Monthly Bank Regulatory Report

May 31, 2024

We are pleased to provide you with the May edition of Gibson Dunn's monthly U.S. bank regulatory update. Please feel free to reach out to us to discuss any of the below topics further.

KEY TAKEAWAYS:

- Banking-as-a-service remains a key discussion topic, both from a consumer perspective given the Synapse bankruptcy and from a bank perspective in determining the best practices in managing third-party risk.

- FDIC Chairman Martin J. Gruenberg announced that he will be stepping down from his position as Chairman of the FDIC "once a successor is confirmed" following the independent third party review that found that the FDIC has failed to provide a workplace safe from sexual harassment, discrimination, and other interpersonal misconduct. The successor is yet to be named, but we expect the Biden administration to move quickly (with some outlets already reporting the likely successor).

- In hearings before the House Financial Services Committee and Senate Banking Committee, Vice Chair for Supervision Michael S. Barr signaled "broad" and "material changes" to the Basel III endgame proposal and "targeted adjustments" to liquidity and discount window preparedness guidance and supervisory expectations.

- The access to master accounts for "tier 3" institutions, recently viewed as nearly impossible to obtain, may become more realistic for institutions that are willing and able to meet the relevant Federal Reserve Bank's expectations. According to media reports, Numisma Bank (f/k/a Currency Reserve Bank), a *de novo* Connecticut uninsured bank is expected to receive a master account as a "tier 3" institution.

- The OCC, FDIC, and FHFA reproposed an incentive-based compensation rulemaking, as required by Section 956 of the Dodd-Frank Act. The reproposal retains the text of the

prior proposal (ignoring all previously submitted comments), with a number of alternatives and questions raised in the preamble. The Federal Reserve did not join in the proposal; the NCUA and SEC are expected to act on the proposal imminently. Until all required agencies act on the proposal in accordance with the Dodd-Frank Act requirements, it will not be published for public comment in the *Federal Register*, though the proposal is available for comment on the relevant agencies' websites.

DEEPER DIVES:

Complications from the Synapse Bankruptcy Impact the BaaS Debate

On April 22, BaaS middleware provider Synapse Financial Technologies, Inc. (Synapse) abruptly filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the Central District of California and announced its assets would be acquired by TabaPay—a transaction that has since not materialized. Most recently, on May 24, the bankruptcy court appointed former FDIC Chairman Jelena McWilliams to serve as the chapter 11 trustee in the bankruptcy case. Court filings, media reports, and online message boards have painted a picture of customer confusion, loss of or restricted access to funds, and other issues arising in connection with Synapse's bankruptcy filing.

- **Insights:** Banking-as-a-service remains a key discussion topic. Over the past few years, BaaS providers have faced enhanced regulatory scrutiny, enforcement actions, and evolving supervisory expectations. We expect the regulatory focus to continue and banks partnering with fintechs should expect heightened examiner focus on their due diligence of third parties and ongoing oversight processes, contractual provisions, product risk assessments, board oversight and management's supervision of those relationships, and contingency planning and wind-down planning efforts, among other factors.

  It is critical that consumers understand where their funds are held. Consumer-facing third parties that partner with banks for BaaS may also be subject to more robust governance, compliance, and risk management requirements through their bank partners directly and may be subject to examination and supervision by the federal bank regulators under the Bank Service Company Act. Moreover, the CFPB has in the past taken enforcement actions against third-party program managers where consumer harm has been alleged.

FDIC, Federal Reserve and OCC Release Third-Party Risk Management Guide for Community Banks

On May 3, the FDIC, Federal Reserve and OCC (collectively, the Agencies) released "*Third-Party Risk Management: A Guide for Community Banks*" (Community Bank Guide) that is intended to assist community and other banks implement risk management practices consistent with related Interagency Guidance on Third-Party Relationships: Risk Management (Interagency TPRM Guidance) that the Agencies released in June 2023. Stressing that engagement of a third-party vendor "does not diminish or remove a bank's responsibility to operate in a safe and sound manner and to comply with applicable legal and regulatory requirements … just as if the bank were to perform the service or activity itself," the Community Bank Guide lays out examples of how to apply the Interagency TPRM Guidance in various circumstances, from an initial planning phase to ongoing monitoring and any eventual termination of the relationship.

