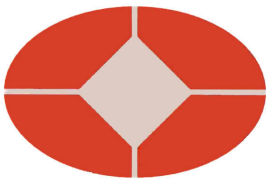

FINANCIAL DEREGULATION UNDER TRUMP

Basel May Not Go Away as Fast as Banks Believe

REGULATORY PERSPECTIVES

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By Jeb Beckwith and Sanjay Sharma, Ph.D.

"We don't want to [reform] in an unregulated way. We want to do it in a smart, regulated way." – Gary Cohn, White House National Economic Council Director & Former President, Goldman Sachs & Co.[1]

Friday's Presidential Executive Order[2] and Memorandum[3] kick off the Trump Administration's ambitious plans for financial deregulation. Notably absent from these documents is any direct mention of the FRTB or other Basel initiatives. **A careful reading of Trump's new Core Principals, in the context of previous publications, leads us to conclude that the FRTB and the Basel Framework will persist for most banks.**

Friday's Presidential Executive Order[4] on financial deregulation aligns with previous statements and documents published by candidate Trump as well as the Republicans in Congress. WSJ analysis, published only days after the election entitled "*We will Dismantle Dodd-Frank*"[5], laid out a plan for fundamental reform

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based on detailed position papers from candidate Trump[6] as well as even more detailed draft legislation from the House Financial Services Committee known as the **Financial Choice Act (FCA)**[7]. Friday's headlines[8] miss the fact that President's Trump's proposed financial reforms, while well telegraphed, do not directly target rules already promulgated by the Basel Committee on Bank Supervision (BCBS)[9] and agreed to by the Board of Governors of the Federal Reserve system (BGFRS).

In our view, these reforms will be substantial, but will not materially impact BCBS initiatives, including the Fundamental Review of the Trading Book (FRTB). The Trump Administration seeks to attack financial deregulation through three mechanisms: **Executive Orders and Memoranda, Legislation** and **Appointments**. These reforms will be significant, but most of these changes are directed at regulation specific to the United States and not part of international frameworks. Table 1 summarize the changes we expect to see.

Table 1

Financial Deregulation: What Stays and What Goes		
Major Overhaul or Repeal	**Tools of Change**	**Limited Change Expected**[10]
Dept. of Labor (**DOL**) rules	Changes via **Executive Order or Memorandum**	NA
Consumer Finance Protection Bureau (**CFPB**)	Changes of Legislation - **Dodd-Frank Amendment** (DFA)	NA
DFA, Title II (including Systemically Important Financial Institutions or **SIFIs**)		
DFA, **FSOC**		
DFA, **CCAR**		
DFA, **Volker Rule**		
Basel "Opt-Out" for Community Banks (10% test)	Changes through combination of **Legislation and Appointments** made over more extended periods of time.	**Basel III, IV** for most banks
Federal Reserve System (FRS), Initiative to bring the Federal Reserve System (FRS) under the Congressional Appropriation Process will be resisted		Fundamental Review of the Trading Book (**FRTB**) for most banks
FRS, various new restrictions through Title VII of FCA[11]		
FRS, various new notice and consultation requirements for new BCBS initiatives not already agreed		

Presidential Executive Order – February 4th, 2017

President Trump outlined six Core Principles for Financial Regulation and directed the Treasury Secretary to consult with all FSOC[12] members and to issue a report within **120 days** describing all laws, treaties, regulations, guidance, reporting, recordkeeping requirements, and other government policies that would inhibit regulation according to the Core Principles.

President Trump's Core Principles for Financial Deregulation
(a) Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth
(b) Prevent taxpayer-funded bailouts
(c) 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
(d) Enable American companies to be competitive with foreign firms in domestic and foreign markets
(e) Advance American interests in international financial regulatory negotiations and meetings
(f) Restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework

Actual changes may take time to implement depending on what this study finds. Trump's Treasury Secretary and most FSOC[13] heads have yet to be confirmed. These confirmations are a prerequisite for orchestrating and executing any rule changes. **Past statements imply that the Trump Administration will use the FCA as a blueprint for implementing financial reform.**

Executive Memorandum – February 4th, 2017

President Trump also issued an Executive Memorandum on February 4th directing the Department of Labor (DOL) to examine their Fiduciary Duty Rule and to repeal it if it is found to reduce investor access or increase investor costs. It should be noted that **this rule change does not require consent beyond the DOL.**

Legislation: Deconstructing the Financial Choice Act (FCA) - HR 5983

FCA is the 513 page blueprint for financial reform. Despite recent headlines, the FCA does not seek to replace the DFA in its entirety. Rather, the Republican Congress seeks to replace certain aspects of DFA and other legislation which it considers to be most limiting to growth or which fosters the potential for tax-payer funded bailouts of large financial institutions.

