Bank Regulatory Report

December 31, 2024

We are pleased to provide you with the final 2024 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

- The incoming administration continues to take shape. Intended nominees for Secretary of the Treasury and Chairman of the Securities and Exchange Commission (SEC) have been identified and although President-elect Trump has not announced his intended nominees to lead the OCC, CFPB, FDIC and CFTC, all of those selections will influence significantly the agencies' regulatory and supervisory priorities and enforcement activity.

- The Board of Governors of the Federal Reserve System (Federal Reserve) announced it intends to propose changes to its stress test procedures, including (i) seeking comment on the stress-test scenarios and models used to set banks' capital requirements and (ii) averaging results over two years to reduce the year-over-year capital requirements changes resulting from the stress test.

- In his testimony before the U.S. House Committee on Financial Services, Acting Comptroller Hsu made clear his support for the U.S. Treasury Department's "call for federal payments regulations and a chartering regime for nonbanks," signaling his support for a "dual fintech" system modeled on the dual banking system, with "distinct roles for federal versus state authorities."

- The Federal Reserve released its Supervision and Regulation Report highlighting the Federal Reserve's current supervisory priorities and trends in supervisory ratings and findings for banks of all sizes, indicating that approximately half of large financial institutions (*i.e.*, those with total consolidated assets of $100 billion or more) received supervisory findings for the governance and controls component of the Large Financial Institution Rating System.

- The Federal Deposit Insurance Corporation (FDIC) extended the comment period on its proposed rule for "custodial deposit accounts with transactional features" from December 2, 2024 to January 16, 2025, raising the prospects of a potentially substantially modified final rule—if adopted at all.

DEEPER DIVES

Economic and Financial Services Agendas Continue to Take Shape. Although President-elect Trump has announced his intentions to nominate Scott Bessent to serve as Secretary of the Treasury and Paul Atkins to serve as the next Chairman of the SEC, he has not yet announced his intended nominees to lead the OCC, CFPB, FDIC and CFTC. When coupled with known (and unknown) departures from the agencies, all nominees if appointed will influence significantly the federal financial services regulatory agencies' regulatory, supervisory and enforcement priorities in the next administration.

- *Insights*. Even in the absence of publicly announced intended nominees, the industry has coalesced around certain prospects in the next administration including an uptick in M&A activity, a reconsideration of the bank capital reform proposal (*i.e*., Basel III endgame) and other currently pending proposals, a pragmatic approach to innovation, regulatory reform efforts (some final rules from the current administration will be subject to legal challenge or Congressional Review Act review and disapproval), changes in supervisory expectations and priorities and a review of inefficiencies in the banking system.

  It is anticipated the federal banking agencies will revisit their approach to crypto-asset activities, potentially starting with addressing the permissibility of at least some of the five crypto-asset activities highlighted in the interagency policy sprint, in particular crypto custody activities; activities involving payments, including stablecoins; and the facilitation of customer purchases and sales of crypto-assets (perhaps using finder authority). The purchase and sale of crypto assets by banks and their holding companies as principal will require additional consideration because the authority to engage in trading activities of those assets is tied in part to any federal legislation clarifying the status of crypto-assets as securities, commodities, or other financial instruments. Loans collateralized by crypto-assets and other crypto-based lending activities seem likely to be addressed through separate guidance (if addressed). The federal banking agencies also seem poised to continue to support tokenization of traditional financial assets.

  Cybersecurity should continue to feature prominently on the list of federal bank regulators' areas of concern and we expect regulators will become more proactive in both prescribing specific requirements and monitoring compliance with those requirements, including by conducting horizontal exercises to test the resilience of the sector and individual institutions within the system and also specific areas of the financial services sector (such as banking and payments). Cybersecurity risks relating to AI will continue to be an area of priority.

  On the regulatory enforcement front, certain state attorneys general are anticipated to be more aggressive in their enforcement efforts in consumer compliance, which we expect will be heightened in the case of a de-fanged CFPB. Others will continue to be aggressive in enforcement of fair access to lending and the provision of financial services to certain industries, as well as with respect to broader ESG or DEI initiatives.

