C A D W A L A D E R

A Closer Look

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In This Issue ...

As the banking industry continues its efforts to return to business as usual following a hectic and complicated three weeks, we are now seeing the early stages of the process to determine what went wrong, who was responsible and what can be done in the future to prevent a recurrence.

That closer look began earlier this week with Congressional hearings involving some of the nation's top banking regulators, and it is pretty obvious that this is only the beginning of an industry-wide introspection period. This should be very enlightening, and it is something that we will follow carefully in the weeks and months to come.

We also continue to follow the ongoing judicial matters around CFPB funding, with another important development last week addressed here by my colleague, Rachel Rodman.

Lots more to read and discuss this week, so please reach out here if there's anything on your mind.

Daniel Meade
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Congressional Hearings Calling Federal Regulators to Task for Recent Bank Failures

By **Daniel Meade**
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Both the Senate Banking Committee and House Financial Services Committee held hearings this week on the federal regulatory response to the failures of Silicon Valley Bank ("SVB") and Signature Bank. Witnesses at both hearings were Federal Reserve Board ("FRB") Vice Chair of Supervision Michael Barr, Federal Deposit Insurance Corporation ("FDIC") Chairman Martin Gruenberg, and Treasury Department Under Secretary for Domestic Finance Nellie Liang.

In Vice Chair Barr's testimony, he stated: "SVB's failure is a textbook case of mismanagement," noting poor interest rate risk management. However, he also noted that the Federal Reserve will be conducting a review on how appropriate the supervisory approach to SVB was and what lessons can be learned. In response to questions, Vice Chair Barr noted that he intends to conduct such review "humbly."

One striking thing to note, in both Vice Chair Barr's prepared testimony and during the questions from members of the respective committees, was the highly unusual inclusion of public discussion of confidential supervisory information ("CSI"). In his testimony, Vice Chair Barr noted some of the ratings of SVB and SVB Holdings, along with some supervisory findings, such as matters requiring attention ("MRAs"), and the fact that SVB Holdings was subject to an agreement under section 4(m) of the Bank Holding Company Act due to it being rated as not well managed. Regulators normally strictly guard CSI in similar fashion to how other parts of the government might guard classified information. However, one of the main reasons to keep CSI confidential is to prevent a bank run, and the thinking must have been that the reasons for keeping CSI related to SVB were now moot.

Chair Gruenberg's testimony was similar to Vice Chair Barr's in that he noted bank management failures, and that FDIC would be conducting a review of both banks, but noted FDIC was the primary Federal supervisor for Signature Bank. Chair Gruenberg also provided some details on the resolutions and ultimate sale of a substantial portion of the assets and deposits of both banks to buyers.

Under Secretary Liang's testimony focused on the Department of Treasury's role in the systemic risk exceptions that enabled the FRB to invoke section 13(3) of the Bank Holding Company Act to provide the Bank Term Funding Program (which we discussed last week) and the FDIC to provide insurance for all deposits and establish bridge banks for SVB and Signature.

There were partisan themes to the questions the regulators received from the members of the respective committees. While there was at least some bipartisan agreement that management at the failed banks bear responsibility, Republicans did seem to want to pin at least equal responsibility on the regulators. Republicans also questioned the FDIC's bid process, and suggested the FDIC was too slow in ultimately reaching purchase and assumption agreements for both banks.

While this is the first Congressional hearing on SVB and Signature, it is unlikely to be the last. The FRB’s and FDIC’s internal reviews are due out in May, and are very likely to generate another round of hearings.

Second Circuit Rules CFPB Funding Mechanism Is Constitutional, Deepening Split with Fifth Circuit

By **Rachel Rodman**
Partner | Consumer Financial Services Enforcement and Litigation

On March 23, the U.S. Court of Appeals for the Second Circuit ruled that the CFPB's funding mechanism is constitutional.[1] The case, *CFPB v. Law Offices of Crystal Moroney*, is significant for two reasons. First, the Second Circuit expressly declined to follow the Fifth Circuit's recent ruling in *CFPB v. Community Financial Services Association of America* that the CFPB's funding mechanism violates the Appropriations Clause of Article I of the Constitution.[2] Second, the Second Circuit issued its ruling *after* the Supreme Court granted certiorari in *Community Financial* – weighing in on a controversial issue that the Supreme Court has already agreed to address.

