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Monthly Bank Regulatory Report (April 2024)

May 1, 2024

From the Financial Institutions Practice Group: We are pleased to provide you with the April edition of Gibson Dunn's monthly U.S. bank regulatory update. This update covers recent federal banking agency initiatives and legal news updates on the Community Reinvestment Act final rules and Federal Reserve Bank master accounts. Thank you for your interest.

KEY NEW DEVELOPMENTS

FDIC Board Members Withdraw Proposals to Monitor Asset Managers for Compliance with Change in Bank Control Act

At the Federal Deposit Insurance Corporation's (FDIC) [board meeting](#) on April 25, 2024, FDIC Directors Jonathan McKernan and Rohit Chopra (Director of the Consumer Financial Protection Bureau) each put forth proposals to monitor large asset managers' compliance with the Change in Bank Control Act with respect to their investments in depository institution holding companies and, indirectly, their insured depository institution subsidiaries. Director McKernan's [proposal](#) would have required the FDIC's Director of the Division of Risk Management Supervision to submit within 90 days for the review and approval of the FDIC Board a plan to (i) monitor compliance with any passivity commitment or other condition of any FDIC comfort provided to a "covered fund complex" and (ii) annually determine whether any covered fund complex controls, or has controlled, directly or indirectly an FDIC-supervised institution. Director Chopra's [proposal](#) would have removed the exemption from the Change in Bank Control Act's prior notice requirement for acquisitions of voting securities of a depository institution holding company with an FDIC-supervised subsidiary institution for which the Board of Governors of the Federal Reserve System (Federal Reserve) reviews a notice, thus requiring duplicative notices to be filed with both the Federal Reserve and FDIC.

- **Insights:** Director McKernan’s proposal garnered the [support](#) of Vice Chair Travis Hill and Director Chopra’s proposal garnered the [support](#) of FDIC Chairman Martin J. Gruenberg. Ultimately, though, neither had the support of Director Michael J. Hsu, Acting Comptroller of the Currency, who [pushed](#) for any proposed rulemaking to be done on an interagency basis. Although neither proposal was acted upon, given concerns raised by members of the FDIC Board, continued regulatory scrutiny on passivity commitments and the ownership of shares in financial institutions by large asset managers will undoubtedly remain.

FDIC Releases Comprehensive Report on Orderly Resolution of Global Systemically Important Banks

On April 10, 2024, the Federal Deposit Insurance Corporation (FDIC) released a comprehensive report regarding the orderly resolution of a large, complex financial company under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The report first outlines the resolution-related provisions of the Dodd-Frank Act before describing key measures for planning and strategy in the event of a bank failure, with a particular eye towards the resolution of global systemically important banks (G-SIBs).

- **Insights:** In issuing the report, the FDIC aims to promote transparency around the G-SIB resolution process, a topic of significant relevance in light of recent regulatory reforms aimed at aligning the regulatory framework across the largest banks, including both G-SIBs and non-G-SIBs. Most notably, the FDIC affirmed its commitment to the Single Point of Entry strategy. By providing such clarity, G-SIBs can continue to better structure their organizations to account for a potential resolution scenario, which may in turn provide opportunities for realizing operational efficiencies. Moreover, the FDIC’s report can serve as a blueprint for those firms that are not G-SIBs but which, over time, may become subject to a regulatory framework that more closely aligns with the framework currently applicable to G-SIBs.

Federal Reserve Board Publishes Financial Stability Report

On April 19, 2024, the Board of Governors of the Federal Reserve System (Federal Reserve) published the its semi-annual [Financial Stability Report](#). According to the Federal Reserve Bank of New York’s industry survey, persistent inflation and monetary policy tightening; policy uncertainty, including trade policy, foreign policy issues related to escalating geopolitical tensions and uncertainty associated with the upcoming elections; and commercial real estate market stress were the three most commonly cited potential risks to financial stability over the next 12 to 18 months. Though commercial real estate concerns and banking sector stress did decrease as financial stability risks compared to the fall 2023 semi-annual survey.

- **Insights:** In a nod to the Financial Stability Oversight Council’s (FSOC) focus on the potential risks to financial stability stemming from the use of leverage by certain hedge funds, the Federal Reserve’s report cites that “measures of hedge fund leverage increased in the third quarter of 2023 to the highest level observed since the beginning of data availability, with the increase driven primarily by the largest hedge funds.” This focus of course 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.

Preliminary Injunction Delays Revised CRA Rules

In early February, seven industry and business associations sued the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the Agencies) in the Northern District of Texas, seeking to block the Agencies' final rules interpreting the Community Reinvestment Act of 1977 that were approved on October 24, 2023 and due to take effect beginning on April 1, 2024. According to the industry and business associations' complaint, the Agencies exceeded their authority because the final rules provided that the Agencies would (1) "begin assessing banks' activities outside of the locations where they maintain a physical presence and accept deposits, thus ignoring the critical geographic limits that Congress incorporated into the CRA," and (2) "assess banks' deposit products rather than the credit products that Congress targeted in the statute." Finding that the trade associations "demonstrate[d] a substantial likelihood of success on the merits," the District Court granted a preliminary injunction on March 29, 2024 and enjoined the Agencies from enforcing the final rules against the industry and business associations pending the resolution of the suit, and tolled the effective date and all associated implementation dates while the preliminary injunction remains in place. The Agencies are appealing the decision to the Fifth Circuit.