BSA/AML, sanctions and FCPA compliance will continue to be top priorities of the criminal enforcement and federal and state bank regulatory agencies in the new administration and we expect regulators will continue to bolster supervisory expectations and examinations in this area, as well as penalties for weaknesses or failures in relevant compliance programs. Moreover, increasing geopolitical risks will undoubtedly create new sanctions compliance obligations, as tensions escalate in certain jurisdictions and (potentially) de-escalate in others, or the incoming administration takes unilateral actions against jurisdictions or actors not currently subject to sanctions or relax sanctions currently imposed on others, resulting in new jurisdictions or state or non-state actors and their proxies being added to OFAC sanctions lists, with sanctions against other actors potentially being relaxed.

Federal Reserve Previews Changes to Stress Test Procedures. On December 23, 2024, the Federal Reserve announced it will seek public comment on changes to its stress test procedures. According to the release, the proposed changes include disclosing and seeking comment on the stress-test scenarios and models used to set banks' capital requirements and averaging results over two years to reduce the year-over-year changes in the capital requirements that result from the stress test.

- *Insights*. The Federal Reserve attributed its announcement that it will seek public comment on changes to its stress test procedures to the "evolving legal landscape" and to what it said were significant changes in the "framework of administrative law … in recent years"; in view of those developments, the Federal Reserve said, it "determined to modify the test in important respects to improve its resiliency." These statements appear to acknowledge some of the same legal concerns at the heart of the lawsuit filed the next day. (*See immediately below*).

Bank Policy Institute, Business Groups and Trade Associations File Legal Challenge Against Federal Reserve to Compel Changes to Stress Testing Framework. On December 24, 2024, the day after the Federal Reserve's announcement, the Bank Policy Institute, Ohio Chamber of Commerce, Ohio Bankers League, American Bankers Association and U.S. Chamber of Commerce (represented by Gibson Dunn) filed suit against the Federal Reserve in U.S. District Court, challenging the legality of the current the stress testing framework. The complaint alleges that the Federal Reserve's failure to allow notice and comment on the scenarios and models used in the stress tests, and its failure to publish the models, violates the Administrative Procedure Act and constitutional due process, and is the product of arbitrary and capricious decision-making at the time the current stress test framework was established. The suit also alleges that the current Federal Reserve stress tests produce unjustified volatility in bank capital requirements, forcing banks to hold more capital than warranted with adverse effects on the economy as a whole.

- *Insights*. According to the plaintiffs, the suit aims to "ensure that beginning in 2026, the [Federal Reserve] subjects the components of the stress tests to public notice and comment and complies with other applicable legal requirements." Plaintiffs assert that stress testing is important and that they do not seek to end Federal Reserve stress tests, but rather to ensure they conform with the law. The complaint acknowledges the Federal Reserve's December 23, 2024 announced changes and "applauds" the announcement, but notes that "the deadline for a court challenge to some of the government actions undergirding the current stress test process is February 2025" and, therefore, the plaintiffs filed suit "to preserve their legal rights and to ensure timely reform to the current, flawed process" in the event the Federal Reserve's proposed reforms fall short.

FDIC Enters into Passivity Agreement with The Vanguard Group. On December 27, 2024, the FDIC released the terms of its passivity agreement with The Vanguard Group. Under the passivity commitments, Vanguard must, among other things, promise not to exert its proxy powers over the banks (which is consistent with Vanguard's existing practices). Vanguard is responsible for providing ongoing reporting to the FDIC and make available to the FDIC information related to their ownership in banks subject to the passivity agreement.

- *Insights*. The passivity agreement follows a now year's-long path that started in January when FDIC Director Jonathan McKernan first stated that the federal banking agencies should "revisit the regulatory comfort" the agencies had given the "big three" asset managers on "control." Following that came dueling proposals from Directors McKernan and Chopra to monitor large asset managers' compliance with the Change in Bank Control Act (CIBCA) with respect to their investments in depository institution holding companies and, indirectly, their insured depository institution subsidiaries (both withdrawn), and on July 30, 2024, the FDIC issued a proposed rule to amend the FDIC's regulations under the CIBCA that, among other changes, would remove the exemption from filing a CIBCA notice with the FDIC if the transaction to acquire control of the institution's holding company is subject to notice to the Federal Reserve.