Moroney concerned a challenge by a law firm to a civil investigative demand issued by the CFPB. The law firm argued, among other things, that the CID was invalid because the CFPB's funding mechanism is unconstitutional. Under the Consumer Financial Protection Act, the CFPB does not receive funds through annual appropriations from the Treasury Department but is authorized to request a capped amount of funds from the Federal Reserve System. The law firm argued that this arrangement violates the Appropriations Clause because it uniquely insulates the CFPB from the appropriations process.

Importantly, the Fifth Circuit recently adopted this same argument in *Community Financial*. There, the Fifth Circuit held that funding the CFPB outside of the annual appropriations process means that the CFPB has powers of the "purse" and the enforcement "sword" in violation of the Constitution's separation-of-powers doctrine. As a remedy, the Fifth Circuit vacated the CFPB's Payday Lending Rule because it was finalized while the CFPB was unlawfully funded. The Fifth Circuit recognized that its ruling contradicted the decision of "every court to consider" the CFPB's funding structure. In February, the Supreme Court granted the CFPB's petition for certiorari in *Community Financial*. The case is expected to be argued this fall.

In *Moroney*, however, the Second Circuit rejected the argument that the CFPB's funding mechanism is unconstitutional. The Second Circuit held that the Appropriations Clause simply requires that "the payment of money from the Treasury must be *authorized by a statute*."[3] The Court ruled that "[h]ere, Congress expressly appropriated the CFPB's funding by enacting the CFPA."[4] Next, the Second Circuit addressed the Fifth Circuit's ruling, holding that it could not find "any support" for the Fifth Circuit's conclusion in Supreme Court precedent, the Constitution's text, or the history of the Appropriations Clause.[5]

The Second Circuit's ruling in *Moroney* deepens the divide between the Fifth Circuit and every other court to address the constitutionality of the CFPB's funding mechanism. *Moroney* is also likely to be a factor as federal courts across the country weigh whether to allow cases involving the CFPB to proceed while

Community Financial is pending with the Supreme Court. We expect *Community Financial* and *Moroney* to continue to reverberate across cases involving both the CFPB and other federal financial agencies that are funded outside the annual appropriations process.

[1] *See CFPB v. Law Offices of Crystal Moroney*, Slip Op. (Dkt. No. 151-1), No. 20-3471 (2d Cir. March 23, 2023).

[2] *CFPB v. Cmty. Fin. Servs. Ass'n of Am.*, No. 22-448 (Feb. 27, 2023), available at https://www.supremecourt.gov/docket/docketfiles/html/public/22-448.html.

[3] *Moroney*, Slip Op. at 13.

[4] *Id.*

[5] *Id.* at 14–19.

CFPB Seeks Comments Regarding the Collection and Sale of Consumer Information by Data Brokers

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Earlier this month, the CFPB issued a press release and a Request for Information ("RFI") that is focused upon whether the CFPB should promulgate additional rules implementing the Fair Credit Reporting Act.

The Fair Credit Reporting Act is landmark privacy legislation that was passed by Congress in 1970 and requires lenders, credit bureaus and even employers to provide consumers with information regarding the use of the information in their credit reports and provides rights for consumers to challenge items on their credit reports and to be able to view their credit reports. The RFI explains that its purpose is fueled by, "in addition to supervision of consumer reporting agencies, including the three largest nationwide consumer reporting agencies, the CFPB endeavors to gain insight into the full scope of the data broker industry. The data broker industry is growing and expanding its reach into new spheres of consumers' personal lives, as more sophisticated computerization has increased the power of these companies to track and predict consumer behavior. Yet, many people lack an understanding of the scope and breadth of data brokers' business practices and the impact of those practices on the marketplace and peoples' daily lives."

