2019 Banking Law Committee Meeting
Washington, D.C.

Hot Topics/ What to Watch in 2019
January 11, 2019

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2. Cleary Gottlieb Discusses New Law Revising Dodd-Frank Act


4. S&C - New Supervisory Rating System for Large Banking Organizations

5. Buckley Sandler - Is the CFPB bound by its non-binding guidance?
## Selected Prudential Regulatory Proposals/Developments Anticipated in 2019

### Recovery & Resolution Planning
- FRB-FDIC finalized version of resolution planning guidance for 8 US GSIBs – Jan 2019
- FRB-FDIC request for comment on resolution planning guidance for 4 FBO LISCC firms – **1Q 2019**
- FRB-FDIC NPR revising Section 165(d) resolution planning requirements – **1Q 2019**
- FRB NPR setting requirements for resolution liquidity and capital pre-positioning – **uncertain**
- FRB NPR recalibrating internal TLAC requirements for IHCs closer to the 75% end of the FSB’s range – **1Q 2019**
- FRB NPR seeking to streamline elements of the FRB’s resolution loss absorbency regime, which include both TLAC and long-term debt requirements – **1Q 2019**
- FDIC ANPR re: IDI plan changes – **1Q 2019**
- FDIC proposed statement about how it would use OLA under SPOE – **unknown**
- FRB NPR creating a regulatory regime to address continuity of access/service to FMUs (including CCPs) by a GSIB in resolution – **unknown**

### Bank Regulatory/ Governance
- FRB tailoring proposal for FBO IHCs – **1Q 2019**
- FRB NPR IHC Board Governance – **unknown**
- FRB NPR on “Control” – **1/2Q 2019**
- Banking agencies NPR on holding company source of strength – **2Q 2019**
- FRB NPR on DFA changes to 23A/Regulation W – **unknown**
- FRB DFA § 166 early remediation re-proposal – **unknown**
- FRB and OCC guidance on third-party risk management for SIFMUs – **unknown**
- FRB NPR on an update on SR 08-8 to address compliance and conduct risk - **unknown**
- FFIEC third-party service provider examination tool for cybersecurity – **unknown**
- FRB NPR on Regulation L: Management Official Interlocks – **unknown**
- FRB NPR on Regulation O: Loans to Officers, Director, Shareholders – **unknown**
- FRB NPR on the DFA § 604(d) financial stability factor – **unknown**
- Banking Agencies/SEC/NCUA/FHFA final rule re: incentive compensation restrictions under section 956 of the DFA – ? / fate uncertain

### Finance
- Banking Agencies NSFR final rule – **1Q 2019**
- U.S. implementation of SMA operational risk framework – **2019**
- U.S. implementation of revised standardized credit risk framework – **2019**
Cleary Gottlieb Discusses New Law Revising Dodd-Frank Act

By Derek M. Bush, Hugh C. Conroy Jr., Allison H. Breault, Zachary L. Baum and Rebecca F. Green  May 30, 2018

The Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Act”), which became law on May 24, contains the first major package of revisions to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Act leaves the architecture and core features of Dodd-Frank intact but significantly recalibrates applicability thresholds. While the changes mandated by the Act are significant, it also places significant discretion for further changes in the hands of the Federal Reserve Board.

Both the House of Representatives and the Senate passed the Act on bipartisan votes. The Chairman of the House Financial Services Committee and the Senate Majority Leader have signaled a commitment to take up additional regulatory relief legislation that would make further changes to Dodd-Frank. Whether additional legislation would garner the bipartisan support ultimately required for passage remains to be seen.

Most of the Act’s reforms reduce burdens on mid-size and smaller banks and bank holding companies. Significantly, the Act raises the asset threshold for application of Dodd-Frank’s enhanced prudential standards from $50 billion to $250 billion, thereby exempting a number of smaller and regional institutions from stress testing, resolution planning and heightened risk management requirements, among other things. In other significant changes, banks and bank holding companies with assets of $10 billion or less are exempt from the Volcker Rule, and could be exempt from risk-based capital rules if they maintain a high “community bank leverage ratio”.

As with Dodd-Frank, the ultimate effect and scope of the Act will depend significantly on how it is implemented by the Federal Reserve Board and other bank regulators. Our companion Alert Memorandum analyzes key implementation considerations, including highlighting a number of regulations for which the regulatory agencies, and in particular the Federal Reserve Board, will likely need to reconsider applicability, scope and thresholds.

Enhanced Prudential Standards

The Act makes significant changes to the enhanced prudential standards (“EPS”) provisions of Dodd-Frank. EPS include heightened capital, liquidity and risk management standards, as well as resolution planning requirements, mandatory stress testing and single counterparty credit limits, for large bank holding companies (“BHCs”) and foreign banking organizations (“FBOs”).

The Act also enhances the Federal Reserve Board’s (“FRB”) discretion to tailor EPS standards to BHCs and FBOs based on their risk profile.

1. Increased Asset Thresholds

$250 Billion EPS Threshold

• Among the Act’s most significant reforms is a substantial increase in the threshold for subjecting a BHC to EPS. The Act raises the threshold from $50 billion in total consolidated assets to $250 billion, with staggered effective dates.
  • BHCs with less than $100 billion in assets are immediately exempt from EPS.
  • BHCs with between $100 billion and $250 billion in assets are exempt 18 months following enactment.
    • The FRB is authorized to accelerate the off-ramp for BHCs with total assets between $100 billion and $250 billion during the 18-month transition period.
  • The FRB retains discretion to apply any or all EPS to BHCs below $250 billion in total consolidated assets.
• The FRB would need to determine that application of the EPS is appropriate to prevent or mitigate risks to U.S. financial stability or to promote the safety and soundness of the BHC (or group of BHCs), after taking into consideration capital structure, riskiness, complexity, financial activities, size and any other risk-related factors that the FRB deems appropriate.

**GSIBs**

• A BHC that qualifies as a Global Systemically Important Bank (“GSIB”), under the FRB’s systemic indicator score remains subject to the most stringent EPS, regardless of its asset size.
• The FRB’s systemic indicator score aligns with the Basel capital framework’s methodology for identifying GSIBs and takes into account size, interconnectedness, substitutability, complexity and cross-jurisdictional activity.
• There are currently 8 U.S. GSIBs: JPMorgan Chase, Citigroup, Bank of America, Goldman Sachs, Wells Fargo, Morgan Stanley, State Street, and Bank of New York Mellon.

**OCC and FDIC Regulatory EPS for Subsidiary Banks**

• Many of the changes in the Act amend provisions of Dodd-Frank that apply at the BHC or FBO level, and not to subsidiary national banks or other insured depository institutions (“IDIs”). The Office of the Comptroller of the Currency (“OCC”) and the Federal Deposit Insurance Corporation (“FDIC”) have adopted their own counterparts to some EPS for the bank subsidiaries that they regulate, including recovery and resolution planning. A key consideration will be whether the OCC and the FDIC take similar measures under their regulations and guidance to align asset thresholds with what is reflected in the Act.
• For example, the FDIC may have a different focus in evaluating thresholds for resolution planning as applied to mid-size IDIs. Regulatory changes at the bank subsidiary level will remain an area to watch. The FDIC is responsible for bank resolutions irrespective of the asset threshold or systemic importance of the bank, and the FDIC historically has been concerned about complications in resolving banks smaller than $100 billion. As a result, while a new Board and Chairman may consider simplifying the resolution planning requirements for some banks below the proposed BHC thresholds, it is unlikely that the FDIC will eliminate resolution planning requirements for those banks entirely.
• At both the OCC and FDIC, regulatory changes at the bank subsidiary level will remain an area to watch.

2. **Recalibration of Stress Testing Requirements**

**Supervisory Stress Tests**

• BHCs with more than $250 billion in total consolidated assets remain subject to annual supervisory stress tests, although the Act reduces the number of stress test scenarios from three to two by eliminating the “adverse” scenario (leaving only the “baseline” and “severely adverse” scenarios).
• Eighteen months after enactment, BHCs with total consolidated assets between $100 billion and $250 billion would be subject to periodic supervisory stress tests to evaluate whether they have capital sufficient to absorb losses under adverse economic conditions. The frequency of these periodic tests remains to be determined.
• BHCs with less than $100 billion in total consolidated assets are longer be subject to capital stress testing.

**Company-Run Stress Tests**

• The Act exempts all banking organizations—including not only BHCs, but also depository institutions and savings and loan holding companies (“SLHCs”)—with less than $250 billion in total consolidated assets from the current requirement to conduct company-run stress tests.
• Banking organizations with $250 billion or more in total consolidated assets are still required to conduct company-run stress tests on a periodic basis but are no longer be required to do so on a semi-annual or annual basis.
• Consistent with the proposed changes to the supervisory stress tests, the Act also reduces the number of scenarios for the company-run stress tests from three to two.

3. **Foreign Banking Organizations**

**Asset Thresholds**: The Act generally applies the asset-based thresholds to domestic BHCs and FBOs similarly.

• FBOs are treated as BHCs for purposes of the EPS requirements, and the increase in asset thresholds for domestic BHCs applies to FBOs. However, the FRB has interpreted the Dodd-Frank asset threshold to apply to FBOs based on their global assets, rather than U.S. assets, and the Act appears not to change that approach.

**Intermediate Holding Companies of FBOs**

• Under a rule of construction for FBOs, nothing in the Act may be construed to: (1) affect the legal effect of the FRB’s intermediate holding company (“IHC”) rules as applied to FBOs with $100 billion or more of total consolidated assets, or (2) limit the FRB’s authority to require the establishment of an IHC, impose EPS, or tailor regulation of an FBO with $100 billion or more of total consolidated assets.
• The existing IHC asset threshold is $50 billion in U.S. non-branch assets. Any revisions to the threshold must be made by the FRB amending its regulations (since the threshold, like the IHC requirement itself, was created by the FRB and was not a feature of Dodd-Frank).

