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Latin American and Caribbean Financial Institutions: Potential Impact of the U.S. Elections

Lawton M. Camp, Gregory Harrington, Raul R. Herrera, Edward Vergara, and Andrew Joseph Shipe*

The authors of this article explore issues that financial institutions in Latin America should focus on, including possible changes to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Foreign Account Tax Compliance Act, and enforcement priorities, as a consequence of the U.S. elections.

Financial institutions in Latin America and the Caribbean should consider the potential opportunities that have arisen as a result of the recent U.S. elections. For the first time since 2006, Republicans control the White House and both houses of the U.S. Congress. Among other issues, President Trump and the new Congress are expected to prioritize regulatory relief for the financial services industry. And while President Trump campaigned in part on a protectionist platform, his focus in that area was on the manufacturing sector, not financial services, and numerous restrictions on financial institutions and businesses operating in the capital markets are expected to be reduced or outright eliminated. The domestic and international agenda of the Trump Administration and the new Congress is still developing, but Latin American financial institutions should expect new opportunities and new risks over the next few years from a vastly changed U.S. legislative and regulatory agenda.

In these early days of the Trump Administration the media has focused significantly on President Trump's executive orders, particularly on those dealing with immigration and travel, where the U.S. legal system gives the president significant authority. However, for financial institutions in Latin America, attention should focus on more medium- and long-term issues, including possible changes to:

- the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), in particular the Volcker Rule and the provisions applicable to securitization transactions;
- the Foreign Account Tax Compliance Act ("FATCA") and the taxation of remittances as part of broader reforms of the U.S. taxation system;

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and

- enforcement priorities on matters such as anti-corruption, anti-money laundering, cybersecurity and economic sanctions.

PERSONNEL IS POLICY

In the United States, the saying "personnel is policy" means that to implement his or her policies, the President needs to have officials in key areas who will support those policies and work to achieve them. This is particularly important in the area of financial regulation, where independent regulatory agencies, such as the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC") and the Commodities Futures Trading Commission ("CFTC"), have the primary role in issuing and enforcing regulations.

Through the filling of existing leadership vacancies, the SEC and the CFTC will quickly be controlled by Trump Administration appointees, who will presumably approach regulatory reform from the same philosophical direction as the Administration. In addition, over the next 11 months, a majority of the board members of the Financial Stability Oversight Council ("FSOC"), the FDIC, as well as the Comptroller of the Currency and at least three members of the Federal Reserve, including the Chair and the Vice Chair for Supervision, will similarly be replaced by Administration appointees. Cabinet officers of the new Administration who play key roles in shaping regulatory policy over financial institutions, including the Secretary of Treasury and the Secretary of Labor, will also presumably advance the policy objectives of the new Administration.

Finally, with Republicans in the majority in each of the U.S. Senate and the House of Representatives, and therefore controlling the key chairmanships of relevant Senate and House committees, the Trump Administration is expected to find common cause in Congress for his legislative agenda. For example, the House Financial Services Committee, under the leadership of Chair Jeb Hensarling (R-TX), has an early start with the Financial CHOICE Act, which was passed by that Committee in September 2016 and is expected to form the basis for financial industry reform.

RELEVANT AREAS OF REFORM

The Trump Administration intends to follow a general de-regulatory policy focused on allowing businesses to expand and increase hiring. To that end, the President is expected to pursue policies that favor the development of deeper capital markets. In particular, the President has committed to repealing (or at least reforming) the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and purging laws and regulations that are seen to impede job growth. The following are areas that may be targeted for reform:

Dodd-Frank

One area of frequent complaint by financial institutions has been the added regulatory burden imposed by the Dodd-Frank Act, which became law in 2010 in response to the 2008–2009 financial crisis, but with very little Republican support. The new Administration and Congressional leaders have expressed strong opposition to the Dodd-Frank Act and in some cases have called for its outright repeal. Thus, the election of President Trump and continued Republican control of Congress are widely expected to result in significant regulatory relief for capital markets and for financial services firms, including Latin American and Caribbean financial institutions with U.S. operations.