The public may provide comments responsive to the RFI through June 13, 2023. Interestingly, the CFPB solicits input from both data brokers and financial industry participants, as well as from consumers themselves. The specific questions from the CFPB for data brokers focus upon collecting general information such as, "What types of data do data brokers collect, aggregate, sell, resell, license, derive marketable insights from, or otherwise share?" and "What specific types of information do data brokers receive from financial institutions?", as well as more specific information regarding whether financial institutions place restrictions on the data they provide to data brokers, and whether consumers are able to avoid collection of their data. The questions for consumers delve into a variety of categories, including obtaining information regarding whether consumers have attempted to remove data from a specific data broker and how that process worked, as well as their viewpoints on the benefits and harms of collection of their information by data brokers.

Basel 3.1 – Implications for the Real Estate Finance Market

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On 30 September 2022, the Prudential Regulation Authority (the "PRA") published Consultation Paper 16/22 (the "Consultation Paper") proposing for the implementation of Basel 3.1 standards in the UK. The consultation closes on 31 March 2023, with the proposed implementation date beginning 1 January 2025 (with a transition period of five years from that date for most provisions).

This article sets out a summary of the key changes of interest to those in the real estate finance ("REF") market.

Background

The Basel 3.1 standards were published by the Basel Committee on Banking Supervision ("BCBS") on 7 December 2017, with an original implementation date of 1 January 2022 delayed due to COVID-19.

The Basel 3.1 standards are the parts of the Basel III standards that remain to be implemented in the UK. The Basel III standards that have been implemented in the UK have primarily focused on increasing the quantity and quality of capital maintained by firms (the numerator of capital ratios) and also introduced new requirements for leverage and liquidity.

Concerned that downward movement in average risk weights (measured by the ratio of RWA to assets) over the last 10 years is due to fairly pervasive underestimation in internally-modelled risk, the PRA is proposing to align with international standards and implement the final Basel III package of significant changes to the way firms calculate risk-weighted assets ("RWAs"). The PRA's aim is to mitigate the threats to confidence caused by degrees of variability in calculation of risk weights and resultant inconsistencies in capital ratios and difficulties in comparing like-for-like.

The proposals in the Consultation Paper address mainly the final element of the Basel III standards – the measurement of RWAs (the denominator of capital ratios). The proposals would, among other things, revise the calculation of RWAs by improving both the measurement of risk in internal models ("IMs") and standardised approaches ("SAs"), and the comparability of risk measurements across firms.

Summary of Key Changes

General

Basel 3.1 standards include revised standard and internal ratings-based approaches for credit risk, revisions to the use of credit risk mitigation techniques, a revised approach to market risk, the removal of the use of IMs for operational risk capital requirements and for credit valuation adjustment and their replacement with new standard and basic approaches, and the introduction of an aggregate "output floor" to ensure that total RWAs using IMs cannot fall below 72.5% of RWAs derived under standard approaches.

This means a more granular set of standard approaches for assessing risk exposures and the removal of some internal model approaches, as well as a new modelling approach for internal ratings-based assessments, alongside improvements to the trading book/non-trading book boundary.

Real Estate Loans under Credit Risk Standardised Approach

The Consultation Paper proposes changes in respect of the treatment of real estate loans (either secured on commercial property or on residential property). The overall intended effect of these changes would be to bring SA RWAs for real estate lending closer to those under the internal ratings-based approach ("IRB"), particularly for low-risk residential mortgages, while introducing new requirements to help ensure RWAs for real estate exposures are appropriate.

In summary, real estate loans would be divided into two categories, namely:

1. "regulatory real estate exposure" which meet six specific conditions that are consistent with the relevant Basel criteria (namely: (i) it is finished; (ii) there is legal certainty on claims over the property; (iii) the exposure is secured by a first charge over the property; (iv) an assessment is made on the ability of the borrower to repay; (v) it is prudently valued; and (vi) adequate documentation is maintained); and
2. "other real estate" in cases where these requirements are not met.

Each of these categories would in turn include different sub-categories distinguishing between loans secured on residential real estate and loans secured on commercial real estate.