4. Credit Exposure Reports

The Act amends Dodd-Frank to authorize, instead of require, the FRB to promulgate rules regarding BHCs’ reporting of credit exposure to the FRB, the Financial Stability Oversight Council (“FSOC”) and the FDIC. The FRB had proposed credit exposure reporting requirements in connection with its resolution planning rulemaking, but it never finalized those requirements pending completion of its single-counterparty credit limit rules.

5. Assessments

The Act eliminates assessments on BHCs with less than $250 billion in total assets to fund expenses of the Office of Financial Research.

Regulatory Capital and Liquidity Requirements

1. Supplementary Leverage Ratio

The Act requires the federal banking agencies to amend the Supplementary Leverage Ratio (“SLR”) to exempt from the SLR denominator funds on deposit with certain central banks for BHCs and their subsidiaries that are “predominantly engaged in custody, safekeeping and asset servicing” activities, provided that the funds are less than or equal to deposits linked to fiduciary, custodial or safekeeping accounts.

• The large custody banks have argued that cash they hold on deposit at the FRB in connection with their trust and fiduciary businesses should not result in SLR capital requirements. Other large banking organizations have argued to exclude cash from the SLR calculation more broadly, but the Act takes a narrower approach.

• This provision causes the U.S. SLR to diverge from the Basel leverage framework in its treatment of central bank deposits. While the so-called “Basel IV” revisions of December 2017 allow for national discretion to exempt central bank reserves from the leverage ratio exposure measure, the exemptions are permitted only temporarily and in exceptional macroeconomic circumstances, and they must be accompanied by a corresponding increase in the calibration of the minimum leverage ratio to offset the impact of exempting central bank reserves.

• The Federal Reserve has indicated that the Act likely will result in a recalibration of its proposed revision to the enhanced SLR. See 83 Fed. Reg. 17317 (Apr. 19, 2018).

2. Liquidity Coverage Ratio

The Act requires the banking agencies to amend their liquidity coverage ratio (“LCR”) rules to permit more favorable treatment of municipal bonds—as Level 2B high quality liquid assets (50% haircut)—so long as the bonds are liquid, readily-marketable and investment grade.

• The FRB amended its LCR rule in 2016 to permit certain municipal securities to be treated as level 2B assets, subject to a number of limitations in addition to the requirements in the Act. However, the OCC and the FDIC have not adopted or proposed similar amendments.

3. Risk Weight for Certain High-Risk Real Estate Loans

The Act prohibits federal banking agencies from assigning heightened risk weights to high volatility commercial real estate (“HVCRE”) exposures, unless the exposures are classified as HVCRE acquisition, development, and construction loans.

Currently, a 150% risk weight applies to loans classified as HVCRE under the U.S. capital rules. The federal banking agencies issued a proposal in September 2017 to simplify the treatment of HVCRE and to create a new category of commercial real estate loans—“high-volatility acquisition, development or construction” (“HVADC”) exposures—with a lower risk weight of 130%.

• The most significant difference between the Act and the agencies’ HVADC proposal arises from the Act’s preservation of the exemption for projects where the borrower has contributed at least 15% of the real property’s appraised “as completed” value. The agencies’ HVADC proposal would have eliminated this exemption in the interest of simplification.

Volcker Rule

Banks and BHCs with (1) $10 billion or less in total consolidated assets and (2) total trading assets and liabilities of 5% or less of total consolidated assets are exempt from the Volcker Rule.

Any banking entity may share its name with a hedge fund or private equity fund for which it serves as an investment adviser, provided that (1) the investment adviser is not, and does not share a name with, an IDI, a company that controls an IDI, or an FBO, and (2) the name does not contain the word “bank.”
Although not related to the Volcker Rule amendments in the Act, a provision designed to provide relief for certain small venture capital funds has Volcker Rule implications. The Act expands the exemption from the definition of “investment company” under Section 3(c)(1) of the Investment Company Act of 1940 (the “Investment Company Act”) for venture capital funds that have fewer than 250 investors and $10 million or less in capital commitments. This has the possibly unintended consequence of sweeping these funds into the scope of the Volcker Rule, since the agencies’ definition of “covered funds” uses the Section 3(c)(1) exemption as a baseline definition.

**Acquisitions of Interests in Nonbanks**

As amended by the Act, Dodd-Frank requires FHCs with assets of $250 billion or more (up from $50 billion or more) to obtain prior FRB approval if the non-bank target engaged in Gramm-Leach-Bliley Act “financial in nature” activities has assets of more than $10 billion.

**Community Banks**

1. **Capital Rules**

Banks and BHCs that have less than $10 billion in total consolidated assets and that maintain a “community bank leverage ratio” (defined as tangible equity capital to average total consolidated assets) of at least 8-10% are exempt from U.S. risk-based capital rules imposed under Basel III and the generally applicable leverage ratio and would be deemed well-capitalized.

   - The federal banking agencies maintain discretion to disqualify banks and BHCs from this relief if they determine the relief is not appropriate to the bank’s or BHC’s risk profile.

The threshold for qualifying for the FRB’s “Small Bank Holding Company Policy Statement” is increased from $1 billion to $3 billion, provided the small BHC or SLHC is not engaged in significant non-banking activities, is not engaged in significant off-balance sheet activities and does not have a material amount of debt or equity registered with the Securities and Exchange Commission (the “SEC”).

2. **Risk Committee**

The Act raises the total asset threshold from $10 billion to $50 billion for the Dodd-Frank risk committee requirement for publicly traded BHCs, although the FRB retains discretion to require a risk committee at smaller institutions.

3. **Savings Association Election to Operate as a National Bank**

Federal savings associations with total consolidated assets of $20 billion or less have the option to operate as national banks and to have the same privileges and duties as national banks without converting their charters.

**Real Estate and Mortgage Lending**

1. **Mortgage Lending Requirements for Small Banks**

Certain mortgage loans that are (1) originated by an IDI or an insured credit union with less than $10 billion in total consolidated assets, (2) held in portfolio, and (3) satisfy certain other criteria are deemed to satisfy the Truth in Lending Act’s “ability to repay” requirements and therefore be treated as “qualified mortgages.”

The Act directs federal banking agencies to issue regulations exempting certain IDIs and insured credit unions with assets of $10 billion or less from the requirement to establish escrow accounts in connection with certain residential mortgage loans.

Certain mortgage loans of $400,000 or less made with respect to property in rural areas are exempt from appraisal requirements under the Financial Institutions Reform, Recovery, and Enforcement Act, provided that the originator makes a good faith effort to find a state-certified or state-licensed appraiser and is unable to do so.

2. **Home Mortgage Disclosure Act Reporting**

IDIs and insured credit unions that originated fewer than 500 closed-end mortgage loans or 500 open-end lines of credit in each of the two preceding years are exempt from a subset of disclosure requirements (recently imposed by the Consumer Financial Protection Bureau (“CFPB”)) under the Home Mortgage Disclosure Act (“HMDA”), provided they have received certain minimum Community Reinvestment Act ratings in their most recent examinations.

The Act also directs the Comptroller General to conduct a study assessing the effect of the exemption described above on the amount of HMDA data available at the national and local level.
Brokered Deposits

The Act provides a limited exemption from treatment as “brokered deposits” for certain “reciprocal deposits” placed by an IDI through a deposit placement network. Reciprocal deposits of an agent institution are not considered to be brokered deposits up to the lesser of $5 billion or 20% of the IDI’s total liabilities, provided that the IDI (1) has an “outstanding or good” composite condition examination rating and is well capitalized, (2) has obtained a waiver, or (3) if it has a rating less then outstanding or good, or is less than well-capitalized, the reciprocal deposits received do not exceed certain average amounts held prior to receiving a rating or capital downgrade.

Securities Laws

1. Investment Company Act Exemptions

Venture capital funds with less than $10 million in capital commitments and fewer than 250 investors may rely on the exemption from the definition of “investment company” in Section 3(c)(1) of the Investment Company Act.

The Act eliminates the Section 6(a)(1) exemption from registration under the Investment Company Act for companies organized under the laws of Puerto Rico and the U.S. territories.

2. State Blue Sky Laws

The Act expands the federal exemption from state Blue Sky Laws to cover securities qualified for trading in the national market system, rather than those listed on a limited number of specified exchanges.

3. Algorithmic Trading

The Act directs the SEC to conduct a study on the costs and benefits of algorithmic trading and to make a recommendation about whether the SEC should change any of its regulations based on its analysis and, if so, whether it needs additional legal authorities or resources.

4. Closed-End Funds

The Act directs the SEC to issue rules permitting publicly listed closed-end funds to use the securities offering and proxy access rules available to other issuers and to consider the disclosures necessary to treat such funds as well-known seasoned issuers.

Consumer Financial Protection

1. Identity Theft, Fraud, and Exploitation

The Act institutes a number of consumer protection reforms, including measures targeting identity fraud, permitting consumers to place freezes on their credit reports without charge, and providing protection for whistleblowers who report the exploitation of senior citizens by financial institutions.

2. Student Loans

Private student loan borrowers and co-signors are protected by a number of measures that generally prohibit counting the bankruptcy or default of a borrower or co-signor as an event of default. Government-funded loans are not be affected.

The Act eases requirements for private student loan borrowers to remove defaults from consumer credit reports if they participate in loan rehabilitation programs offered by lenders.

Cybersecurity

The Act directs the Secretary of the Treasury to issue a report assessing the threat of cyber-attacks on U.S. financial institutions, evaluating current efforts to address such risks, and recommending additional legal authorities or resources for financial regulatory agencies.