Dodd-Frank—The "Volcker Rule"

The so-called "Volcker Rule" is one of the most controversial aspects of the Dodd-Frank Act. In brief, it prohibits banks and bank affiliates that are subject to the rule from engaging in proprietary trading or investing in private investment funds. Due to its broad reach, the Volcker Rule has proved to be a major impediment for non-U.S. financial institutions doing business, or seeking to do business, in the U.S. For example, a Latin American bank that maintains a single branch or agency office in the U.S., regardless of size, is subject to the Volcker Rule, and must comply with its terms, no matter where it is organized, where it is based, where it conducts activities, or with whom it does business. As a result, Latin American financial institutions have become cautious about establishing any sort of presence in the U.S., and many have closed (or have at least considered closing) their U.S. offices. The Volcker Rule's restrictions on proprietary trading have also been blamed for lower liquidity in U.S. capital markets, which has resulted in wider bid-ask spreads and less efficient pricing for new issuances.

Republicans have made no secret of their desire to eliminate the Volcker Rule, and it is likely that Congress will make repeal of the Volcker Rule a priority. Even if they fail to do so, regulators appointed by the Trump Administration would likely seek to adopt significant changes to the Volcker Rule's implementing regulations to reduce compliance burdens. Such reforms may facilitate the ability of non-U.S. financial institutions to open and operate branches, agencies and other offices in the U.S. Although the Republican campaign platform included reinstatement of the Glass-Steagall Act (which required separation of banking and investment banking firms, and presents complex issues for the cross-border financial sector), we view this as a product of new participants in the platform-drafting process who reflect the populist leanings that fueled the Trump candidacy. It remains to be seen whether implementing such a major proposal would have any likelihood of success in Congress.

Dodd-Frank—Threshold for Large Bank Regulation

The Dodd-Frank Act subjects bank holding companies with over $50 billion in worldwide assets—including foreign banking organizations with a U.S. presence (such as a branch, agency or bank or commercial lending company subsidiary)—to enhanced prudential standards. Once this threshold is crossed, these financial institutions become subject to enhanced capital, liquidity and other regulatory and compliance standards, resulting in significant additional opportunity costs and compliance expenses. For example, since 2016, should a Latin American financial institution with a U.S. branch pass the $50 billion worldwide assets threshold, then it is required to comply with capital certification, capital stress tests, liquidity stress tests, risk management and counterparty limit requirements. Those requirements represent significant additional costs to any bank that passes that threshold.

And should a foreign banking organization grow even more significantly in the United States, such that its non-branch assets in the United States reach $50 billion, then it must establish an intermediate holding company for all of its U.S. subsidiaries, which holding company will then become subject to even more restrictive standards. These aspects of the Dodd-Frank Act have been seen as impediments to natural growth by financial institutions, as well as to have resulted in decreased merger and acquisition activity, because banks are reluctant to bear the regulatory scrutiny and costs they would face when they cross these thresholds. There are also significant stress testing requirements for foreign banking organizations with total consolidated assets of more than $10 billion and risk committee requirements for foreign banking organizations that meet the asset threshold and are publicly traded.

A number of members of Congress, particularly Republicans, have advocated for raising the current $50 billion threshold, or otherwise replacing it with better indicators of systemic risk. Even President Obama's appointees to the Federal Reserve Board, including Federal Reserve Chair Janet Yellen and departing Governor Daniel Tarullo, have signaled an openness to raising the threshold. A Republican-controlled Congress is likely to implement reform in this area, which could remove an impediment to growth and pave the way for increased merger and acquisition activity in the future.

For Latin American financial institutions, many of which already have a U.S. presence that would subject them to this aspect of Dodd-Frank, the impact of any change will depend largely on whether the institution is already above or below the $50 billion threshold in worldwide assets. Many of the region's largest banks—including many Brazilian, Mexican, Colombian, and Chilean banks—are already well-above this $50 billion threshold, and are already subject to the Federal Reserve's enhanced prudential standards. While the very largest of these would not be impacted by an increase in this threshold to, for example, $100 billion, those banks just over the $50 billion threshold may find that a change in regulation lowering the threshold would offer significant regulatory relief and lower compliance costs.