Importantly, only the smallest community banks are expected to meet the 10% leverage test required under the FCA to opt-out of Basel capital and liquidity rules.[16]

Here is an outline of how the FCA is constructed.

How the Financial Choice Act Works		
	Description	**Impact**
I	Opt-Out Capital Option	a. Allows banks to apply for Qualifying Banking Organization (QBO) status IF: 1) Total Leverage Ratio[14] > 10% 2) CAMELS[15] of 1 or 2 for all group depositories 3) Election made for all depositories and holding companies within the group simultaneously b. QBO's shall be exempt from: 1) All other capital or liquidity requirements 2) Any Financial Stability or Living Will reporting 3) Limitations of mergers or acquisitions c. Use of RWA is NOT allowed d. Expected to be applicable only for smallest banks[16]
II	Ending "Too Big to Fail"	a. Dramatically eases CCAR tests and exempts QBO's b. Dramatically reduces the powers of FSOC[17] c. Repeals the Fed's Orderly Liquidation Authority (OLA) found in Title II of the DFA d. Replaces the OLA framework with a new Financial Institution Bankruptcy framework e. Eliminates the use of government guarantees (except FDIC deposit guarantees) f. Repeals the use of systemic risk determination, the exchange stabilization fund g. Eliminates the Financial Market Utility designation
III	Replace CFPB	a. Replaces the CFPB with a new Consumer Financial Opportunity Commission (CFOC) b. CFOC governance is a commission structure which congressional budget oversight and Presidential reporting of commissioners

IV	Capital Markets Reforms	a. SEC Reforms b. Repeal of DOL Fiduciary Rules[18] c. Repeal of Risk Retention requirements for commercial mortgages d. Repeal of many Private Equity reporting requirements e. CFTC Reforms, including swap dealer registration rules and harmonization of OTC derivatives rules f. Other reforms including the use of risk based measures for NRSRO's and many section repeals
V	Insurance Regulation	a. Repeals the Federal Insurance Office
VI	Reforms in the Oversight of Regulators Other Than the Fed	a. Require Cost-Benefit Analysis for each proposed regulation b. New requirements for Notices of Proposed and Final Rulemaking including 90-day comment period between each c. Congressional Review procedures established for all rules with Congressional Approval required for Major Rules d. Bringing Federal agencies under the annual Congressional appropriations process e. Establishing rules for participation in International regulatory bodies such as the BCBS, the BIS, and IOSCO
VII	Fed Oversight Reforms	a. Bringing the non-monetary wing of the Federal Reserve System under the Congressional appropriations process b. Creating a new Centennial Monetary Commission to reexamine the FRS's "Dual Mandate" and whether changes need to be made c. Strengthens various reporting requirements including compensation disclosures
VIII	Penalty Reforms	a. Increases monetary penalties levied against financial institutions
IX	Repeal of Volcker Rule	a. Repeals Volcker Rule restrictions on proprietary trading and private equity
X - XI	Reforms Aimed at Small Business	a. Various reforms aimed at reducing regulatory burdens for small businesses

Note that **neither the FCA, the Executive Order, nor the Presidential Memorandum on Fiduciary Duty Rule[19] have any direct mention of Basel III, Basel IV or the FRTB other than FCA Title I.** Congress has already granted the BGFRS with broad powers to create implementing legislation for international rules and these powers have not been rescinded within the FCA.

Executive Branch and the Federal Reserve System Appointments

Financial regulation in the U.S. is governed by a complex network of agencies, bureaus and governmental authorities. Sitting atop it all is the Federal Reserve System (FRS) and governing the FRS is its 7-member board. The BGFRS represents the U.S. at most international bank regulatory organizations including the Bank for International Settlements (BIS), the BCBS, and the Financial Stability Board (FSB).

Unlike cabinet or agency appointments in the Executive Branch, the FRS's governance is independent. **No member of the BGFRS can be removed by Presidential Order alone and no members' term expires prior to February 1st, 2020**.[20] Of the 7-member board, the Trump Administration does have the power to nominate 2 new individuals to vacant board seats, including the Vice-Chair for Supervision. Trump can also elect to change the Chair (currently held by Janet Yellen) and Vice-Chair (currently held by Stanley Fischer) in 2018, but only from within the existing members of the BGFRS and only with Senate confirmation. While there is speculation that Ms. Yellen, Mr. Fischer and a third governor, Daniel Tarullo, may retire early[21], there is no legal mandate for them to do so. **We do not expect that the governors who spent years creating the Basel framework will easily now step aside to see it undone**

Conclusion

Unlike many parts of the DFA, CFPB, Volker and other U.S. focused reform initiatives, we fully expect that rules promulgated by the BCBS under BGFRS guidance will be implemented on a timely basis for most banks. In particular, this includes the Fundamental Review of the Trading Book (FRTB) which is the first BCBS rule to contain specific dates for local rule making and implementation.

