



## U.S. Treasury Department Report on Core Principles for Regulating the United States Financial System

As required by the President's Executive Order 13772 setting forth the core principles that should be taken into account in connection with the regulation of the U.S. financial system, the U.S. Treasury Department published a report identifying regulations inconsistent with the seven principles articulated in the order.<sup>1</sup> The report is the first of series of reports. The current report addresses only the depository system and defers an evaluation of the orderly liquidation authority established by the Dodd-Frank Act. We await future reports that address the regulation of the capital markets, the asset management and insurance industries, and non-bank financial services companies. The report notes that stimulating economic growth depends, in the administration's view, on relieving regulatory burdens on financial institutions and establishing a more efficient system of financial regulation. The report not only identifies regulations inconsistent with the core principles but also recommends changes in varying degrees of specificity and identifies whether the recommendations contemplate regulatory changes or Congressional actions. Thus the report provides both recommendations and a general road map for implementing changes. The report summarizes its recommendations as directed toward:

- Improving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap and duplication across regulatory agencies;
- Aligning the financial system to help support the U.S. economy;
- Reducing regulatory burden by decreasing unnecessary complexity;
- Tailoring the regulatory approach based on size and complexity of regulated firms and requiring greater regulatory cooperation and coordination among financial regulators; and
- Aligning regulations to support market liquidity, investment, and lending in the U.S. economy.

Below we summarize briefly several of the principal areas of recommendations included in the report. This summary does not address the recommendations relating to the regulation of community banks, the mortgage markets, or matters relating to the Consumer Financial Protection Bureau, which we will address in a separate alert.

### **Regulatory Structure**

The report recommends that Congress take steps to reduce fragmentation, overlap and duplication in financial regulation. In order to do so, the report recommends that:

- The Financial Stability Oversight Council's (FSOC) mandate be broadened so that FSOC can assign a primary regulator on issues as to which multiple agencies may have jurisdiction; and

<sup>1</sup> See our chart summarizing the Presidential Executive Orders [here](#).

- The Office of Financial Research (OFR) be reformed so that its effectiveness is improved and would make the OFR part of Treasury, with a director to be appointed by the Treasury Secretary, without a fixed term, subject to removal at will, and a budget controlled by the Treasury Department.

### **Tailoring of Bank Capital and Liquidity Rules**

The report concludes that existing regulations do not go far enough in tailoring capital and liquidity rules. In order to remedy this, the report suggests better tailoring of rules based on an institution's size and complexity. The report focuses principally on the enhanced prudential standards (EPS) requirements that arose under the Dodd-Frank Act, including the various current stress-testing requirements. Specifically, the report recommends:

- Company-run Dodd-Frank Act Stress Test (DFAST) requirements be raised to apply to institutions that have total consolidated assets of \$50 billion (instead of \$10 billion), with some discretion allowed to banking agencies to calibrate the threshold upward from time to time based on an institution's activities;
- The mid-year DFAST be eliminated and the scenarios simplified;
- The threshold for the application of the EPS be re-evaluated and tailored based on an entity's risk profile; and
- The scope of the liquidity coverage ratio (LCR) be narrowed and made applicable to globally systemically important banks (G-SIBs) with a less stringent standard applied to internationally active bank holding companies (BHCs) that are not G-SIBs.

The report also suggests the possibility of an alternative regulatory "off ramp" approach like that reflected in the Financial CHOICE Act.

The report recommends increasing the transparency of regulatory requirements. For example, the report suggests that stress-testing and capital planning review frameworks be subject to public notice and comment. The Comprehensive Capital Analysis and Review (CCAR) process should be simplified to allow bank management greater control of capital distribution planning. The countercyclical capital buffer would be eliminated and any countercyclical capital requirements would be implemented through the DFAST and CCAR processes.

The report also notes the interaction of the leverage ratio, the enhanced supplementary leverage ratio (eSLR) and other capital rules as limiting the ability of banks to engage in certain critical banking functions. Consequently, the report suggests changes to the calculation of the SLR, expanding the treatment of certain instruments as high quality liquid assets (HQLA) for purposes of the LCR, and modifying LCR cashflow assumptions incorporated into the calculations of the LCR.

The report suggests reevaluating capital and liquidity requirements that exceed those mandated by Basel III or other standard-setting bodies and cites three such areas where recalibration is needed: the U.S. G-SIB risk-based surcharge and its focus on short-term wholesale funding reliance, the mandatory minimum debt ratio in the total loss absorbing capacity (TLAC) and eligible long-term debt rules, and the calibration of the eSLR.

### **Improving the Regulatory Engagement Model**

The report suggests re-evaluating the requirements imposed on the boards of directors of depository institutions. According to the report, banking agencies should be subject to a uniform and more rigorous cost-benefit analysis requirement in order to improve the rulemaking process. The cost-benefit analysis would be included in proposed rules and made available for public comment. The report recommends an interagency assessment of the approach to identifying matters requiring attention, matters requiring immediate attention, and consent orders in order to achieve more consistency and transparency.