Smaller banks may also be directly impacted, as they would have less disincentive to grow total worldwide assets beyond $50 billion or to open a presence in the United States. In addition, smaller banks may find themselves become more attractive as acquisition targets, as larger financial institutions again have additional room to grow their balance sheets.

Dodd-Frank—Rules Affecting Securitization

The Dodd-Frank Act significantly changed the regulatory environment for securitization transactions, including the adoption of credit risk retention rules affecting many securitization vehicles, including residential mortgage-backed securities ("RMBS"), commercial mortgage-backed securities ("CMBS"), asset-backed commercial paper ("ABCP"), and collateralized loan obligations ("CLOs"). In addition, the Volcker Rule and the Swap Regulation (as discussed below) have significantly impacted the structures of certain securitizations. For example, the structuring of CLOs, synthetic securitizations, and certain re-securitizations have changed to conform to these new regulations.

For Latin American and Caribbean financial institutions, particularly those located in countries that are currently rated below "investment grade," securitization transactions have traditionally been an important source of funding during otherwise difficult market conditions. Numerous banks in the region have used securitization vehicles for transactions securitizing assets ranging from credit card receivables, automobile and commercial loans, and remittances and other diversified payment rights. There has been an increased interest in revisiting off-shore securitization structures for trade receivable and other future-flow securitizations.

An area of possible change to the Dodd-Frank securitization rules is contained in the Financial CHOICE Act, a piece of legislation drafted by Congressman Jeb Hensarling, the chairman of the House Financial Services Committee, before the 2016 election. The Financial CHOICE Act, which is expected to form the basis of future Dodd-Frank reform, would repeal the Dodd-Frank requirement that a securitization sponsor retain five percent of the credit risk in the assets forming the underlying collateral (other than for securities backed by residential mortgages). A repeal of this requirement—which came into effect at the end of 2016—would benefit the CLO and leveraged loans markets generally, but would also have a positive effect on the marketability of securitizations by companies and financial institutions in Latin America that would be sold into the U.S. market.

One other important consideration, particularly for remittance-based securitizations, is whether the Trump Administration's tax reform proposals will institute a tax on remittances, in particular as part of an effort to capture a portion of the dollar-flow sent to Latin America by immigrants living in the United States. While it is too early to predict whether significant U.S. tax reform will be adopted, possible changes to the taxation of remittances should be considered a risk factor for both current and planned remittance-based securitizations.

Dodd-Frank—Swap Regulation

The Dodd-Frank Act established a comprehensive system for regulation of the swap markets. Core aspects of this regulatory regime, such as central clearing, exchange trading and transaction reporting, are expected to remain in place. However, certain elements of the CFTC's swap regulatory program have been questioned and may be changed. For example, legislation is now pending that would limit the CFTC's broad application of its swaps regulations to fewer international swap transactions, and prevent the CFTC from lowering its current thresholds for "swap dealer" and "major swap participant" registration. Other suggested changes would include allowing personnel located in the United States to participate in arranging, negotiating or executing swaps without triggering the full panoply of CFTC swap regulations.

For Latin American financial institutions, these changes—if adopted—may result in fewer transactions being caught in the CFTC regulatory net, while at the same time permitting U.S.-based employees to work more closely on swap transactions.

FATCA—The Foreign Account Tax Compliance Act

Aside from the many issues involved in Dodd-Frank, one other set of challenging compliance requirements of recent years for Latin American and Caribbean financial institutions has been the Foreign Account Tax Compliance Act ("FATCA"). FATCA's reporting burdens and complexity, not to mention compliance costs, have caused many Latin American and Caribbean institutions simply to cease doing business with U.S. customers, resulting in lost revenue and reduced trade, and perhaps less U.S. investment in those regional economies. U.S. citizens living and working outside the United States find it difficult to obtain mortgage loans, insurance, payment services, or otherwise manage their finances.