What the Act Does Not Cover

- It does not alter the CFPB’s authorities, governance structure, or appropriations.
- It does not change the composition or role of FSOC.
- It leaves intact core elements of Dodd-Frank adopted in response to the financial crisis, such as the resolution planning process, the orderly liquidation authority, FSOC’s authority to designate nonbanks as systemically important financial institutions, and the power to force troubled BHCs to divest certain assets if they pose a grave threat to financial stability.

This post comes to us from Cleary, Gottlieb, Steen & Hamilton LLP. It is based on the firm’s memorandum “Financial Regulatory Relief Enacted,” dated May 24, 2018, and available here.
A Dramatic Departure?

National Treatment of Foreign Banks
One of the most controversial elements of the Federal Reserve Board’s implementation of enhanced prudential standards for foreign banking organizations is a new structural requirement. The final rule requires FBOs with $50 billion or more in U.S. non-branch assets to restructure the ownership of their U.S. subsidiaries into a single “intermediate holding company,” regulated as a U.S. bank holding company whether or not it owns a U.S. bank.

Some commenters have characterized the IHC requirement as a dramatic departure from historical U.S. approaches to cross-border banking supervision and regulation; former Rep. Spencer Bachus described it as having “eradicated decades of codified law and regulatory practice in international banking.”1 It certainly stands out as a noteworthy decision in the FRB’s post-financial crisis policymaking.

The IHC requirement represents a subtle but profound change in policy toward cross-border banking, with consequences that are farther reaching and of broader relevance than the more obvious and intentional departures from past practice (such as eliminating organizational variation and imposing bank regulatory capital requirements on activities conducted through nonbank subsidiaries). The FRB explicitly notes that it based the requirement on changed goals, such as reducing reliance on parent bank/home country support. However, the requirement marks a distinct shift, which this article will put into an historical context, away from the U.S. policy of parity between foreign and domestic banks in similar circumstances, known as “national treatment.”

Historical Approaches to U.S. Regulation of Foreign Banks


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and extent of foreign bank regulation in different and meaningful ways, and yet all four were guided by the principle of national treatment for foreign banks.

THE INTERNATIONAL BANKING ACT OF 1978

The IBA established the foundation for modern U.S. regulation of foreign banks. Until the late 1970s, the bank regulatory framework for most foreign banks’ U.S. operations derived largely from state bank powers and licensing laws. Unless a foreign bank controlled a U.S. bank subsidiary, it generally was not subject to Bank Holding Company Act limitations on nonbank activities and investments or subject to restrictions on interstate branching. As foreign banks’ presence in U.S. markets grew during this period, a concern emerged that this lack of regulation created a competitive advantage for foreign banks. At the same time, it became apparent that a largely state law-based regulatory regime for foreign banks did not afford foreign banks the full benefits of the U.S. “dual banking system.”

The IBA overhauled the U.S. regulatory framework for foreign banks operating through branches in the United States, bringing them under centralized federal oversight by the FRB for the first time. These foreign banks became subject to BHC Act restrictions on nonbanking activities and investments in the United States and restrictions on interstate expansion (with grandfathering of existing operations). Branches also became subject to federal law reserve requirements.

At the same time, the IBA created new opportunities for foreign banks by allowing branches to obtain FDIC deposit insurance for retail deposits and by allowing foreign banks to obtain a federal branch license from the Office of the Comptroller of the Currency. Federal branches were to be subject to the same powers and restrictions as national banks, with some exceptions, such as an adjustment allowing restrictions based on capital stock and surplus (e.g., lending limits) to be based on the consolidated capital stock and surplus of the foreign bank. The IBA also authorized the OCC to waive U.S. citizenship requirements for national bank directors (up to a minority of the directors) for national banks owned by foreign banks.

Congress’ explicit guiding principle behind the IBA’s approach to foreign bank regulation, endorsed by the FRB at the time, was a non-discrimination principle of “national treatment and equality of competitive opportunity.” The IBA’s concept of national treatment, as it has been understood at least since 1978, entails “parity of treatment between foreign and domestic banks in like circumstances.” As a policy objective, national treatment is designed not just to promote fairness but also to improve availability of financial services and competition in banking markets.

The IHC requirement represents a subtle but profound change in policy toward cross-border banking, with consequences that are farther reaching.
also facilitates U.S. banking organizations’ ability to expand into non-U.S. markets where they would expect comparable national treatment to be applied to them, and strengthens the U.S. government’s hand in free trade and other treaty negotiations over access to local financial services markets for U.S. banks.15

As illustrated by the IBA, national treatment is a double-edged sword. It gives foreign banks the benefits of opportunities available to domestic banks, but it imposes restrictions designed to be comparable to those that apply to domestic banks, taking into account applicable differences in circumstances.

FOREIGN BANK SUPERVISION ENHANCEMENT ACT OF 1991

Congress passed FBSEA in the wake of the collapse of Bank of Commerce Credit International and a scandal involving Banca Nazionale de Lavoro, and following the savings and loan crisis of the late 1980s and a number of significant commercial bank failures in the same period. The FRB requested from Congress, and received, broad new supervisory authority over foreign banks, including a requirement that all new branches (whether state or federally licensed) obtain prior FRB approval under newly tightened statutory standards, including that foreign banks be subject to comprehensive supervision or regulation on a consolidated basis by home country authorities.16 FBSEA also gave the FRB direct examination authority over both federal and state branches of foreign banks.17

In a provision tracking a similar development for FDIC-insured state banks, FBSEA also limited the powers of state-licensed branches by providing that no state-licensed branch could engage in activities not permitted for a federal branch, and subjected state branches to the same lending limits as federally licensed branches.18 FBSEA also curtailed foreign banks’ ability to establish branches authorized to take FDIC-insured deposits, grandfathering the relatively small number of existing FDIC-insured branches.19

Of particular relevance to the FRB’s later consideration of the IHC requirement, FBSEA required the Treasury Secretary and the FRB to study “whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches.”20 In their report following the study (the “Roll-up Study”),21 the Treasury Secretary and the FRB recommended against such a requirement, in part because it would be inconsistent with national treatment.22 The study confirmed that any branch roll-up requirement (now known as subsidiarization) would require a change in law.

RIEGLE-NEAL INTERSTATE BANKING AND BRANCHING EFFICIENCY ACT OF 1994

Unlike the IBA and FBSEA, Riegle-Neal did not target foreign banks’ U.S. operations. On the contrary, Riegle-Neal’s relaxation of restrictions on interstate banking and branching was designed primarily to reduce restrictions on U.S. banking organizations. Consistent with the national treatment principle, Congress provided for comparable treatment for foreign banks operating branches in the United States, allowing foreign banks to establish branches outside of their home states under circumstances similar to the ones required for U.S. banks to branch across state lines. This required some adaptation, through the FRB’s rulemaking process, to take into account structural differences between foreign banks and U.S. banks, including the fact that interstate branching would involve establishment of an additional

16 FBSEA § 202.
17 FBSEA § 203(a).
18 FBSEA § 202(a).
19 FBSEA § 214(a).
20 FBSEA § 215.
22 See Roll-up Study at 4.
branch by the foreign bank (not one U.S. branch establishing another branch in another state).

Although Congress designed the foreign bank provisions of Riegle-Neal to be consistent with national treatment for foreign banks, there were stages in the legislative process when that outcome was less clear. The Kentucky Bankers Association led an effort, which succeeded for a time in the Senate, to require that foreign banks roll-up their U.S. branches into bank subsidiaries in order to branch across state lines. The Treasury Secretary weighed in against the provision based on concerns that it would be inconsistent with national treatment and could invite retaliation against U.S. banks abroad.23 The proponents of the roll-up requirement argued that it was necessary to preserve competitive equality, because in order to branch across state lines U.S. banks by necessity were required to be organized as separately incorporated and capitalized banks.

What this argument ignored, however, is the feature of national treatment that requires comparable treatment of U.S. and foreign institutions “in like circumstances.” By defining the non-discrimination equation in a way that ignored the character of a foreign bank’s operations, and forcing foreign banks to restructure their operations into a U.S. subsidiary model, the proponents of the roll-up requirement had oversimplified the national treatment equation. They essentially argued that comparable treatment required a comparable structure, which was inconsistent with the concept of national treatment in previous legislation and the Roll-up Study. Ultimately, the provision was eliminated in conference committee, and national treatment as it traditionally had been understood was preserved.

**GRAMM-LEACH-BLILEY ACT OF 1999**

Like Riegle-Neal, GLBA and its provisions allowing qualifying BHCs known as “financial holding companies” to engage in an expanded range of financial activities were designed mainly to reduce restrictions on domestic banking organizations. Consistent with the principle of national treatment, GLBA also made these advantages available to FBOs. In general, the task of extending these benefits was more straightforward in GLBA than in Riegle-Neal, because the structural differences between U.S. BHCs and FBOs did not significantly matter in the expansion of activities related to U.S. nonbank subsidiaries and investments.