  According to media reports and as alluded to Blackrock's comment letter to the FDIC in response to the July 30, 2024 CIBCA proposal, Blackrock and Vanguard were expected to submit notices under the CIBCA to the FDIC for any 10% or greater holdings in holding companies of state-chartered non-member banks or enter into passivity agreements to rebut the CIBCA's presumption of control – all while a pending proposed rule remained outstanding and not yet effective. Because there appears to be support from both sides on this issue, it remains to be seen whether the FDIC's proposed rule will go final and if so, Vanguard's passivity commitments with the FDIC may serve as a useful tool for future investors in holding companies of state-chartered non-member banks seeking to rebut the presumption of "control" under the CIBCA of the underlying institution.

Federal Reserve Board Releases Supervision and Regulation Report. On November 15, 2024, the Federal Reserve released its Supervision and Regulation Report, highlighting, among other things, the Federal Reserve's current supervisory priorities and trends in supervisory ratings and findings.

- *Insights*. According to the report, approximately one-third of large financial institutions (*i.e.*, those with total consolidated assets of $100 billion or more) met supervisory expectations across all three components of the Large Financial Institution Rating System: capital planning, liquidity risk management and governance. Most large financial institutions met supervisory expectations with respect to capital planning and liquidity risk management, with about 80% of the remaining two-thirds receiving supervisory findings for the governance and controls component in areas such as operational resilience, cybersecurity and BSA/AML compliance per the report. The report cited (i) credit risk (namely commercial real estate and certain consumer loan sectors), (ii) banks' preparedness for managing liquidity risk, and (iii) cybersecurity risk, as supervisory priorities. The report notes that "[s]upervisors view cybersecurity as a high priority given the increasing and evolving nature of cybersecurity threats," an area of heightened focus we anticipate continuing in the next administration.

Federal Reserve Board Publishes Financial Stability Report. On November 22, 2024, the Federal Reserve published its semi-annual *Financial Stability Report*. According to the Federal Reserve Bank of New York's industry survey, there were meaningful increases relative to its spring survey in the percentage of respondents citing among their top risks to financial stability fiscal debt sustainability, Middle East tensions or a U.S. recession; with declines in the percentage of respondents citing persistent inflation pressures and monetary tightening or generalized policy uncertainty as among the most notable risks to financial stability.

- *Insights*. In its discussion of near-term risks to the financial system considering possible interactions of "existing domestic vulnerabilities" with "potential near-term risks, including international risks," the report included a discussion of two of the same risks as the April 2024 report (worsening of global geopolitical tensions and potential impacts of unexpectedly weak economic growth), while removing higher-for-longer interest rates and replacing with a discussion of risks associated with shocks to the U.S. financial system caused by cyber events, an area of heightened focus we anticipate continuing in the next administration.

OCC Releases Semiannual Risk Perspective. On December 16, 2024, the OCC released its *Semiannual Risk Perspective for Fall 2024*. Coming just days after a speech by Acting Comptroller Hsu discussing the increasing prevalence of fraud in the banking system, the OCC's report includes a special topic focusing on the "increasing trend in external fraud activity targeting consumers and the federal banking system."

- *Insights*. The special topic highlights the OCC's concerns that instances of fraud, suspected fraud or other suspicious activities be "promptly" identified, investigated, reported and resolved in accordance with the Bank Secrecy Act, Expedited Funds Availability Act (Regulation CC) and Electronic Fund Transfer Act (Regulation E). It also highlights that increases in fraud cases heighten risks of unfair or deceptive acts or practices (UDAP) violations where banks "take prolonged timeframes to complete investigations or implement broad account access limitations, preventing customers—including those who are not victims of fraud—from accessing their funds. If banks on either side of the transaction do not complete investigations expeditiously, customers may not have access to funds for extended periods of time, which may create financial hardship for them."

FSOC Releases 2024 Annual Report. On December 6, 2024, the Financial Stability Oversight Council (FSOC) released its 2024 Annual Report. The report highlights many of the same risks covered in the 2023 Annual Report and the Federal Reserve's *Financial Stability Report* and OCC's *Semiannual Risk Perspective*. The report devotes more attention to commercial real estate vulnerabilities than the FSOC's 2023 Annual Report and details the forces driving stress in the sector, before highlighting the first losses to AAA-rated CMBS issued after the financial crisis.