The official Republican Party platform adopted for the 2016 election explicitly called for the repeal of FATCA. However, FATCA's stated goal of preventing tax evasion enjoys popular support, and members of the Democratic Party still hold positions in Congress that would permit obstruction or delay of action. In this setting, it may prove difficult to repeal the law. On the other hand, it may be possible for Democrats and Republicans to reach a compromise that will make FATCA compliance less onerous. It remains to be seen how and whether the Republican Congress and the Trump Administration will take up the issue of repeal or reform.

Enforcement Priorities

Enforcement is another area where "personnel is policy," and the Trump Administration brings with it new cabinet secretaries and senior staff in the U.S. Department of Justice and the U.S. Department of the Treasury, as well as many new senior officials in the relevant regulatory agencies as mentioned above. And particularly early in a new administration, where the president has not yet nominated or the U.S. Senate has not yet confirmed many second and third tier officials, it can be even more difficult to predict how a certain federal department or regulatory agency will approach its enforcement priorities.

One question that companies around the world, including Latin American and Caribbean financial institutions, have been asking is with respect to the likelihood that the new Administration will pursue cases under the Foreign Corrupt Practices Act as vigorously as the administrations of George W. Bush and Barack Obama. While Donald Trump in 2012 described the FCPA as "a horrible law" that "should be changed," new Attorney General Jeff Sessions is well-known for his law-and-order approach, and the person nominated as Deputy Assistant Attorney General (Trevor McFadden) with oversight over the Fraud Section (which prosecutes white collar crime cases) has written in favor of the prosecution of individuals in FCPA cases. That said, the person nominated to head the SEC (Jay Clayton) has, while in private practice, expressed concern that the FCPA may cause non-U.S. companies to be reluctant to enter the U.S. capital markets. Latin American financial institutions should certainly pay attention to these developments, but it would be expected that any changes to FCPA enforcement would be incremental, as opposed to radical.

In terms of anti-money laundering ("AML"), recent agency guidance, rulemakings, and enforcement actions—all issued prior to the change in administrations—demonstrate the financial regulatory agencies' commitment to enforcing the U.S. Bank Secrecy Act ("BSA") and its implementing regulations, and, in particular, their willingness to hold lead compliance professionals personally accountable. In terms of the direction of the new

Trump Administration, while significant regulatory relief is expected in the financial services industry in light of the new administration's stated objectives, we do not anticipate the Trump Administration will ease AML enforcement. Add to that Mr. Trump's rhetoric of fighting terrorism and bolstering national security, and financial institutions should expect an upsurge of AML supervision and enforcement in the coming years.

STATE-LEVEL REGULATIONS

In addition to the actions of the Trump Administration, it is important to consider the supervision and enforcement authorities of state-level regulators. Given that state regulators have significant independent jurisdiction over the financial institutions they regulate—and some regulators, such as the New York State Department of Financial Services ("NYDFS"), are in states led by Democratic governors—state regulators may seek to fill any perceived supervisory or enforcement void created by the Trump Administration. Although many industry observers expect state agencies to increase supervision over certain consumer-related aspects of banking, we expect increased state supervision in other areas as well, such as AML and cybersecurity.

As a recent example, on February 16, 2017, the NYDFS released final cybersecurity regulations believed to be the first state effort of its kind regulating cybersecurity of financial services firms. Although in some ways New York's cybersecurity rule is similar to federal requirements and guidance on cybersecurity for banks and securities firms, it differs in details, will impose significant compliance burdens on financial institutions qualifying as "covered entities," and will require annual certifications to the NYDFS that each covered entity is in compliance with the rule. This may present an unexpected burden on Latin American and Caribbean financial institutions that operate in New York under state (as opposed to federal) charters.

Finally, New York further signaled its intention to increase supervision and enforcement over New York-regulated financial institutions when Governor Cuomo released his 2017–2018 Executive Budget proposal, which, in part, seeks to expand the enforcement authority of the NYDFS. In particular, the proposal amends certain provisions of the New York Banking and Financial Services Laws to provide the NYDFS with explicit independent civil litigation authority and the power to ban from the financial services industry bad actors that commit "disqualifying events."