Tailoring Bank Regulations

BY TIM SABLIK

On Oct. 2, 2018, Fed Governor and Vice Chairman for Supervision Randal Quarles appeared before the Senate Committee on Banking, Housing, and Urban Affairs to discuss the Fed's progress in implementing new reforms to bank regulation.

The reforms are a result of the Economic Growth, Regulatory Relief, and Consumer Protection Act, or EGRRCPA, signed into law in May 2018. In addition to introducing protections for consumers and relaxing mortgage lending rules, EGRRCPA amended several banking regulations put in place by the Dodd-Frank Act of 2010.

Dodd-Frank introduced new rules for financial firms, such as stronger capital and liquidity requirements and stress tests to assess institutions' resiliency to future crises. While Dodd-Frank set easier requirements for smaller entities than for large institutions whose failure could create spillover effects for the overall economy, leaders of community banks argued that the law's new requirements were nevertheless disproportionately burdensome for their smaller staff.

There is some evidence that the cost of regulatory compliance can be significant for smaller financial institutions. A 2013 Minneapolis Fed study found that for a third of community banks, hiring just two additional employees to manage regulatory compliance would be enough to make them unprofitable. Some have suggested this burden may have contributed to the dearth of new community banks formed in recent years. (See "Who Wants to Start a Bank?" *Econ Focus*, First Quarter 2016.)

To address these concerns, EGRRCPA makes a number of changes to how Dodd-Frank applies to community banks. Existing rules require all banks to maintain capital at no less than 4 percent of total assets. Banks are also subject to additional risk-weighted capital requirements. Under EGRRCPA, banks with less than $10 billion in assets have the option to instead meet a new Community Bank Leverage Ratio, which requires them to maintain capital at between 8 percent and 10 percent of total assets unweighted by risk. While this new leverage ratio is higher than the old one, banks that meet this requirement will be exempt from any additional capital requirements. In his October testimony, Quarles noted that the Fed and other banking regulators plan to issue a proposal for implementing the Community Bank Leverage Ratio "in the very near future."

Under EGRRCPA, banks with less than $10 billion in assets are also exempt from the so-called "Volcker Rule," which prohibits proprietary trading by banks. (See "Rolling Out the Volcker Rule," *Econ Focus*, First Quarter 2014.) Finally, EGRRCPA seeks to ease some of the reporting costs for smaller banks. Banks must file quarterly "call reports" collecting a variety of information on their operations for regulators. Under the new law, banks with less than $5 billion in assets can file more simplified reports for the first and third quarters of the year. Additionally, EGRRCPA allows banks with less than $3 billion in assets to reduce the frequency of bank examinations from yearly to once every 18 months. Under Dodd-Frank, this was only available to banks with less than $1 billion in assets.

EGRRCPA makes a number of changes to regulations for larger banks as well. Under Dodd-Frank, all banks with more than $50 billion in assets were subject to additional requirements and regulatory scrutiny. They were subject to periodic stress tests, asked to provide living wills detailing how regulators could unwind them in the event of failure, and required to maintain a certain threshold of assets that could easily be liquidated in a crisis, among other measures. EGRRCPA raised the asset threshold for applying these requirements to $100 billion and gave the Fed greater discretion to tailor requirements for banks with more than $100 billion in assets. In an Aug. 17 letter, a group of senators urged the Fed to use that discretion to reduce regulations for large banks that do not pose a systemic risk to the economy.

On Oct. 31, the Fed's Board of Governors released a draft framework for implementing these changes. The proposal creates four categories for large banks based on asset size and risk profile. The first category applies to globally systemically important banks and their subsidiaries. Regulators have determined that these institutions pose the greatest risk for the financial system, and under the new framework they would remain subject to the most stringent requirements introduced by Dodd-Frank and the international Basel Committee on Banking Supervision.

The second category of regulations would apply to banks with $700 billion or more in assets as well as those firms engaged in significant international activity. These firms would be subject to many of the same enhanced requirements as the firms in the first category. Firms with $250 billion or more in assets that do not meet the criteria for the first two categories would also face similar rules but less demanding liquidity requirements.

The biggest changes under the proposed framework would be for firms with between $100 billion and $250 billion in assets. Those firms would no longer be subject to certain liquidity requirements and would need to submit to stress tests only every other year rather than annually.

In a statement accompanying the new framework, Quarles said that he was "hopeful that firms will see reduced regulatory complexity and easier compliance with no decline in the resiliency of the U.S. banking system." **EF**