million paperwork burden hours, not to mention its reduction in liquidity and banks' ability to make markets. Instead of tinkering with a rule written to fix a non-problem, Congress should simply repeal the Volcker Rule.

The Ugly

Tinkering with Volcker was bad, but the Treasury report had one really ugly part, too: its recommendation that "Congress expand FSOC's authority to play a larger role in the coordination and direction of regulatory and supervisory policies." The report goes on to say that "[t]his can include giving it the authority to appoint a lead regulator on any issue on which multiple agencies may have conflicting and overlapping regulatory jurisdiction."

The idea to have one point person (or point agency) in charge of choosing which regulator takes the lead on a particular issue when there is regulatory overlap is a good one, but giving that power to FSOC is a bad idea. As

we've seen, especially with FSOC's designation of non-bank financial institutions, FSOC lacks transparency both in its process and its policy and tends to overstep its statutory reach. So although the intention is good, any additional power given to FSOC has the potential to reap unintended consequences.