### **Living Will Requirements**

The report suggests raising the threshold for living will requirements from \$50 billion in total consolidated assets to match the revised threshold for EPS, making the process subject to a two-year cycle, and improving the guidance provided by regulators in response to living will submissions. The FDIC should be eliminated from the living will process, according to the report, and the Federal Reserve should be required to review and provide feedback within six months.

### **Foreign Banking Organizations**

The report recommends reassessing the regulations applicable to foreign banks so that these institutions are not unduly contained. The report reviews various requirements applicable to foreign banking organizations, including the EPS requirements, the living will requirements, the intermediate holding company (IHC) requirement, and the capital and other requirements applicable to IHCs. The report suggests that:

- The EPS and living will requirements be based on a foreign bank's U.S. risk profile and not on the entity's global consolidated assets;
- The threshold for IHCs to comply with U.S. CCAR requirements be raised consistent with the higher threshold recommended for U.S. bank holding companies;
- The living will and other requirements applicable to IHCs be reevaluated and where home country requirements are sufficiently comparable, foreign banks should be allowed to meet U.S. requirements by meeting their home country standards; and
- Other requirements applicable to IHCs, such as the internal TLAC requirement, be recalibrated.

### **Volcker Rule**

The report recommends exempting smaller institutions from the Volcker Rule (those banks with \$10 billion or less in total consolidated assets) from all aspects of the rule, while banks with over \$10 billion in total consolidated assets that have limited trading assets and liabilities would be exempt from the proprietary trading restrictions of the rule (but subject to the covered funds provisions of the rule). The report notes the need for better coordination among the agencies charged with oversight for Volcker Rule compliance. In addition to these changes, the report would simplify the definition of "proprietary trading" by eliminating the "purpose test" and eliminating the rebuttable presumption of proprietary trading in respect of financial instruments held for fewer than 60 days. The report notes the negative effect of the rule on market-making activity and suggests that regulators give banks additional flexibility to adjust their determinations of the reasonable amount of inventory. The report raises other possible approaches to modifying the reasonably expected near-term demand (RENTD) requirement. The compliance and recordkeeping burdens associated with hedging activities. The report also makes a number of suggestions that are intended to simplify the covered fund restrictions, as well as reduce the burdens associated with the compliance program requirements. All of the suggestions regarding the rule are qualified by a final recommendation that consideration be given to implementing an "off-ramp" approach by which banks that are sufficiently well-capitalized, such that they can address risks posed by proprietary trading, would cease to be subject to the rule's prohibitions.

### **Leveraged Lending**

The report cites a number of shortcomings with the banking agencies' leveraged lending guidance. For example, the report notes that the guidance leaves ambiguity regarding the definition of "leveraged lending." The report also explains that the guidance lacked clear penalties for noncompliance. As a result of the ambiguity and confusion created by the guidance, the report recommends that the guidance be re-issued for public comment. Following the comment period, the guidance should be refined with a view toward avoiding ambiguity and achieving consistency in supervision, examination, and enforcement. Banks also should be encouraged, according

to the report, to incorporate a clear and robust set of metrics when underwriting a leveraged loan rather than relying solely on a 6x leverage ratio discussed in the existing guidance.

### **Small Business Lending**

The report notes a number of impediments to small business lending and in order to promote small business lending, the report recommends:

- Changes to the regulatory framework for community banks and credit unions, which institutions are critical to small business lending;
- Changes to the leveraged lending guidance, which should result in improved access to capital for small and medium-sized businesses;
- Changes to banking agency guidance relating to commercial real estate lending;
- Addressing the calibration of the SLR for working capital loans and unfunded lines of credit to small businesses; and
- Repealing Section 1071 of the Dodd-Frank Act, which requires that the CFPB establish regulations and issue guidance for small business loan collection.

### **Conclusion**

These recommendations and the assignments of responsibility for carrying them out are one part of a multi-pronged approach to addressing current issues of regulatory burden. The passage of the CHOICE Act by the House of Representatives last week and the start of hearings in the Senate Banking Committee provide momentum for potential legislative changes. The President's announcement of his intent to nominate Joseph Otting for Comptroller of the Currency also starts the process of administration appointments to the depository institution regulatory agencies which will play a key role in implementing recommended regulatory changes as well as any statutory changes. At the same time many details are yet to be resolved. There are differences between the Treasury report and the CHOICE Act. For example, the report would change the Volcker Rule, while the CHOICE Act would repeal it. Some of these differences may be practical as opposed to philosophical. In addition a significant number of the recommendations in the report are directional but require further effort to work out the details. Whatever the outcome, it is clear that the process of rethinking the post-financial crisis regulatory system has begun in earnest.

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