- *Insights*. Secretary Yellen's statement accompanying the release of the report detailed the work of the FSOC during the current administration and highlighted "emerging risks from significant technological changes" including digital assets and AI, as well as staff and infrastructure shortages. She echoed the FSOC's recommendation (again) for legislation to create a comprehensive federal prudential framework for stablecoin issuers and for legislation on crypto assets that addresses the risks identified by the FSOC and encouraged building further interagency expertise on the potential systemic risks associated with the use of AI in the financial services sector.

FDIC Announces Extension of Comment Period for Proposed Rule on Recordkeeping Requirements for Custodial Deposit Accounts with Transactional Features. On November 18, 2024, the FDIC extended the comment period on its proposed rule that would establish new recordkeeping requirements at insured depository institutions for "custodial deposit accounts with transactional features" from December 2, 2024 to January 16, 2025, raising the prospects of a potentially substantially modified final rule if adopted at all.

- *Insights*. Both Vice Chairman Hill and Director McKernan voted in favor of the proposal, each citing Synapse Financial Technologies, Inc.'s failure and resultant significant hardship for consumers. However, each noted certain reservations with the proposal in their statements accompanying the proposed rule—which may shed light on the direction of a final rule, *if adopted*.

  Vice Chairman Hill's statement highlighted four specific concerns with or suggestions for the proposal: (1) consider a minimum threshold for applicability given that, as applied, between 600 and 1,100 banks could be in scope, "even though only a few dozen are heavily engaged in the type of activity at which the proposal is targeted;" (2) the certification of compliance requirement signed by the CEO, COO, or highest ranking official should either be deleted or qualified as was done in Part 370, which requires that the certification be signed by the CEO or COO and "made to the best of his or her knowledge and belief after due inquiry"; (3) reduce the burden on institutions – *e.g.*, by deleting the requirement that banks establish and maintain written policies and procedures; and (4) the timing of the proposal should have been delayed until after the feedback to the request for information soliciting feedback on partnerships between fintechs and banks was received.

  Director McKernan in his statement made clear his support for any final rule would depend on whether the final rule is "appropriately targeted, tailored, and consistent with" the agency's statutory authorities, before listing 11 questions (with multiple embedded questions) from which he believes the FDIC would benefit from public input, including whether the proposal extends beyond the FDIC's stated statutory authorities, whether the policy underlying the proposal can be achieved "better or more directly under other statutory authorities," whether the proposal should include tailored or tiered for requirements for application of the rule and whether the definition of "custodial deposit account with transactional features" itself should be modified.

OTHER NOTABLE ITEMS

Testimony by Acting Comptroller Hsu Before House Financial Services Committee. On November 20, 2024, Acting Comptroller Michael J. Hsu testified before the U.S. House Committee on Financial Services. In his testimony, Hsu made clear his support for the U.S. Treasury Department's call for a federal payments/fintech charter, creating a system modeled on the dual banking system. Of course, initiatives like a federal payments charter (absent implementation by statute) could be subject to challenge by the states following the Supreme Court's decision in *Loper Bright* overturning the Chevon doctrine. A prior OCC initiative to create a federal fintech charter was challenged in parallel suits by the Conference of State Bank Supervisors and the New York State Department of Financial Services.

Testimony by Federal Reserve Board Vice Chair for Supervision Barr Before House Financial Services Committee. On November 20, 2024, Vice Chair for Supervision Barr testified on the Federal Reserve's supervisory and regulatory activities before the U.S. House Committee on Financial Services. On regulation, Barr noted that the Federal Reserve continues to consider ways to "improve liquidity resilience and improve banks' ability to respond to funding shocks" and in his testimony made clear that he intends to work with his "new colleagues" at the OCC and FDIC to move forward with the re-proposed Basel III endgame proposal. On supervision, Barr testified that the Federal Reserve is "working to ensure that supervision intensifies at the right pace as a bank grows in size and complexity" and "modifying supervisory processes so that once issues are identified, they are addressed more quickly by both banks and supervisors."