- **Insights:** The Community Bank Guide supplements the Interagency TPRM Guidance by providing example considerations, sources of information, and applications of the Interagency TPRM Guidance. It provides a user-friendly breakdown of appropriate practices specific to smaller banks. As community banks continue to utilize third-party service providers to remain competitive, the guidance serves as a reminder that third-party risk management should remain a core focus, both at the onboarding phase, as well as on the go forward. The oversight requirements necessitate the inclusion of appropriate contract provisions, an ongoing allocation of resources, and a fulsome governance framework.

Testimony by Federal Reserve Vice Chair for Supervision Barr Before Financial Services Committee and Senate Banking Committee

On May 15 and 16, 2024, Vice Chair for Supervision Barr offered his thoughts on the current conditions of the banking sector and the Federal Reserve's supervisory activities and regulatory proposals before the U.S. House Committee on Financial Services and the U.S. Senate Committee on Banking, Housing, and Urban Affairs. In his written remarks submitted to both committees, Barr highlighted certain risks that are the subject of ongoing monitoring, including delinquency rates in commercial real estate, credit card, and auto loans, and certain supervisory and regulatory developments.

- **Insights:** Most notably, in respect of the Basel III endgame proposal, Barr noted the Federal Reserve has "received numerous and meaningful comments" on the Basel III endgame proposal that it is "closely analyzing" and highlighted his expectation that the agencies "will have a set of broad, material changes to the proposal that allow us to have a broad consensus in moving the proposal forward." On liquidity and discount window preparedness, Barr noted that the agencies "are exploring targeted adjustments to our regulatory framework that would address each of these concerns: deposit outflows, held-to-maturity monetization, and discount window preparedness." With respect to the latter, he noted that the Federal Reserve is engaging with "depository institutions of all sizes to learn from their experiences with the discount window" and "will identify and prioritize changes to operations that can improve the efficacy of our liquidity provision." One prominent issue that has recently been discussed, including in remarks by Federal Reserve Governor Michelle W. Bowman in opposition, is whether there should be some form of pre-positioning requirement (i.e., whether banks should be required to hold collateral at the discount window in anticipation of the need to access discount window loans in the future).

The OCC, FDIC, and FHFA Repropose the Rulemaking on Incentive-based Compensation Agreements

On May 6, the OCC, FDIC, and FHFA reproposed a notice of proposed rulemaking on incentive-based compensation arrangements as required under Section 956 of the Dodd-Frank Act. The reproposal is generally consistent with the proposed rule issued by the agencies in 2016. Section 956 of the Dodd-Frank Act requires the appropriate federal regulators—FDIC, Federal Reserve, OCC, NCUA, FHFA, and SEC—to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at certain financial institutions that have $1 billion or more in assets. The NCUA is expected to act on the proposal in the near term and the SEC has included a rulemaking to implement Section 956 on its rulemaking agenda. The Federal Reserve

did not join the proposal. Once the proposed rule is adopted by all six agencies, it will be published in the *Federal Register* with a comment period of 60 days following publication. Until then, each agency acting on the proposal will make it available on its website, and will accept comments.

- **Insights:** The proposal represents the third proposed rule (2011 and 2016) aimed at implementing the requirements of Section 956, nearly 14-years after the passage of the Dodd-Frank Act. Like the 2016 proposal, the proposed rule establishes general qualitative requirements applicable to all covered financial institutions and includes additional requirements for institutions with total consolidated assets of at least $50 billion (Level 2) and the most stringent requirements for institutions with total consolidated assets of at least $250 billion (Level 1). The general qualitative requirements include (1) prohibiting incentive-based compensation arrangements at covered financial institutions that encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss; and (2) requiring those covered financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate federal regulator.