While we do expect an opt-out provision for Basel capital and liquidity standards to prevail in the U.S. and possibly other parts of the world, we believe such a provision will be directed only to the smallest, community banks.

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1. as quoted in the WSJ, 2/3/17, *Trump Plans to Undo Dodd-Frank*, *Fiduciary Rule*, by Michael C. Bender and Damian Paletta
2. Presidential Executive Order on Core Principals for Regulating the United States Financial System https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states
3. Presidential Memorandum on Fiduciary Rule, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule;
4. https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states
5. *Donald Trump's Transition Team: We will 'Dismantle' Dodd-Frank*", by Ryan Tracy, WSJ, 11/10/16
6. https://www.donaldjtrump.com/policies
7. A 513-page bill proposed by the House Financial Services Committee in 2016, HR 5983, http://financialservices.house.gov/uploadedfiles/bills-114hr-hr5983-h001036-amdt-001.pdf
8. Such as "*Trump Begins Assault on Dodd-Frank Financial Regulations*", New York Times, by Ben Protess and Julie Hirshfield Davis, 2/3/17
9. he Basel Committee for Bank Supervision (BCBS)
10. The FCA does provide an opt-out provision to these rules under Title I, but only under liited circumstances. Please see FCA, Title 1 discussion below.
11. http://financialservices.house.gov/uploadedfiles/bills-114hr-hr5983-h001036-amdt-001.pdf
12. The Financial Stability Oversight Council (FSOC) is a creation of the DFA designed to foster cooperation and coordination amongst disparate US financial regulators, as well as to implement consolidated rulemaking around G-SIFI's. The FSOC voting member agencies are the BGFRS, CFTC, FDIC, FHFA, NCUA, OCC, SEC, Treasury, CFPB. The US Treasury Secretary serves as Chair. More information can be found at https://www.treasury.gov/initiatives/fsoc/rulemaking/Pages/default.aspx. Also, please see our earlier whitepaper entitled *Basel Under Trump*.
13. See footnote 7
14. Total Leverage means Tangible Equity/Total Liabilities. The term Total Leverage Exposure is defined under section 3.10(c)(4)(ii), 217.10(c)(4), or 324.10(c)(4) of title 12, Code of Federal Regulations as of 1/1/15.

15. The key, U.S. regulatory metric of depository solvency measured on a scale of "1" (best) to "5" (worst). CAMEL rating are not publically available but are made known to bank executive managements and boards. CAMELS stands for Capital adequacy, Assets, Management capability, Earnings, Liquidity, and Sensitivity to market risk.
16. **A peer review of 20 regional banks** published by Wintrust Financial Corporation finds that the **median average Tangible Equity/Total Assets ratio was 8.61% as of 12/31/16**, well below the 10% threshold. These 20 banks were: Associated Banc-Corp (ASB), BancorpSouth, Inc. (BXS), Cullen/Frost Bankers, Inc. (CFR), First Citizens BancShares, Inc. (FCNCA), First Horizon National Corporation (FHN), First Midwest Bancorp, Inc. (FMBI), First Niagara Financial Group, Inc. (FNFG), FirstMerit Corporation (FMER), Fulton Financial Corporation (FULT), International Bancshares Corporation (IBOC), MB Financial, Inc. (MBFI), Old National Bancorp (ONB), PrivateBancorp, Inc. (PVTB), Susquehanna Bancshares, Inc. (SUSQ), TCF Financial Corporation (TCB), UMB Financial Corporation (UMBF), Umpqua Holdings Corporation (UMPQ), Valley National Bancorp (VLY), Webster Financial Corporation (WBS), Wintrust Financial Corporation (WTFC). Please see http://www.wintrust.com/investor-relations/peer-analysis
17. Largely through the elimination of provisions in the Financial Stability Act of 2010
18. Legislation will not be required to overturn the DOL rules if the DOL, under the Trump Administration, revokes these rules on its own
19. Dated 2/3/17 directing the Labor Secretary to investigate elimination of this rule, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule
20. https://www.federalreserve.gov/aboutthefed/bios/board/default.htm
21. http://www.cnbc.com/2016/11/16/obscure-part-of-law-could-let-yellen-fischer-thwart-trump-on-reshaping-the-fed.html