GLBA’s criteria for an FBO to qualify as an FHC required some interpretation. The criteria for U.S. BHCs were based on the “well managed” and “well capitalized” status of their U.S. bank subsidiaries, but the relevant tests needed to be adapted to foreign banks with U.S. branches and agencies. GLBA directed the FRB to apply “comparable capital and management standards to a foreign bank that operates a branch … in the United States, giving due regard to the principle of national treatment and equality of competitive opportunity.”24

In implementing this provision of GLBA, the FRB determined to look primarily to foreign banks’ home country consolidated capital to determine whether they were “well capitalized” and to their U.S. branch supervisory ratings to determine whether they were “well managed.” This represented an adaptation from the U.S. standards, but it was viewed as consistent with

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national treatment, taking into account the different circumstances of foreign versus domestic banks.25

**Dodd-Frank Act and Enhanced Prudential Standards**

On its face, the statutory language of the enhanced prudential standards provisions of Dodd-Frank Act section 165 appears to align neatly with the milestones reviewed above. It authorizes the FRB to develop EPS in the areas of risk-based and leverage capital, capital planning and stress testing, liquidity, risk management, and single counterparty credit limits, for both U.S. BHCs and FBOs that meet applicable size thresholds. In the case of FBOs, the FRB is required to “give due regard to the principle of national treatment and equality of competitive opportunity,”26 a standard that tracks the comparable GLBA provision. For this reason, among others, foreign banks generally expected that the implementation would involve a typical exercise in adapting U.S.-based EPS to the cross-border nature of foreign banks operating in the United States. For example, by analogy to the IBA’s federal branch lending limit provisions, FBOs expected that a single-counterparty credit limit for foreign banks would look to aggregate exposures of a foreign bank’s U.S. operations measured as a percentage of the foreign bank’s consolidated capital and surplus.

**THE FRB’S EPS RULE AND THE IHC REQUIREMENT**

Some aspects of the FRB’s regulation implementing section 165 followed this expected path for applying the U.S. national treatment principle, consistent with historical U.S. approaches to similar requirements. Some, including the IHC requirement, did not.

When FRB Governor Daniel Tarullo foreshadowed the IHC requirement in a speech at Yale University in November 2012, he specifically referred to the U.S. policy of national treatment, which he defined as treating a “foreign-owned service provider no less favorably than like domestic service providers.” Tarullo noted that “of course, differences in business organization, domestic regulatory systems, and other factors mean that there must sometimes be determinations whether foreign and domestic firms are ‘like’ one another in relevant respects.”27 In the rulemaking process, however, the issue of national treatment, and the question of “like” foreign and domestic firms, became a particular topic of controversy in relation to the IHC requirement.

As implemented, the IHC requirement requires FBOs with $50 billion or more in total U.S. non-branch assets (assets in essentially all U.S. subsidiaries) to restructure the ownership of their U.S. subsidiaries into a single U.S. IHC. The IHC would be supervised and regulated by the FRB, and subject to EPS as well as ordinary course FRB regulatory and reporting requirements as if it were a U.S. BHC (whether or not the IHC owns a U.S. bank).

The purposes of the IHC requirement articulated by the FRB were several-fold. Among other things, the IHC addressed the FRB’s concerns that in the environment following the financial crisis, it was no longer realistic to assume, as previous policies had done, that a parent foreign bank would (or could) support its U.S. operations in times of stress. The FRB also observed that the U.S. operations of FBOs “became increasingly concentrated, interconnected, and complex after the mid-1990s,” justifying a change in regulatory approach. The IHC requirement also was motivated by concerns about the capital adequacy of broker-dealer subsidiaries of foreign banks regulated by the Securities and Exchange Commission, some of which are large and play a significant role in U.S. markets. In addition, the IHC requirement would, in the FRB’s view, provide a

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26 Dodd-Frank Act § 165(b)(2). The FRB is also required to “take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States,” which became a separate point of controversy in the rulemaking process relating to the IHC requirement.

27 Remarks of FRB Governor Tarullo, Nov. 28, 2012.
uniform platform for the supervision and regulation of U.S. subsidiaries of foreign banks in a format that more closely resembled the structure of U.S. BHCs. The FRB also suggested that the IHC structure would facilitate an orderly cross-border resolution of an FBO.28

SHIFT IN APPLICATION OF THE NATIONAL TREATMENT PRINCIPLE

When viewed in historical context, the IHC requirement indicates a distinct shift in the FRB’s application of the national treatment principle. Discussion about national treatment featured prominently in the rulemaking process – in both industry objections and the FRB’s response. In the preamble to the final rule, the FRB stated that “the principles of national treatment and equality of competitive opportunity were central considerations in the design of the enhanced prudential standards for foreign banking organizations.”29

From the foreign banks’ perspective, the IHC requirement contravened national treatment because it did not treat foreign banks operating in the United States comparably to U.S. BHCs (e.g. did not apply or adapt EPS on a consolidated basis, and applied capital and other requirements on a sub-consolidated level). From the FRB’s perspective, the IHC requirement was consistent with national treatment because IHCs would be subject to a regulatory framework, including EPS, that was comparable to the framework that applies to U.S. BHCs. These perspectives in the end appeared to be two ships passing in the night, as the foreign banks and the FRB defined the relevant equation differently.

It is this difference – in how national treatment was applied in practice – that marked the most distinct shift from historical approaches. As traditionally articulated, and as phrased by Tarullo in his speech at Yale, national treatment is defined as comparable treatment for domestic and foreign institutions “in like circumstances.” For the FRB in designing the IHC requirement, the institutions in like circumstances were U.S. BHCs and IHCs. As long as the treatment between these two groups was comparable, national treatment was achieved. However, like virtually any non-discrimination question, the rub lies in how like circumstances are defined. For the foreign banks, IHCs could only be viewed as in like circumstances with U.S. BHCs if one were to first force

National treatment has been a U.S. policy priority because it strengthens our government’s hand in trade negotiations where access to financial markets is at issue.

an FBO’s U.S. subsidiaries into a BHC-like structure, akin to the roll-up requirements that had previously been rejected on national treatment grounds, and then ignore the fact that an IHC is a subgroup of a consolidated FBO, which itself is subject to consolidated capital, liquidity, and other prudential requirements.

The FRB’s articulation of the national treatment equation as based on the structure and regulation of the U.S. operations of a foreign bank in isolation, without regard to their ownership by, and role as part of, a foreign bank, is precisely the point at which the shift in application of national treatment occurred.

One can also illustrate this shift by applying the FRB’s “new” national treatment principle backwards through the historical context described above. For example, if the FRB’s current views of national treatment had been applied in the context of the IBA, Congress would not have given the OCC authority to waive director citizenship requirements for national banks owned by FBOs in the name of national treatment. A national bank owned by a U.S. BHC is – at the level of the national bank – no different than a national bank owned by an

FBO. It is only because of the national bank’s ownership by, and role as part of, an FBO, that the need for such an adaption becomes appropriate. Similarly, Congress’ decision to measure a federal branch’s lending limit as a percentage of the foreign bank’s consolidated capital is an adaption that is based on an understanding of the federal branch’s role as part of a foreign bank; otherwise, in theory a federal branch’s loans would need to be limited to some measure of deemed capital of the branch itself based on the branch’s balance sheet. Lastly, when the Kentucky Bankers Association pressed to require foreign banks to operate through bank subsidiaries in order to branch across state lines, Congress (at the urging of the Treasury Secretary) instead concluded that in order to achieve national treatment foreign banks needed to be permitted to establish direct branches in multiple states without incorporating a U.S. bank subsidiary, even though – at the level of the U.S. bank subsidiary – that would have made the structure and regulatory framework the same and would have provided a consistent platform for interstate branching regulation.

The Broader Implications

The U.S. national treatment principle, which has both benefitted and burdened foreign banks operating in the United States since the 1970s, has important practical and policy implications for all internationally active banks. How the principle is defined and applied in practice by the FRB is critically important, not only for FBOs (because of the direct consequences for their U.S. operations), but also for all internationally active banks in view of the FRB’s leading role as an international bank supervisor and its role as the consolidated supervisor of many of the world’s largest banking organizations. National treatment historically has been a U.S. policy priority in part because it strengthens our government’s hand in trade negotiations where access to financial markets is at issue. And more broadly, U.S. national treatment for foreign banks helps promote U.S. banks seeking national treatment abroad.

This consequence becomes especially relevant as many jurisdictions, including ones with major financial centers, continue to consider their own structural approaches to the regulation of domestic and cross-border banking operations. And it leads to the question of how the FRB’s recent shift in application of the national treatment principle will inform other countries’ approaches.

Defining national treatment based on how U.S. regulations are applied to U.S. operations of foreign banks in isolation (without regard to their role as part of an FBO) arguably reflects the broader thrust of FRB policy developments in this area. A “Fortress America” approach involves a distinctly discounted reliance on parent bank and home country support and cross-border supervisory coordination, understandably reflecting the FRB’s experiences during the financial crisis and its outlook on how relevant actors are likely to behave in a future crisis. Thus, it may be that as other countries turn inward and adopt a more nationalist approach to banking and financial stability regulation, notwithstanding ongoing efforts to coordinate internationally, they will follow the FRB in redefining the application of national treatment, with potentially lasting changes to the organizational structure and efficiency of cross-border banking.
New Supervisory Rating System for Large Banking Organizations

Federal Reserve Establishes a New Rating System for the Supervision of Large Financial Institutions

SUMMARY

On November 2, the Board of Governors of the Federal Reserve System (the “FRB”) issued a final rule (the “Final Rule”) that establishes a new rating system for the supervision of large financial institutions (“LFIs”). The LFI rating system applies to all bank holding companies with total consolidated assets of $100 billion or more; all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of $100 billion or more; and all U.S. intermediate holding companies of foreign banking organizations with total consolidated assets of $50 billion or more.¹ The LFI rating system is designed to align with the FRB’s existing supervisory program for LFIs,² enhance the clarity and consistency of supervisory assessments, and provide greater transparency regarding the consequences of a given rating. For LFIs, the new rating system replaces the RFI/C(D) rating system currently used by the FRB for holding companies of all sizes.³

The LFI rating system includes a new four-level rating scale and three component ratings. The four levels are: Broadly Meets Expectations; Conditionally Meets Expectations; Deficient-1; and Deficient-2. The component ratings are assigned for: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls.