Testimony by Chairman Gruenberg Before House Financial Services Committee. On November 20, 2024, FDIC Chair Martin Gruenberg testified before the U.S. House Committee on Financial Services. In his testimony, FDIC Chair Gruenberg clarified the FDIC does not anticipate acting on the proposed brokered deposits rulemaking before the end of President Biden's term.

CFPB Director Chopra Calls for Deposit Insurance Reform. Following the failure of First National Bank of Lindsay, a $108 million asset size community bank in Oklahoma, CFPB Director Rohit Chopra submitted a statement for the record at the November 12, 2024 closed meeting of the FDIC Board of Directors calling for Congress "to remove – or at least dramatically increase – limits on federal deposit insurance for payroll and other non-interest bearing operating accounts," citing what he described as a "fundamentally unfair" result for depositors of a small community bank versus depositors in the spring 2023 bank failures. The FDIC, as receiver, made 50% of uninsured deposits available to depositors following the bank's failure, which could increase as assets of the failed bank are sold over time by the FDIC. Prior to closing the bank and appointing the FDIC as receiver, the OCC identified "false and deceptive bank records and other information suggesting fraud that revealed depletion of the bank's capital" and has since referred the matter to the Department of Justice.

Federal Reserve Amends Account Access Guidelines to Clarify that Excess Balance Accounts are in the Scope of the Guidelines. On December 9, 2024, the Federal Reserve issued final guidance clarifying that the six pillars of its account access guidelines also apply to excess balance accounts—limited-purpose accounts at Federal Reserve Banks established for maintaining excess reserves. An excess balance account is managed by an agent on behalf of one or more participating institutions. The clarification is effective upon publication in the *Federal Register*.

Speech By Governor Bowman on AI in Banking. On November 22, 2024, Federal Reserve Board Governor Bowman gave a speech titled "Artificial Intelligence in the Financial System." In her speech, Governor Bowman applied the same principles to AI that she applies to innovation, namely understanding the technology and openness to its adoption. From that, she urges regulators to adopt "a coherent and rational policy approach" to governing the implementation and use of AI in financial services.

Speech by Governor Bowman on a Pragmatic Approach to Regulation. On November 20, 2024, Federal Reserve Board Governor Bowman gave a speech titled "Approaching Policymaking Pragmatically." In her speech, Governor Bowman noted the importance of regulators taking a pragmatic approach to bank regulation, including "consider[ing] the costs and benefits of any proposed change, as well as incentive effects, impacts on markets, and potential unintended consequences," while also considering the "limits of regulatory responsibility—grounded by our statutory objectives—when taking regulatory action."

Speech by Governor Kugler on Central Bank Independence. On November 14, 2024, Federal Reserve Board Governor Kugler gave a speech titled "Central Bank Independence and the Conduct of Monetary Policy." Governor Kugler's speech stressed that central bank independence is fundamental to achieving sound policy and good economic outcomes.

Federal Reserve Bank of New York Publishes Article on Financial Stability Implications of Digital Assets. On November 20, 2024, the Federal Reserve Bank of New York's *Economic Policy Review* published an article titled "The Financial Stability Implications of Digital Assets." The article considers the "potential vulnerabilities" associated with the digital asset ecosystem and "examines the potential channels through which stress in cryptoasset markets could be transmitted to the traditional financial system."

Federal Reserve Bank of New York *Staff Reports* Examines Discount Window Stigma. On November 21, 2024, the Federal Reserve Bank of New York's *Staff Reports* published an article finding "conclusive evidence" that, despite increased usage since 2020, use of the Discount Window remains "stigmatized", particularly "among smaller banks and when financial markets experience disruptions."

The following Gibson Dunn lawyers contributed to this issue: Jason Cabral and Ro Spaziani.

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 or any of the member of the Financial Institutions practice group:

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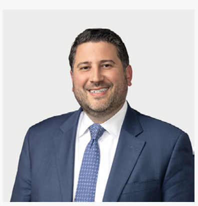

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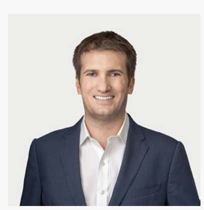

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