OTHER NOTABLE ITEMS:

Supreme Court Announces Standard for Determining Whether Federal Law Preempts State Laws Regulating National Banks

On May 30, 2024, the Supreme Court held 9-0 that there is no categorical rule for determining whether federal law preempts state banking laws when applied to national banks, and instead adopted a test focused on whether the law interferes with a national bank's exercise of its powers. The Court's opinion is available here. For more information, please see our *Client Alert*.

Federal Reserve Invites Comments on Proposed Changes to Merger-Related Application Forms

On April 30, 2024, the Federal Reserve published a notice in the *Federal Register* proposing to update two of its merger-related application forms, the FR Y-3 and FR Y-4. Most of the proposed changes are relatively minor, however, there are two changes worth highlighting. First, the updated forms would require applicants to provide an "integration plan to merge the operations of the combined organization." Among other items, this plan would need to provide specific details, including timelines, completion dates, and key personnel, relating to how risk management, operations, and other functions of the acquirer and target would be combined to achieve the goals of the transaction. Second, the updated FR Y-3 would require applicants to provide support for all assumptions underlying their financial projections, whereas the current FR Y-3 instructions only require support for those projections which deviate from historical performance. Comments on the proposed changes are due by July 1, 2024.

- **Insights:** In a year in which the FDIC and the OCC have both proposed major changes to their review of bank mergers, the Federal Reserve's proposed updates in this domain are less likely to draw significant attention. However, the proposed updates to the FR Y-3 and FR Y-4 forms should not be overlooked or minimalized. The integration plan requirement is consistent with information currently requested by the Federal Reserve during application review processes, but the level of detail is frequently addressed at the

supervisory level, with the expectation being aligned to the banks involved. The proposed changes may result in heightened applications costs, thus reducing the anticipated value of certain proposed mergers (especially smaller transactions). Echoing this sentiment, Governor Bowman issued a short statement and, in remarks at the Pennsylvania Bankers Association 2024 Convention, expressed concern that the requirement "could result in significantly increased upfront costs and burdens for banks in preparing for and submitting applications for mergers and acquisitions." Accordingly, Governor Bowman encouraged "industry stakeholders to review and provide comment on the proposed changes."

Financial Stability Oversight Council Meets

On May 10, 2024, the FSOC met in executive and public sessions. At the meeting, the FSOC received updates from Treasury and Federal Reserve Bank of New York staff on market developments related to corporate credit, including private credit. The readout from the meeting noted that "[w]hile risks remain balanced in credit markets overall, the private credit market has grown substantially and is a relatively opaque segment of the broader financial market that warrants continued monitoring."

- **Insights:** The FSOC's 2023 Annual Report included a new discussion of the potential risks related to the rapid increase in nonbank private credit and, like the readout to the meeting, described private credit as "a relatively opaque segment of the broader financial market that warrants continued monitoring," and noting that global private credit funds "have experienced substantial growth in recent years, with estimated assets under management (AUM) of $1.5 trillion as of year-end 2022, up from $500 billion at yearend 2015." This new area of focus follows the FSOC's easing of its process to designate nonbank financial companies as systemically important financial institutions, subject to any potential legal challenges. It remains to be seen whether in an election year any designations will be made by the FSOC.

Speech by Governor Bowman on Innovation and the Evolving Financial Landscape

On May 15, 2024, Governor Bowman gave a speech titled "Innovation and the Evolving Financial Landscape" at the Digital Chamber DC Blockchain Summit encouraging federal financial regulators to be more open-minded about new technologies. Specifically, Governor Bowman offered three principles for regulators: (1) understand new technologies and their impact on financial markets and users; (2) be open to fostering innovation in the financial system; and (3) promote innovation through transparency and open communication. Governor Bowman argued that such principles would allow U.S. financial institutions to meet the needs of the evolving financial market in a safe and sound manner.

- **Insights:** Governor Bowman's speech reflects the increased pressure on U.S. financial regulators to accommodate rapidly developing financial technologies including tokenization and distributed ledger technology. The Federal Reserve understands that the failure to accommodate emerging technologies results in increased risk to the financial system and capital flight to more technologically-savvy jurisdictions. It is critical that U.S. regulators enable banks to proactively adapt their risk and oversight frameworks such that new technologies can be integrated into the U.S. financial system.