These four levels and three components of the LFI rating system are generally the same as those described in the proposed rule (the “Proposed Rule”).⁴ Unlike the RFI/C(D) system, the LFI rating system does not include a stand-alone composite rating.
The Final Rule will become effective on February 1, 2019. The FRB will assign initial ratings under the new rating system in 2019 for those bank holding companies and U.S. intermediate holding companies that are subject to the Large Institution Supervision Coordinating Committee (“LISCC”) framework\(^5\) and in 2020 for all other LFIs.

**BACKGROUND**

As described in the preamble accompanying the Final Rule, in the years following the 2007–2009 financial crisis, the FRB developed a supervisory program specifically designed to address the risks to U.S. financial stability posed by LFIs. This program focuses supervisory attention on the core areas that are deemed most likely to threaten a firm’s financial and operational strength and resilience (namely, capital, liquidity, and governance and controls).

The FRB coordinates its supervision of firms deemed to pose the greatest risk to U.S. financial stability through the LISCC. For large financial institutions that are not LISCC firms, the FRB performs horizontal reviews and firm-specific supervisory work focused on capital, liquidity, and governance and control practices, which are tailored to reflect the risk characteristics of these institutions.

Prior to the issuance of the Final Rule, the FRB had not modified its supervisory rating system for bank holding companies to reflect the substantial changes to the statutory and regulatory framework relating to LFIs or the FRB’s implementation of the supervisory program for LFIs in recent years. Since 2004, the FRB has used the RFI/C(D) rating system to communicate its supervisory assessment of every covered firm regardless of its asset size, complexity, or systemic importance.\(^6\) The RFI/C(D) rating system would continue to be used in the supervision of other organizations, including community and regional bank holding companies.\(^7\)

**DISCUSSION**

The LFI rating system is intended to provide a supervisory evaluation of whether a firm possesses sufficient financial and operational strength and resilience\(^8\) to maintain safe and sound operations through a range of conditions, including stressful ones. The LFI rating system is designed to:

- Fully align with the FRB’s current supervisory programs and practices, which are based upon the LFI supervision framework’s core objectives of reducing the probability that an LFI will fail or experience material distress, thereby mitigating the risk to U.S. financial stability;
- Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
- Provide transparency related to the supervisory consequences of a given rating.

The preamble accompanying the Final Rule notes that the final LFI rating system adopts the core elements of the proposed LFI rating system, with certain modifications to address commenter concerns. Consistent with the Proposed Rule, a banking organization will be assigned three component ratings:
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Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. Although the final LFI rating system retains a four-category, non-numeric rating scale, it identifies the top two categories as “Broadly Meets Expectations” and “Conditionally Meets Expectations” (rather than “Satisfactory” and “Satisfactory Watch,” as proposed) to align with the definitions of those categories.

The proposed LFI rating system would have applied to bank holding companies, non-insurance, non-commercial savings and loan holding companies, and U.S. intermediate holding companies of foreign banking organizations with $50 billion or more in total consolidated assets. According to the FRB, the increase in the asset threshold to $100 billion is “consistent with the minimum threshold for enhanced prudential standards established by [section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”)] as well as the [FRB’s] proposal to tailor certain of its regulations for domestic firms to implement EGRRCPA.” The FRB has retained the asset threshold of $50 billion for U.S. intermediate holding companies as it continues to consider appropriate tailoring of its regulations for foreign banking organizations in light of EGRRCPA, but the FRB notes that it “may adjust this asset threshold in the future if necessary.”

A. LFI RATING SYSTEM COMPONENTS

Under the LFI rating system, the FRB will evaluate and assign ratings to LFIs for the following three components: Capital Planning and Positions, Liquidity Risk Management and Positions and Governance and Controls.

1. Capital Planning and Positions

The Capital Planning and Positions component encompasses an evaluation of (i) the effectiveness of a firm’s governance and planning processes used to determine the amount of capital necessary to cover risks and exposures and to support activities through a range of conditions; and (ii) the sufficiency of a firm’s capital positions to comply with applicable regulatory requirements and to support the firm’s ability to continue to serve as a financial intermediary through a range of conditions.

The Capital Planning and Positions component rating will reflect a broad assessment of the firm’s capital planning and positions, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions. According to the preamble, a firm’s compliance with minimum regulatory capital requirements will be considered in assigning the firm’s Capital Planning and Positions component rating; however, the FRB may determine that a firm does not meet expectations regarding its capital position in light of its idiosyncratic activities and risks, even if the firm meets minimum regulatory capital requirements. Findings from the Comprehensive Capital Analysis and Review (“CCAR”) process for LISCC firms and certain other large and complex LFIs, and from similar supervisory activities for other LFIs,10 will be used to help determine the Capital Planning and Positions component rating.11 Consistent with requests from commenters, the FRB confirms in the preamble that the final LFI rating system does not create any new capital planning expectations applicable to LFIs.
2. Liquidity Risk Management and Positions

The Liquidity Risk Management and Positions component encompasses an evaluation of (i) the effectiveness of a firm’s governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures and to support activities through a range of conditions; and (ii) the sufficiency of a firm’s liquidity positions to comply with applicable regulatory requirements and to support the firm’s ongoing obligations through a range of conditions.

The Liquidity Risk Management and Positions component rating will be based on findings of coordinated examinations of liquidity positions and risk management practices conducted across several firms (horizontal examinations), as well as ongoing assessments of an individual firm’s liquidity positions and risk management practices conducted through the supervisory process.

3. Governance and Controls

The Governance and Controls component encompasses an evaluation of the effectiveness of a firm’s (i) board of directors, (ii) management of core business lines and independent risk management and controls, and (iii) recovery planning (for domestic LISCC firms only). This rating assesses a firm’s effectiveness in aligning strategic business objectives with its risk appetite and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise planning for the ongoing resiliency of the firm.

The FRB has previously invited comment on two proposals that relate to the Governance and Controls component rating—the first would establish principles regarding effective boards of directors focused on the performance of a board’s core responsibilities (the board effectiveness proposal), and the second would set forth core principles of effective senior management, the management of business lines, and independent risk management and controls for LFIs (the risk management proposal). As noted in the preamble, the FRB continues to consider comments on both proposals and is not adopting either proposal at this time. Given that the board effectiveness proposal is not finalized, the FRB intends to rely primarily on the principles set forth in SR letter 12-17/CA letter 12-14 and safety and soundness to assess the effectiveness of a firm’s board of directors. Given that the risk management proposal is not finalized, the FRB will rely on existing risk management guidance to assess the effectiveness of a firm’s management of business lines and independent risk management and controls.

The preamble notes that U.S. intermediate holding companies will not be subject to examinations solely focused on effectiveness of the U.S. intermediate holding company’s board of directors in recognition of the fact that a U.S. intermediate holding company is a subsidiary of a foreign banking organization. This was an important issue for foreign banking organizations. Rather, the FRB will indirectly assess the effectiveness of a U.S. intermediate holding company’s board by considering whether weaknesses or deficiencies that are identified within the organization while conducting other supervisory work may be
evidence of, or result from, governance-related oversight deficiencies. For example, governance-related oversight deficiencies could be noted in the context of a significant risk management or control weakness that is identified during an examination of capital planning or business line management.¹⁷

The FRB notes that it has determined not to include a separate component rating for a firm’s resolution planning as part of the final LFI rating system, but will continue to consider whether the LFI rating system should be modified in the future to include an assessment of the sufficiency of a firm’s resolution planning efforts.

B. LFI RATING SCALE

Each component of the LFI rating system is assigned a rating using a four-level scale: Broadly Meets Expectations; Conditionally Meets Expectations; Deficient-1; and Deficient-2. A firm must be rated “Broadly Meets Expectations” or “Conditionally Meets Expectations” for each of its component ratings to be considered “well managed” in accordance with various statutes and regulations that permit additional activities, prescribe expedited procedures or provide other benefits for “well managed” firms.¹⁸ The requirement for those ratings reflects the FRB’s judgment that an LFI is not in satisfactory condition overall unless it is considered sound in each of the key areas of capital, liquidity, and governance and controls. In accordance with the FRB’s regulations governing confidential supervisory information, ratings assigned under the LFI rating system will be communicated to the firm by the FRB but not disclosed publicly.

1. Broadly Meets Expectations

A “Broadly Meets Expectations” rating indicates that the firm’s practices and capabilities broadly meet supervisory expectations, and the firm possesses sufficient financial and operational strength and resilience to maintain safe and sound operations through a range of conditions. The firm may be subject to identified supervisory issues requiring corrective action, but these issues are unlikely to present a threat to the firm’s ability to maintain safe and sound operations through a range of conditions.

2. Conditionally Meets Expectations

A “Conditionally Meets Expectations” component rating indicates that there are certain material financial or operational weaknesses in a firm’s practices or capabilities that may place the firm’s prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.¹⁹

The FRB notes that it does not intend for a firm to be assigned a “Conditionally Meets Expectations” rating for a prolonged period, and will work with the firm to develop an appropriate time frame to fully resolve the issues leading to the rating assignment and merit upgrade to a “Broadly Meets Expectations” rating. As noted in the preamble, the final ratings framework reflects an understanding that completion and validation of remediation activities for selected supervisory issues—such as those involving
information technology modifications—will require an extended time horizon. Unlike the Proposed Rule, the final ratings framework does not establish a fixed timeline for how long a firm can be rated “Conditionally Meets Expectations.” There is the clear implication, however, that the failure to resolve the issues in a timely manner would most likely result in the firm’s downgrade to a “Deficient” rating. The Proposed Rule states that the “Conditionally Meets Expectations” rating is consistent with the FRB’s existing practice of providing notice that a downgrade to a less-than-satisfactory rating is likely if identified weaknesses are not resolved in a timely manner.