- **Insights:** Although the District Court prohibited the Agencies from enforcing the new CRA regulations against the specific plaintiffs to the case, those seven trade associations collectively represent a majority of U.S. banks. The Agencies have noticed their intent to challenge the injunction before the Fifth Circuit and also moved to stay further proceedings before the District Court, indicating that both the final rules, and the compliance efforts required to comply with them, may remain on hold for at least the near future.

Federal Reserve Prevails Against Depository Institutions Seeking Master Accounts

In late March, two U.S. District Courts upheld decisions by the Federal Reserve Bank of Kansas City (FRBKC) and the Federal Reserve Bank of San Francisco (FRBSF) to deny master account applications from two depository institutions. In *Custodia Bank, Inc. v. Federal Reserve Board of Governors and Federal Reserve Bank of Kansas City*, Custodia Bank sued FRBKC challenging the denial of its master account application in 2023. Custodia argued that FRBKC was statutorily required to grant master accounts to all legally eligible depository institutions. The U.S. District Court for the District of Wyoming disagreed, granting summary judgment in favor of FRBKC and finding that FRBKC had discretion to grant or deny master account applications. In a similar case involving the FRBSF, the applicant lost on a similar argument regarding FRBSF's denial of its master account application in 2023. The applicant brought three claims against FRBSF, each ultimately predicated on the existence of a nondiscretionary duty to make a master account available to the applicant. The U.S. District Court for the District of Idaho found that no such duty exists, and that FRBSF accordingly exercised its lawful discretion in denying the application.

- **Insights:** In denying Custodia Bank’s application for a master account, FRBKC characterized Custodia’s business model as “unprecedented” in that it “proposes to focus almost exclusively on offering products and services related to novel crypto-asset activities and to accept entirely uninsured deposits.” FRBKC concluded that accepting deposits from Custodia into a master account would therefore “introduce undue risk” to the Reserve Bank and the economy at large. Likewise, FRBSF denied the pending application on the grounds that the applicant’s “novel, monoline business model” focusing largely on transactions that are either foreign in nature or involve mostly foreign participants “presents undue risk to the Reserve Bank.” FRBSF also considered the applicant’s risk management framework “insufficient” to address the heightened risks associated with its business model, and cited particular concerns with respect to money laundering, terrorism financing risks, and the potential for the applicant to allow the master account to fund or facilitate such illicit activities. While the District Courts’ decisions are not binding on other courts and are likely to be appealed, they do presently support the conclusion that the Federal Reserve maintains discretion to reject master account applications even in those cases involving eligible applicants. This may be especially true when those applicants are proposing novel business models that the Federal Reserve determines pose undue risk to financial stability or the efforts of the United States in combatting money laundering and the financing of terrorism.

FDIC’s Final Rule on Simplification of Deposit Insurance Rules for Trust and Mortgage Servicing Accounts Goes Effective April 1, 2024

On January 21, 2022, the Federal Deposit Insurance Corporation (FDIC) approved a final rule to amend the deposit insurance regulations for trust accounts and mortgage servicing accounts. The final rule became effective April 1, 2024. Under the final rule, irrevocable and revocable trusts are combined into a single category known as “Trust Accounts” for purposes of the deposit insurance coverage rules. Each Trust Account owner is insured up to \$250,000 per eligible primary beneficiary, up to a maximum of five beneficiaries. The FDIC published a presentation highlighting the final [here](#).

- **Insights:** Although insured depository institutions have had more than two years to prepare for changes in coverage, not all Trust Account owners or their beneficiaries may be aware of the changes to the new rule, which could reduce deposit insurance coverage in those cases where Trust Account owners (1) own both revocable and irrevocable trust accounts; and/or (2) have more than five beneficiaries. Clear communication to new and existing customers will be critical in ensuring that customers have an adequate understanding of the impacts, if any, of the new rules on their deposit insurance coverage. In other cases, deposit insurance limits will increase for irrevocable trust owners, which will be calculated in the same manner as revocable trusts, up to a maximum of five beneficiaries.

Speech by Board of Governors of the Federal Reserve System Governor Michelle W. Bowman on Bank Mergers and Acquisitions

On April 2, 2024, Federal Reserve Governor Michelle W. Bowman gave a [speech](#) titled “Bank Mergers and Acquisitions, and De Novo Bank Formation: Implications for the Future of the

Banking System” in which she was critical of the “broad-based and insufficiently focused reform agenda” of the federal bank regulatory agencies which creates higher barriers to entry for *de novo* banks, reduces efficiencies in bank M&A, and increases opportunities for “regulation by application” rather than relying on statutes, regulations, and rulemakings.

