Cravath Financial Institutions Insights

BANK REGULATION IN 2023

Policymakers for the U.S. banking sector have a packed agenda in 2023, in part because of a backlog of matters that require attention and in part because the market continues to present policy issues that require attention.

Below, we review certain key developments from the end of 2022 and offer thoughts on what lies ahead in 2023.

01

End of 2022 Developments

CRYPTO

- Cryptoassets continue to receive attention from policymakers, particularly after FTX's bankruptcy.
- For example, members of Congress have sent letters to the federal banking agencies regarding bank involvement with FTX or other cryptoasset firms. Lawmakers have identified certain banks for additional inquiry, including one (Moonstone Bank) that received an investment from FTX-affiliated Alameda Research Ventures.
- At the federal agency level, the Financial Stability Oversight Council has recommended that Congress pass legislation that: (1) provides explicit rulemaking authorities for federal financial regulators over the spot market for cryptoassets that are not securities; (2) addresses the risk posed by stablecoins; (3) relates to the regulators' authority to have visibility into and supervise the activities of all of the affiliates and subsidiaries of cryptoasset entities; and (4) provides for appropriate service provider regulation.
- At the state level, the New York Department of Financial Services ("NYDFS") issued guidance for institutions that issue U.S. dollar-backed stablecoins (see our summary here) and, more generally, guidance for New York banking organizations that wish to engage in virtual currency-related activities (see our summary here).
- At the global level, Financial Stability Board ("FSB") Chair Klaas Knot said in a letter to G20 Leaders that cryptoassets "will remain a priority area for the FSB given its central role in coordinating global supervisory and regulatory policy".
- In December, a provision was added to the James M. Inhofe National Defense Authorization Act for Fiscal Year 2023 (H.R. 7776) (the "NDAA") that would require the Federal Reserve Board ("FRB") to publish a list of every entity that has—or has applied for—Federal Reserve payment system access. For applications, the FRB also must include whether the request was approved, rejected or withdrawn or is still pending and the date(s) the request was submitted and approved, rejected or withdrawn. The bill has passed Congress, and the FRB is required to comply with the disclosure requirements within 180 days of the bill becoming law.

CAPITAL AND RESOLUTION RESOURCES

- The Basel Committee on Banking Supervision ("BCBS") finalized standards for the prudential treatment of banks' exposures to cryptoassets, including tokenized traditional assets, stablecoins and unbacked cryptoassets (see our summary here). The standards form a new part of the consolidated Basel Framework and the BCBS has agreed that it should be implemented by January 1, 2025.
- In the United States, the federal banking agencies continue to work to develop a proposal to implement the so-called Basel III-endgame standards. On September 9, 2022, they issued a statement that "reaffirmed their commitment" to issuing Basel III-endgame standards and said that they are "developing a joint proposed rule for issuance as soon as possible".
- Thereafter, FRB Vice Chair for Supervision Michael Barr gave a speech titled "Why Bank Capital Matters", and provided some thoughts on the holistic review of capital standards that is underway at the FRB. Vice Chair Barr noted his view that current U.S. capital requirements "are toward the low end of the range described in most of the research literature" and emphasized the "need to be humble about [anyone's] ability . . . to fully anticipate the risks that our financial system might face in the future". He expects to provide more details on the holistic review in early 2023.
- Further, the FRB and Federal Deposit Insurance Corporation ("FDIC") issued a joint advance notice of proposed rulemaking on whether an extra layer of loss-absorbing capacity could improve optionality in resolving a large banking organization or its insured depository institution, and the costs and benefits of such a requirement.

BANK M&A

- Another area that has received attention is bank merger policy. Although earlier in 2022 the FDIC issued a request for information on bank merger policy and the Department of Justice ("DOJ") previously reopened the comment period on its own review of bank merger policy (see a comment letter we submitted to the DOJ), no official policy pronouncements in this area have been finalized yet.
- Nevertheless, the agencies have acted on M&A applications during this review. For example, on September 14, 2022, the FRB approved an application of CBTX, Inc. to merge with Allegiance Bancshares, Inc. In that approval order, the FRB noted that the FDIC's related approval for the merger of those institutions' subsidiary banks includes a condition "requiring the combined institution to develop an action plan, to be submitted to the FDIC for approval, for improving the extent of home mortgage applications from, and originations to, African American applicants in the combined institution's assessment areas". We previously observed that the federal banking agencies may use conditions to merger approvals as a way of advancing policy goals.