For regulatory real estate loans, a loan-splitting approach would apply whereby real estate loans with a loan-to-value ("LTV") ratio below a certain level receive a lower risk weight with any excess above that level being subject to a higher risk weight. This means that for these loans, the prudent valuation of the collateral securing the loan would become increasingly important given the proposed key role of LTV to calculate the applicable SA risk weight.

For other real estate loans, the proposed approach is closer to the current one – but with revisions.

Conclusion

Our regulatory specialists are currently working with the Commercial Real Estate Finance Council ("CREFC") Europe on industry feedback to the Consultation Paper.

Please feel free to get in touch with the Cadwalader team to discuss the contents of this update. We will provide further updates on this topic in due course.

European Commission Aims to Tackle Greenwashing in Latest Proposal

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By **Rachel Rodman**
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On March 22, the European Commission unveiled a proposal, the Green Claims Directive (Proposal), aimed at combating greenwashing and misleading environmental claims. By virtue of the Proposal, the EC is attempting to implement measures designed to provide "reliable, comparable and verifiable information" to consumers, with the overall high-level goal to create a level playing field in the EU, wherein companies that make a genuine effort to improve their environmental sustainability can be easily recognized and rewarded by consumers. The Proposal follows a 2020 sweep that found nearly half of environmental claims examined in the EU may be false or deceptive. Following the ordinary legislative procedure, the Proposal will now be subject to the approval of the European Parliament and the Council. There is no set date for entry into force at this time.

The Proposal complements a March 2022 proposal to amend the Consumer Rights Directive to provide consumers with information on products' durability and repairability, as well as to amend the Unfair Commercial Practices Directive by, among other things, banning "generic, vague environmental claims" and "displaying a voluntary sustainability label which was not based on a third-party verification scheme or established by public authorities." The Proposal builds on these measures to provide "more specific requirements on unregulated claims, be it for specific product groups, specific sectors or for specific environmental impacts or aspects." It would require companies that make "green claims to respect minimum standards on how they substantiate and communicate those claims." Businesses based outside the EU that make environmental claims directed at EU consumers will also have to respect the requirements set out in the Proposal. The criteria target explicit claims, such as "T-shirt made of recycled plastic bottles" and "packaging made of 30% recycled plastic."

Pursuant to Article 3 of the Proposal, "environmental claims shall be based on an assessment that meets the selected minimum criteria to prevent claims from being misleading," including, among other things, that the claim "relies on recognised scientific evidence and state of the art technical knowledge," considers "all significant aspects and impacts to assess the performance," demonstrates whether the claim is accurate for the whole product or only parts of it, provides information on whether the product performs better than "common practice," identifies any negative impacts resulting from positive product achievements, and reports greenhouse gas offsets.

Article 4 of the Proposal outlines requirements for comparative claims related to environmental impacts, including disclosure of equivalent data for assessments, use of consistent assumptions for comparisons and use of data sourced in an

equivalent manner. The level of substantiation needed will vary based on the type of claim, but all assessments should consider the product's life-cycle to identify relevant impacts.

Pursuant to Article 10, all environmental claims and labels must be verified and certified by a third-party verifier before being used in commercial communications. An officially accredited body will carry out the verification process and issue a certificate of conformity, which will be recognized across the EU and shared among Member States via the Internal Market Information System. The verifier is required to be an officially accredited, independent body with the necessary expertise, equipment, and infrastructure to carry out the verifications and maintain professional secrecy.

The Proposal is part of a broader trend of governmental regulators, self-regulatory organizations, and standard setters across industries adopting a more formalized approach toward greenwashing. For example, as we recently reported, the UK's Advertising Standards Authority (ASA) published rules on making carbon neutral and net-zero claims. Instances of enforcement actions over greenwashing allegations have also been on the rise. The Securities and Exchange Board of India recently launched a consultation paper seeking public comment on rules to prevent greenwashing by ESG investment funds, and the European Council and the European Parliament reached an agreement regarding European Green Bonds Standards aimed at, among other things, avoiding greenwashing.

(This article originally appeared in Cadwalader Climate, a twice-weekly newsletter on the ESG market.)