3. **Deficient-1**
A “Deficient-1” rating indicates that, although the firm’s current condition is not considered to be materially threatened, there are financial and/or operational deficiencies that put its prospects for remaining safe and sound through a range of conditions at significant risk. There is a “strong presumption” that a firm with a Deficient-1 component rating would be subject to either an informal or formal enforcement action.

The preamble notes that, consistent with the views of commenters, there is no presumption under the final LFI rating system that a firm rated “Deficient-1” would be deemed to be in “troubled condition.” Whether a firm rated “Deficient-1” receives a “troubled condition” designation will be determined by the facts and circumstances at that firm, but firms rated “Deficient-1” due to financial weaknesses in either capital or liquidity would be more likely to be deemed in “troubled condition” than firms rated “Deficient-1” due solely to issues of governance or controls.

A Deficient-1 component rating could also be a barrier for a firm seeking FRB approval to engage in new or expansionary activities, unless the firm can demonstrate that (i) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (ii) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (iii) the proposed activities would not distract the board or senior management from remediating current deficiencies or issues. It remains to be seen whether, as a practical matter, a banking organization with a Deficient-1 component rating would ever meet these conditions.

Under the Final Rule, a firm previously rated “Deficient-1” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that its prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

4. **Deficient-2**
A “Deficient-2” rating indicates financial or operational deficiencies in a firm’s practices or capabilities present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition. There is a “strong presumption” that a firm with a Deficient-2 component rating would be subject to a formal enforcement action. The FRB states that it would be extremely unlikely to approve
any proposal seeking to engage in new or expansionary activities from a firm with a Deficient-2 component rating. A firm with a “Deficient-2” rating should expect to be deemed to be in “troubled condition.”

The proposal provides the definitions of Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1 and Deficient-2 for each of the three components in the LFI rating system.

C. CHANGES TO EXISTING REGULATIONS

References to holding company ratings are included in a number of the FRB’s existing regulations. In certain cases, the regulations contemplate only the assignment of a stand-alone composite rating using a numerical rating scale, which is consistent with the current RFI/C(D) rating system but is not compatible with the LFI rating system. The FRB identifies three provisions in its existing regulations that are written in this manner, including two in Regulation K\textsuperscript{23} and one in Regulation LL\textsuperscript{24}. As noted in the preamble accompanying the Final Rule, the FRB is amending these provisions so they would apply to firms that receive numerical composite ratings as well as to firms that do not receive numerical composite ratings. To satisfy the requirements of these provisions, a firm subject to the LFI rating system will have to be rated “Broadly Meets Expectations” or “Conditionally Meets Expectations” for each component of the LFI rating system.

D. IMPLICATIONS

Perhaps the most important implication of the new rating system is that banking organizations are explicitly provided with a period of time to remedy even “material” weaknesses in a firm’s practices or capabilities before there is a downgrade to an “unsatisfactory”-type rating. There is a widely held view that banking organizations have been immediately downgraded to a “3,” or “unsatisfactory”-type rating, under the current rating system upon a determination of such weakness.

Another key implication relates to those institutions that are currently rated as a “3.” Under the new rating system, will they be rated as “Conditionally Meets Expectations,” which would presumably free them from the substantial restraints that a “3” rating imposes, or as “Deficient-1,” which would presumably continue those restraints.

Another important implication is that the new rating system still involves substantial subjectivity in the rating process\textsuperscript{25}. Both the capital and liquidity components emphasize planning and risk management, as well as actual financial positions. The governance and control component is inherently subjective. The element of subjectivity may be intensified because an institution will not be considered well managed unless it is rated at least “Conditionally Meets Expectations” for each of the three rating components.
**ENDNOTES**

1. Under the Final Rule, total consolidated assets will be calculated based on the average of the firm’s total consolidated assets in the four most recent quarters as reported in the firm’s quarterly financial reports filed with the FRB. A firm will continue to be rated under the LFI rating system until it has less than $95 billion in total consolidated assets, based on the average total consolidated assets as reported in the firm’s four most recent quarterly financial reports filed with the FRB.


3. Under the current RFI/C(D) rating system, each bank holding company is assigned a composite rating (C) based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The three main components of the rating system are: Risk Management (R); Financial Condition (F); and potential Impact (I) of the parent company and nondepository subsidiaries on the subsidiary depository institution(s). The fourth component rating, Depository Institution (D), generally mirrors the primary regulator’s assessment of the subsidiary depository institution(s). The R and F components each have four subcomponents. For the R component, the subcomponents are board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. For the F component, the subcomponents are capital, asset quality, earnings, and liquidity. The composite, component, and subcomponent ratings are assigned based on a 1 to 5 numerical score with 1 being the highest rating. See SR letter 04-18, “Bank Holding Company Rating System,” 69 Fed. Reg. 70444 (December 6, 2004), available at https://www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm.


5. The LISCC framework is designed to materially increase the financial and operational resiliency of systemically important financial institutions to reduce the probability of, and cost associated with, their material financial distress or failure. Firms subject to the LISCC framework include certain large bank holding companies, the U.S. operations of certain foreign banking organizations, and systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the FRB. See https://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm.


7. The preamble notes that bank holding companies with total consolidated assets of at least $50 billion but less than $100 billion will continue to be evaluated subject to the RFI rating system. The FRB states that it is currently reviewing existing supervisory guidance with respect to these firms to determine whether it is appropriate to make revisions to further distinguish supervisory expectations for firms with total consolidated assets of less than $100 billion.

Concurrently with the Final Rule, the FRB adopted a final rule to apply the RFI rating system on a fully implemented basis to all savings and loan holding companies with total consolidated assets of less than $100 billion, excluding savings and loan holding companies engaged in significant insurance or commercial activities. As noted in the preamble, the FRB had applied the RFI rating system to savings and loan holding companies with total consolidated assets of at least $75 billion but less than $100 billion.
ENDNOTES (CONTINUED)

system to savings and loan holding companies on an indicative basis since assuming supervisory responsibility for those firms from the Office of Thrift Supervision in 2011. The FRB continues to consider the appropriate regulatory regime for savings and loan holding companies that are predominantly engaged in insurance or commercial activities. Accordingly, the FRB will continue to rate these savings and loan holding companies on an indicative basis under the RFI rating system as it considers further the appropriate manner to assign supervisory ratings to such firms on a permanent basis.

As noted in the preamble, the FRB continues to consider the appropriate regulatory regime for systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the FRB.

“Financial strength and resilience” is defined as maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for continuity of the consolidated organization (including its critical operations and banking offices) through a range of conditions.

“Operational strength and resilience” is defined as maintaining effective governance and controls to provide for the continuity of the consolidated organization (including its critical operations and banking offices) and to promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions.

“Critical operations” are a firm’s operations, including associated services, functions and support, the failure or discontinuance of which, in the view of the firm or the FRB, would pose a threat to the financial stability of the United States.

Section 401 of EGRRCPA amended section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to modify the $50 billion minimum asset threshold for general application of enhanced prudential standards. Public Law 115–174, section 401, 132 Stat. 1296 (2018). Effective immediately on the date of EGRRCPA’s enactment on May 24, 2018, bank holding companies with total consolidated assets equal to or greater than $50 billion and less than $100 billion were no longer subject to these standards.

Section 401(f) of EGRRCPA also provides that any bank holding company, regardless of asset size, that has been identified as a Global Systemically Important Bank (GSIB) under the FRB’s GSIB capital surcharge rule shall be considered a bank holding company with $250 billion or more in total consolidated assets for purposes of applying the standards under section 165 and certain other provisions.

In 2017, the FRB amended its capital plan rule, Section 225.8 of Regulation Y, to eliminate the qualitative assessment in CCAR for “large and noncomplex” firms, i.e., those that are not U.S. G-SIBs and have less than $250 billion of total consolidated assets and less than $75 billion of total nonbank assets. For additional information on the elimination of the qualitative assessment for large and noncomplex firms, see our memorandum to clients, Banking Organization Capital Plans and Stress Tests: Federal Reserve Finalizes Elimination of the Qualitative CCAR Assessment for Smaller Firms, Reduction in the De Minimis Exception for Additional Capital Distributions, and Other Notable Revisions to its Capital Plan and Stress Testing Rules (February 1, 2017), available at https://sullcrom.com/banking-organization-capital-plans-and-stress-tests-02-01-2017. The FRB assesses the capital planning processes of large and noncomplex firms through horizontal reviews, separate from the CCAR process. For additional information on the 2017 horizontal capital review for those firms, see our memorandum to clients, Banking Organization Capital Plans and Stress Tests: Federal Reserve Issues Instructions, Guidance and Supervisory Scenarios for the 2017 Comprehensive Capital Analysis and Review Program (February 6, 2017), available at https://www.sullcrom.com/banking-organization-capital-plans-and-stress-tests-02-06-17.

The FRB’s supervisory expectations for capital planning at large bank and intermediate holding companies are set forth in SR letter 15-18 (for LISCC firms and certain other large and complex

The Final Rule notes that references to “board” or “board of directors” in the rating system framework include the equivalent to a board of directors, as appropriate, as well as committees of the board of directors or the equivalent thereof, as appropriate.

Under the Final Rule, “risk appetite” is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm’s strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.


The preamble accompanying the Final Rule notes that the FRB will continue to evaluate the U.S. branches of foreign banks under the ROCA system, and assign a single component rating to the foreign banking organization’s U.S. operations. The FRB is considering adjustments to the ratings for U.S. branches and the U.S. operations of foreign banking organizations to better align with the LFI framework.