New OFR Rule for Data Collection of Non-centrally Cleared Bilateral Transactions in the U.S. Repurchase Agreement Market

On May 6, 2024, the Office of Financial Research (OFR) within the U.S. Department of the Treasury adopted a final rule to establish an ongoing data collection of non-centrally cleared bilateral repo (NCCBR) transactions in the U.S. repo market. The final rule requires reporting by certain "covered reporters" for repo transactions that are not centrally cleared and have no tri-party custodian and establishes the scope of entities subject to reporting. Reporting is required by financial companies (as defined in the final rule) that fall within either of two categories: (i) *Category 1*: a securities broker, securities dealer, government securities broker, or government securities dealer whose average daily outstanding commitments to borrow cash and extend guarantees in NCCBR transactions with counterparties over all business days during the prior calendar quarter is at least $10 billion; and (ii) *Category 2*: any other financial company that has over $1 billion in assets or assets under management, whose average daily outstanding commitments to borrow cash and extend guarantees in NCCBR transactions with counterparties that are not securities brokers, securities dealers, government securities brokers, or government securities dealers over all business days during the prior calendar quarter is at least $10 billion. The final rule goes into effect 60 days after its publication in the *Federal Register* and reporters are required to comply with the final rule 90 days after its effective date.

- **Insights:** The final rule seems to have largely gone unnoticed, but does create new reporting requirements for certain entities. Noteworthy elements of the final rule include: (1) inter-affiliate repo transactions are required to be reported and count toward the Category 1 and Category 2 covered reporter thresholds; (2) the OFR declined to add banking entities to Category 1, although it did note that "data from call reports suggests that over 90% of gross repo by U.S. depository institutions is conducted by depository institutions that are registered as government securities dealers" and, therefore, the OFR "continues to believe that nearly all NCCBR trades are intermediated by either dealers or are intermediated by financial companies that may be required to report under the Category 1 criteria, such as government securities dealers"; (3) all NCCBR transactions should be included in the determination of total commitments for the purposes of reporting, regardless of whether the institution is acting in its capacity as a government securities broker or dealer or in some other capacity; and (4) required data is to be submitted by the 11 a.m. Eastern Time T+1 reporting deadline. Because reporting is required on a daily basis, covered reporters will need to operationalize a reporting function to ensure ongoing compliance with the rule's reporting requirements.

Federal Reserve Requests Comments on Proposal to Expand Operating Days of Large-Value Payments Services

The Federal Reserve issued a proposal to expand the operating days of the Federal Reserve's two large-value payments services, the Fedwire Funds Service (Fedwire) and the National Settlement Service (NSS). As a result, such payments services would operate every day of the year. Currently, the two systems only operate Monday through Friday, excluding holidays. Comments on the proposal are due by July 8, 2024.

- **Insights:** The systems would operate on a 22x7x365 basis, with NSS closing 30 minutes earlier than Fedwire. Industry feedback has indicated support for expanding hours up to 24x7x365 to support (1) liquidity management and innovation for private-sector payment

solutions, (2) greater speed and efficiency in cross-border payments, and (3) the role of the U.S. dollar as the preferred currency for global settlements. In addition, expansion to 24x7x365 would be consistent with the actions of other central banks who are considering or have already expanded operating hours for their large-value payment services, and with the G20 Roadmap for Enhancing Cross border payments. Nonetheless, the Federal Reserve determined that an expansion to 22x7x365 would be the most efficient and effective next target state and could achieve many of the benefits of 24x7x365 hours while giving the industry and Reserve Banks time to adjust technology and operations for potential future expansion.

The following Gibson Dunn attorneys contributed to this issue: Jason Cabral, Ro Spaziani, Rachel Jackson, Zach Silvers, Karin Thrasher, and Nathan Marak.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding the issues discussed in this update. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Financial Institutions or Global Financial Regulatory practice groups, or the following:

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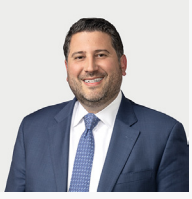

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