- **Insights:** Governor Bowman’s speech highlights the obstacles to *de novo* bank formation and Bowman stressed that the “absence of *de novo* bank formation over the long run will create a void in the banking system.” She also highlighted her “more immediate concern” with the “dramatically evolving” approach” to bank M&A by prudential regulators. She concluded by reiterating her consistent message of the need to rationalize competing regulatory approaches to ensure the long-term viability of banks.

Federal Reserve Board Governor Bowman Speaks on Bank Liquidity, Regulation and the Federal Reserve’s Role as Lender of Last Resort

On April 3, 2024, Federal Reserve Board Governor Michelle W. Bowman gave a [speech](#) titled “Bank Liquidity, Regulation, and the Fed’s Role as Lender of Last Resort.” In her speech, Governor Bowman highlighted the Federal Reserve’s role as a lender of last resort, including with respect to potential changes to the liquidity framework supporting the U.S. banking system. Governor Bowman acknowledged that the spring 2023 bank failures have created pressure to pass additional regulations relating to regulatory capital and/or liquidity, but Governor Bowman cautioned that, “...we should think about the response to banking stress more broadly....” In order to do so, Governor Bowman urged the Federal Reserve to analyze the challenges facing, and tools available to, the Federal Reserve’s liquidity and regulatory capital frameworks. With respect to the former, Governor Bowman highlighted the “perception of stigma” associated with utilizing the Federal Reserve discount window. With respect to the latter, Governor Bowman highlighted both available technology and the Federal Reserve’s prudential regulatory authority. Governor Bowman also discussed potential requirements relating to the pre-positioning of collateral with the Federal Reserve in order to access the discount window, reiterating the need to analyze the “important but as yet unanswered questions” associated with such requirements.

- **Insights:** Governor Bowman is clear in her remarks that the “expectation should not be that the Federal Reserve replaces existing sources of market liquidity for banks in normal times” and reiterated the Fed’s discount window as a “source of backup liquidity.” She reiterated her consistent message of the need for the agencies to “focus on improving the targeted approach of supervision, to enhance the ‘prevention’ of banking system stress,” and described the need to consider the liquidity framework in a “broad-based manner” so that “the available tools, resources, and requirements are working in a complementary way.”

New York Fed Announces Participation in Joint International Research Effort on Tokenization and Cross-Border Payments

On April 3, 2024, the Federal Reserve Bank of New York (FRBNY) [announced](#) that it will participate in an international technical research project, Project Agorá, that will explore whether the tokenization of central bank money and commercial bank deposits operating on a shared programmable ledger can improve wholesale cross-border payments. Project Agorá, a new effort

led by the Bank for International Settlements Innovation Hub in partnership with the Institute of International Finance, will bring together seven central banks and financial institutions from each of their respective jurisdictions to research ways to increase the speed and transparency of international wholesale payments and lower associated costs and risks. The project will focus on overcoming common structural inefficiencies in cross-border payments today related to differing legal, regulatory, and technical requirements, operating hours and time zones, and varying financial integrity controls. Including the FRBNY, the seven participating central banks are the Bank of England, Bank of France, Bank of Japan, Bank of Korea, Bank of Mexico, and the Swiss National Bank.

- **Insights:** Integration of tokenized commercial bank deposits with tokenized wholesale central bank money could lead to improvements in the monetary system's functionality and offer innovative solutions utilizing smart contracts and programmability, all while preserving its existing two-tier structure. While the FRBNY's participation in Project Agora is explicitly limited to research and experimentation, the participation alone marks a significant milestone for cross border Central Bank Digital Currency (CBDC) initiatives. Unlike early adoptions of a CBDC, like the Bahamas' Sand Dollar or Uruguay's e-Peso pilot plan, the United States has been hesitant to commit to the development or use of a CBDC. The United States' involvement in Project Agora does signify the United States' further involvement in exploring the cross-border use for a CBDC but should not be read as a commitment to develop a US Dollar CBDC.

OTHER DEVELOPMENTS / RELEVANT LINKS

- FDIC Board [releases](#) the first semiannual update of 2024 on the Restoration Plan for the agency's Deposit Insurance Fund (see also [Statement by FDIC Chairman Martin J. Gruenberg](#); [Memorandum to the FDIC Board](#)),
- Federal Reserve staff publishes [FEDS Notes article](#) titled, "Tokenized Assets on Public Blockchains: How Transparent is the Blockchain?"
- Federal Reserve Bank of New York publishes a [Liberty Street Economics blog post](#) titled, "Can I Speak to Your Supervisors? The Importance of Bank Supervision."
- Federal Reserve Bank of New York publishes a [Liberty Street Economics blog post](#) titled, "Internal Liquidity's Value in a Financial Crisis."
- Federal Reserve Bank of New York publishes a [Staff Report](#) titled, "Investor Attention to Bank Risk During the Spring 2023 Bank Run."

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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

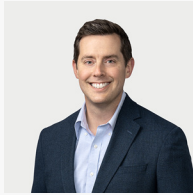
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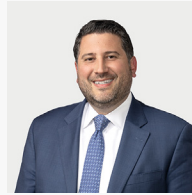
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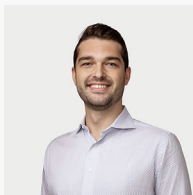
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