For example, under the Bank Holding Company Act and the Home Owners’ Loan Act, companies that have elected to be treated as financial holding companies and that do not remain “well managed” face restrictions on commencement or expansion of certain activities.

In response to requests for clarification by commenters, the FRB provides that, under the final LFI rating system, “normal course of business” means that a firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management, or internal control structures or practices.
ENDNOTES (CONTINUED)

20 The Proposed Rule indicated that the FRB would provide firms that receive a “Satisfactory Watch” rating with a specified time frame (generally no longer than 18 months) to fully resolve the issues leading to that rating.

21 As noted in the preamble, the FRB acknowledges that there are circumstances when a firm may be rated “Conditionally Meets Expectations” for a longer period of time if, for instance, the firm is close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues may be identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.

22 The ramifications of a “troubled condition” designation (as defined in 12 C.F.R. § 225.71(d)) include the application of the “golden parachute” regulations (12 C.F.R. Part 359). In addition, under Subpart H of Regulation Y, a firm in “troubled condition” must give the FRB 30 days’ written notice before adding or replacing any member of its board of directors, employing any person as a senior executive officer, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive officer position. See 12 C.F.R. § 225.72(a).

23 Section 211.2(z) of Regulation K includes a definition of “well managed” which in part requires a bank holding company to have received a composite rating of 1 or 2 at its most recent examination or review; and Section 211.9(a)(2) of Regulation K requires an investor (which by definition can be a bank holding company) to have received a composite rating of at least 2 at its most recent examination in order to make investments under the general consent or limited general consent procedures contained in Sections 211.9(b) and (c).

24 Section 238.54(a)(1) of Regulation LL restricts savings and loan holding companies from commencing certain activities without the FRB’s prior approval unless the company received a composite rating of 1 or 2 at its most recent examination.

25 The preamble states that the FRB is implementing staff training and will undertake a multilevel review and vetting before ratings are assigned in order to ensure that ratings are assigned in a consistent and fair manner.
New Supervisory Rating System for Large Banking Organizations

November 5, 2018

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New Supervisory Rating System for Large Banking Organizations
November 5, 2018
SC1:4796991.3A
Is the CFPB bound by its non-binding guidance?

The implications of the PHH due process decision for TRID and other CFPB rules

By Benjamin K. Olson, Brandy A. Hood, and Steven R. vonBerg

Predictability and certainty are crucial components of the consumer finance market. Consumers crave it, as do industry participants. A common understanding of legal requirements promotes uniformity in the application of consumer protections and allows lenders, servicers, systems providers, investors, and others to cooperate and compete on a level playing field. In contrast, ambiguity can harm consumers and industry participants alike because it places competitors on uneven ground and makes it difficult for consumers to compare products and identify bad actors. If a lender can gain an advantage over its more risk-averse competitors by adopting an aggressive interpretation of an ambiguous regulation, that ambiguity harms everyone in the market, including the consumer. While competition on price and quality is generally beneficial, competition on compliance is not.

This need for certainty and predictability produces an insatiable industry appetite for regulatory guidance. A common sentiment among compliance professionals is “We don’t care what the answer is, as long as we get an answer.” Since July 2011, the Consumer Financial Protection Bureau (CFPB or the Bureau) has been the agency with primary responsibility for providing answers on regulatory requirements for consumer financial products and services. While the CFPB’s guidance is often criticized, there is little doubt that the Bureau surpasses its predecessors in the quantity of guidance it provides. In addition to the “formal guidance” provided in regulations and official interpretations, the Bureau constantly communicates with the industry and the general public through “informal guidance” in reports, preambles to proposed and final rules, supervisory guidelines and highlights, compliance bulletins, letters, webinars, speeches, press releases, blog posts, and other vehicles.

While this informal guidance is frequently helpful, the Bureau undercuts its value by claiming that it is “non-binding” and “do[es] not contain legal interpretations, legal guidance, or legal advice.” These disclaimers appear to be intended to allow the Bureau to provide informal guidance without following the time and

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resource-consuming procedural requirements that apply to more formal actions. Getting informal guidance sooner can be better than getting formal guidance later—and is usually much better than getting no guidance at all—but the disclaimers leave doubts in the minds of industry as to whether they can safely rely on that guidance.

These fears were fueled, in significant part, by the CFPB’s imposition of a $109 million penalty on PHH Corporation and its affiliate for following another agency’s informal guidance, which the Bureau viewed as non-binding and incorrect. This action, combined with the Bureau’s aggressive approach to enforcement generally, led to concerns that the Bureau or another agency might similarly disregard informal Bureau guidance and hold financial service providers retroactively liable if, at some point in the future, doing so was deemed necessary to further a new policy initiative. After all, if an agency can ignore guidance in one instance, what would prevent it from doing so in other instances?

These fears lessened with the change in CFPB leadership in November 2017. Acting CFPB Director Mick Mulvaney has publicly promised that the Bureau’s “days of aggressively ‘pushing the envelope’ are over” and that “the people we regulate should have the right to know what the rules are before being charged with breaking them.” However, lenders and other financial service providers cannot rely on the good will and restraint of whoever happens to be running a government agency at any particular point in time. Most mortgages, for example, last 30 years, and financial products and systems cannot be redesigned with each election cycle or change in agency leadership.

In a recent decision, the judicial branch addressed this concern, at least in part. In January 2018, the U.S. Court of Appeals for the District of Columbia Circuit issued its long-awaited decision on PHH’s appeal of the CFPB’s penalty. The court concluded that the CFPB violated the U.S. Constitution’s Due Process Clause by disregarding informal guidance issued by the U.S. Department of Housing and Urban Development (HUD), which was responsible for RESPA before the CFPB’s creation, and retroactively applying its own interpretation of RESPA to PHH. This article explores whether the court’s decision means that, notwithstanding the Bureau’s claims that its informal guidance is non-binding, regulated entities that rely on that guidance are protected from government enforcement actions.

The CFPB has issued copious informal guidance to facilitate the implementation of its regulations, particularly the mortgage disclosure requirements in what is commonly referred to as the TILA-RESPA Integrated Disclosure or “TRID” rule. In the absence of any practical alternative, the mortgage industry overcame reservations regarding ambiguities in the TRID rule and relied on this guidance to design systems

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4 Although “TRID” is the common industry term, the CFPB often refers to its rule as “Know Before You Owe mortgage disclosure rules” or “KBYO.”
and procedures, to decide which loans to buy, and to determine how to correct errors. Despite the Bureau’s repeated statements that its guidance is not binding, the PHH decision appears to protect those who have relied on the CFPB’s informal guidance from the risk that the Bureau could simply change its mind and apply a new interpretation to past conduct.

This protection may also extend to other government actors and courts. While courts need not blindly apply informal CFPB guidance in private litigation, the D.C. Circuit’s due process analysis may persuade a court that a lender or other financial services provider should not be penalized for relying in good faith on that guidance, even if a court concludes the guidance is unsound.

**Official interpretations of TILA and RESPA**

The Administrative Procedure Act governs the rulemaking process for federal agencies. For substantive rules, the APA requires that a “[g]eneral notice of proposed rule making shall be published in the Federal Register,” followed by a comment period in order to “give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments[].” After consideration of the comments presented, a final rule is published in the Federal Register at least 30 days before its effective date. However, the notice and comment procedure is not required with respect to interpretive rules, i.e., those which merely clarify or explain existing law or regulations.

Both RESPA and the Truth in Lending Act (TILA) expressly provide protections against liability for persons relying on official interpretations. For example, RESPA states that there is no liability for “any act done or omitted in good faith in conformity with any rule, regulation, or interpretation thereof by the Bureau or the Attorney General, notwithstanding that after such act or omission has occurred, such rule, regulation, or interpretation is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.” TILA contains similar language.

However, Regulation X limits what is considered “a rule, regulation or interpretation of the Bureau,” stating that “only the following” are included:

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5 U.S.C. § 553(b)-(c).


9 See 12 U.S.C. § 1640(f) (providing protections for “any act done or omitted in good faith in conformity with any rule, regulation, or interpretation thereof by the Bureau or in conformity with any interpretation or approval by an official or employee of the Federal Reserve System duly authorized by the Bureau to issue such interpretations or approvals under such procedures as the Bureau may prescribe therefor, notwithstanding that after such act or omission has occurred, such rule, regulation, interpretation, or approval is amended, rescinded, or determined by judicial or other authority to be invalid for any reason”); see also 12 C.F.R. § 1026, Supp. I, Introduction, comment 1.
(i) All provisions, including appendices and supplements, of [Regulation X]. Any other document referred to in [Regulation X] part is not incorporated in this part unless it is specifically set out in [Regulation X];

(ii) Any other document that is published in the Federal Register by the Bureau and states that it is an “interpretation,” “interpretive rule,” “commentary,” or a “statement of policy” for purposes of section 19(a) of RESPA. Except in unusual circumstances, interpretations will not be issued separately but will be incorporated in an official interpretation to this part, which will be amended periodically.10

Regulation X goes on to expressly exclude “any other statement or issuance, whether oral or written, by an officer or representative of the Bureau, letter or memorandum by the Director, General Counsel, or other officer or employee of the Bureau, preamble to a regulation or other issuance of the Bureau, Public Guidance Document, report to Congress, pleading, affidavit or other document in litigation, pamphlet, handbook, guide, telegraphic communication, explanation, instructions to forms, speech or other material of any nature....”11

While neither TILA nor Regulation Z contains a comparable limitation or exclusion for informal guidance, it nevertheless appears that, in the Bureau’s view, a bright line exists between formal and informal guidance. As discussed below, however, the D.C. Circuit’s decision in PHH may require the CFPB to reconsider this distinction—or, at the very least, prevent the Bureau from changing course without first issuing new guidance.