CLIMATE

- In the area of climate policy, the FRB invited public comment on proposed principles providing a high-level framework for the safe and sound management of exposures to climate-related financial risks for large banking organizations. This proposal followed substantially similar proposals previously issued by the FDIC and Office of the Comptroller of the Currency. The FRB stated that it "intends to work with those agencies to promote consistency in the supervision of large banks through final interagency guidance". The FRB also announced that it expects to begin and complete a "pilot climate scenario analysis exercise" in 2023, which is "designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks". In late December, the NYDFS issued new proposed guidance for New York State-regulated banking and mortgage institutions to help them manage safety and soundness risks related to climate change. The related press release states that the NYDFS seeks to align its guidance with that of federal and international banking regulators. See here for our summary of various climate-related issues in the banking sector.

02

Early 2023 Outlook

CRYPTO

- After the bankruptcy of FTX, one significant question is whether Congress or the various regulatory agencies will take action to further regulate cryptoasset-related activities and entities.
- For example, The President's Working Group on Financial Markets in late 2021 recommended that Congress pass legislation requiring stablecoin issuers to be insured depository institutions and providing federal agencies with significant regulatory authority over custodial wallet providers and other key participants in stablecoin arrangements (see our summary here).
- Despite fits and starts of legislative momentum, it is not clear if and when stablecoin legislation will be passed, although we continue to believe, from a policy perspective, there is room for bi-partisan agreement (see our summary of various legislative proposals here; see here for our observation of the policy issues that need to be resolved to reach bi-partisan consensus).
- And it also remains unclear whether broader legislation addressing cryptoasset-related activities can be passed.
- Meanwhile, Jay Clayton and Tim Massad (former Chairman of the Securities and Exchange Commission and former Chairman of the Commodity Futures Trading Commission, respectively) have suggested that the regulators should take matters into their own hands.
- Additional scrutiny also may manifest in regulators' already-heightened supervision of the cryptoasset and related activities of banking organizations, and also in their review of investments in banking organizations (*e.g.*, Moonstone Bank).
- Whether through legislation, regulation and / or supervision, it seems like 2023 will see more focused and tangible efforts to regulate cryptoasset activities, and we will be watching to see how the policy process unfolds.
- Of particular interest will be whether the agencies come together to take a coordinated approach or continue to take an ad hoc, more individualized approach (for one example of the diminution in coordination see here). Whether the agencies shift gears and coordinate in a more meaningful way may have significant impact, such as: whether proposals like Messrs. Clayton and Massad's noted above are realistic to achieve; whether there is a regulatory alternative to stablecoin legislation (see here for one proposal that requires coordination); and whether banks providing a safe custody offering for cryptoassets at scale is realistic (see an industry letter on the issue here).

- The NDAA's required disclosure of information regarding applications for access to the Federal Reserve's payment system goes beyond the information that is currently available or even the additional information that the FRB has recently proposed to disclose. We will be watching to see whether the disclosure, or the prospect of disclosure, of additional information regarding payment system access applications will affect the Federal Reserve's approach to granting access and / or the approach taken in any legislation (including, for example, stablecoin-related legislation) regarding the terms, conditions and limits on payment system access.

CAPITAL AND RESOLUTION RESOURCES

- In the area of "traditional" prudential regulation, we will be watching to see the results of the FRB's holistic review of capital standards and the details of any proposal by the federal banking agencies to implement Basel III-endgame standards.
- In particular, we will be watching to see if any proposals are consistent with the "tailoring" categories the agencies previously adopted after the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act in 2018 or, alternatively, if the agencies propose modifying those tailoring categories.
- Another important issue to watch is whether the agencies, after the advance notice of proposed rulemaking noted above, progress to issue a proposed rule regarding the resolvability of large banking organizations or, alternatively, whether this issue fails to gain prominence among the agencies' policy priorities.

BANK M&A

- Relatedly, we will be watching to see if the agencies issue any proposed or other guidance on merger standards and, if so, whether that guidance is joint (reflecting broad agreement) or not (presumably indicating that the agencies' approaches will differ on mergers going forward). In addition, we continue to believe that the agencies may continue to rely on commitments in connection with merger approvals to advance their policy goals.

CLIMATE

- We will be watching to see whether the banking agencies jointly (or otherwise) finalize their proposed safety and soundness principles regarding climate-related financial risks for large banking organizations and indicate whether additional and / or more specific guidance is forthcoming.

As indicated by the above, there are no shortage of issues for the agencies to consider in 2023. And many of them have the potential to have real impact on business models and the competitive posture of the banking industry going forward. As we have said before, it may be practically difficult (if not impossible) to comprehensively address all of the issues catalogued above, so the ultimate impact of policymaking in 2023 very well may depend on how the agencies decide to prioritize their efforts.

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