**CFPB v. PHH Corporation**

*Preliminary Proceedings*

In January 2014, the CFPB’s Office of Enforcement commenced an administrative proceeding against PHH and several affiliates, alleging that PHH selected mortgage insurers for its loans based on whether those insurers purchased reinsurance from a PHH affiliate. This is sometimes referred to as a “captive reinsurance arrangement.” The Office of Enforcement alleged that these actions violated Section 8(a) of RESPA, which states that “[n]o person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.”12

PHH contested the allegations. Among other points, PHH argued that its arrangements were consistent with Section 8(c)(2) of RESPA, which states that “[n]othing in this section shall be construed as prohibiting ... the payment to any person of a *bona fide* salary or compensation or other payment for goods or facilities actually furnished or for services actually performed.” PHH further argued that, in structuring its business arrangements, it relied in good faith on informal guidance provided by HUD. This guidance, which was first

10. 12 C.F.R. § 1024.4(a)(1).
11. 12 C.F.R. § 1024.4(a)(2).
set forth in a 1997 letter from Assistant Secretary Nicholas P. Retsinas and subsequently restated elsewhere, stated that captive reinsurance arrangements were permissible so long as reinsurance services are actually furnished and any payments are “bona fide compensation that does not exceed the value of such services.”

In November 2014, the CFPB’s administrative law judge found that PHH violated RESPA and ordered disgorgement of $6.4 million in reinsurance premiums. Both PHH and CFPB Enforcement staff appealed this decision to CFPB Director Cordray, consistent with the CFPB’s rules of practice for administrative proceedings.

Director Cordray’s decision

In June 2015, CFPB Director Cordray affirmed the conclusion that PHH violated RESPA but increased the required disgorgement of premiums from $6.4 million to $109 million. In rejecting PHH’s argument that it relied in good faith on HUD’s informal guidance, Director Corday concluded that “[t]he HUD letter is not in such a form as to be binding on any adjudicator” and “provides no protection to PHH in this proceeding” because, “[u]nlike some other forms of written guidance issued by HUD, the letter was never published in the Federal Register” and therefore did not constitute a formal interpretation under Regulation X.13

Director Cordray further concluded that the HUD letter misinterpreted RESPA to the extent that it concluded that “payments are bona fide as long as they do not exceed the value of the reinsurance” because, in his view, “the opportunity to participate in a money-making program would be enough to find a violation, regardless of what amounts were paid for that opportunity.”14 PHH appealed Director Cordray’s decision to the D.C. Circuit.

The D.C. Circuit panel decision

In October 2016, a three-judge panel of the D.C. Circuit reversed the CFPB’s determination that PHH violated RESPA. The panel concluded, among other things, that “even if the CFPB’s new interpretation [of RESPA] were consistent with the statute (which it is not), the CFPB violated due process by retroactively applying the new interpretation to PHH’s conduct that occurred before the date of the CFPB’s new interpretation.”15

In the panel’s words, “[a]t the time PHH engaged in its captive reinsurance arrangements, everyone knew the deal: Captive reinsurance arrangements were lawful under Section 8 so long as the mortgage insurer paid no more than reasonable market value to the reinsurer for reinsurance actually furnished.”16

14 Id. at 18 (internal quotation marks omitted).
16 Id. at 46.
Therefore, the panel explained, the CFPB could not change the deal with respect to PHH’s past conduct because:

Retroactivity – in particular, a new agency interpretation that is retroactively applied to proscribe past conduct – contravenes the bedrock due process principle that the people should have fair notice of what conduct is prohibited. As the Supreme Court has emphasized, individuals should have an opportunity to know what the law is and to conform their conduct accordingly. Due process therefore requires agencies to provide regulated parties fair warning of the conduct a regulation prohibits or requires.\(^\text{17}\)

After discussing prior court decisions on retroactivity, the panel continued:

All of those fundamental anti-retroactivity principles are Rule of Law 101. And all of those fundamental anti-retroactivity principles fit this case precisely. PHH did not have fair notice of the CFPB’s interpretation of Section 8 at the time PHH engaged in the conduct at issue here. PHH participated in captive reinsurance arrangements in justifiable reliance on the interpretation stated by HUD in 1997 and restated in 2004. The CFPB therefore violated due process by retroactively applying its changed interpretation to PHH’s past conduct and requiring PHH to pay $109 million for that conduct.\(^\text{18}\)

Most significantly for purposes of this discussion, the panel rejected the CFPB’s contention that PHH was not entitled to rely on HUD’s informal guidance because it was not reflected in a binding HUD rule:

To trigger ... due process protection, an agency pronouncement about the legality of proposed private conduct need not have been set forth in a rule preceded by notice and comment rulemaking, or the like. Here, the agency guidance was provided by top HUD officials and was given repeatedly. Although we do not imply that those two conditions are necessary to justify citizens’ reliance for purposes of the Due Process Clause, they are surely sufficient. Here, the regulated industry reasonably relied on those agency pronouncements.

Put aside all the legalese for a moment. Imagine that a police officer tells a pedestrian that the pedestrian can lawfully cross the street at a certain place. The pedestrian carefully and precisely follows the officer’s direction. After the pedestrian arrives at the other side of the street, however, the officer hands the pedestrian a $1,000 jaywalking ticket. No one would seriously contend that the officer had acted fairly or in a manner consistent with basic due process in that situation. Yet that’s precisely this case. Here, the CFPB is arguing that it has the authority to order PHH to pay $109 million even though PHH acted in reliance upon numerous government pronouncements authorizing precisely the conduct in which PHH engaged.

\(^{17}\) Id. at 46 (internal citations and quotation marks omitted).

\(^{18}\) Id. at 48.
The Due Process Clause does not countenance the CFPB’s gamesmanship...  

The Bureau successfully petitioned the full D.C. Circuit for en banc review, which temporarily vacated the panel’s decision. However, on January 31, 2018, the D.C. Circuit reinstated the panel decision “insofar as it related to the interpretation of RESPA and its application to PHH ... in this case.”

Implications for CFPB informal guidance

As noted above, the CFPB has issued extensive informal guidance, particularly with respect to the implementation of the TRID mortgage disclosure rule. The Bureau has provided this guidance to the mortgage industry in various forms, including webinars, compliance guides, sample forms and calendars, factsheets, and letters. This guidance has been vital because the TRID rule contains a large number of technical disclosure requirements, many of which are ambiguous when applied to specific transactions or scenarios.

Uniform application of the TRID requirements is critical for consumers and the mortgage industry. Not only would the purpose of the disclosures be frustrated if borrowers do not receive consistent disclosures that they can use to make “apples to apples” comparisons between loans, but disagreements between lenders and investors over the correct interpretation can severely restrict the number of loans that are saleable on the secondary market, which could in turn reduce consumers’ access to credit.

The CFPB’s informal guidance has often cleared up confusion or resolved debates over certain requirements. For example, in the year after TRID took effect, liability for errors in completing the disclosures—both “true” errors and perceived errors resulting from disagreements over interpretation—were a major point of contention in the industry. However, in December 2015, CFPB Director Richard Cordray wrote a letter to the Mortgage Bankers Association explaining that, although TRID incorporates RESPA requirements into TILA’s implementing regulation (Regulation Z), the rule “did not change the prior, fundamental principles of liability under either TILA or RESPA.” In particular, the CFPB’s letter indicated that the risk of a borrower lawsuit is generally limited to a small subset of disclosures, that the final Closing Disclosure may limit civil liability for any errors on prior disclosures, and that errors can generally be “cured” by notifying the consumer of the error and providing refunds where appropriate.

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19 Id. at 48-49 (citations omitted).
21 PHH Corp. v. Consumer Fin. Prot. Bureau, 881 F.3d 75, 83 (D.C. Cir. 2018). Notably, the three judges who would have upheld the CFPB’s interpretation of RESPA nevertheless agreed that, “[f]or substantially the reasons given by the panel, ... the Bureau ran afoul of the due process clause by failing to give PHH adequate notice in advance of imposing penalties for past conduct.” Id. at 113.
23 Letter from CFPB Director Richard Cordray to David Stevens, President & CEO, Mortg. Bankers Ass’n (Dec. 29, 2015).
Over the succeeding years, the industry has had no choice but to rely on this and other informal staff guidance, despite the Bureau’s refusal to formalize it through publication in the Federal Register or otherwise. Rather than closing up shop, lenders make mortgage loans and investors purchase them based on the CFPB’s informal guidance, despite lingering concerns that the guidance is not binding on the Bureau or a court.

**Conclusion**

The CFPB is to be applauded for its efforts to support the implementation of TRID and other rules through guidance. Nothing in this article is intended to discourage the Bureau or other regulators from issuing guidance that helps the industry navigate the inherent complexities and ambiguities of regulations so that consumers receive the required protections and lenders avoid liability for unintentional errors or mistaken interpretations.

Instead, this article is intended to provide some degree of comfort to industry participants who have hesitantly chosen to rely on the Bureau’s informal guidance despite the “non-binding” disclaimers and the Bureau’s attempts to disregard HUD’s informal guidance when pursuing PHH. The due process principles affirmed by the full D.C. Circuit in *PHH* indicate that the Bureau and other regulators cannot take actions inconsistent with their own informal guidance without first providing notice to the public and, even then, cannot apply a new interpretation to past conduct. In addition, while informal CFPB guidance is not entitled to the same degree of deference from a court as the Bureau’s formal interpretations, the due process analysis may help a lender or other financial services provider defend itself against private litigation by persuading a court that it should not be penalized for relying in good faith on that informal guidance when the regulation and the formal guidance was unclear.\(^\text{25}\)

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