CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

# Peeling Back the Onion

# May 18, 2023

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## In This Issue ...

Just as we were putting the finishing touches on today's issue, the FDIC voted in favor of a special assessment to recoup the expected $15.8 billion cost to the Deposit Insurance Fund in the aftermath of the Silicon Valley Bank and Signature Bank failures in March. We offer a first take on this vote today and will be looking at this more closely in the weeks to come.

This week's issue also looks at an important report from the Federal Reserve Board in the U.S. and some important guidance from the Prudential Regulatory Authority in London, along with some very noteworthy enforcement news from the CFTC.

Are you also looking past the past and, like the FRB and the PRA, focused on what's coming next? I'd love to hear. You can reach out to me here.

**Daniel Meade**
Partner and Editor, *Cabinet News and Views*

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## More Congressional Hearings on Bank Failures

By **Daniel Meade**
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This week, the Senate Banking Committee and the House Financial Services Committee held multiple hearings on bank failures that have occurred this year, with each committee holding a hearing with former leaders of the failed banks, as well as hearings with the federal depository institution supervisory agencies and the California and New York banking Supervisors.

The Senate Banking Committee had three hearings on the failures this week. On Tuesday, the hearing focused on former leaders of Silicon Valley Bank ("SVB") and Signature Bank ("Signature"), with Gregory Becker, former CEO of SVB, Scott Shay, former Chairman of Signature, and Eric Howell, former President of Signature, as the witnesses.

Wednesday's hearing featured Federal Reserve Board Inspector General Mark Bialek, University of Pennsylvania professor Dr. Peter Conti-Brown, American Enterprise Institute Senior Fellow Paul Kupiec, and MRV Associates banking analyst Mayra Rodriguez Valladares as witnesses discussing lessons and opportunities for reform.

Thursday's hearing in the Senate Banking Committee focused on oversight of the financial services regulators, with the following regulators as witnesses: Michael Barr, Vice Chair for Supervision, Federal Reserve Board ("FRB"); Martin Gruenberg, Chair, Federal Deposit Insurance Corporation ("FDIC"); Todd Harper, Chair, National Credit Union Administration ("NCUA"); Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency ("OCC"); Adrienne Harris, Superintendent, New York State Department of Financial Services ("NYDFS"); and Clothilde Hewlett, Commissioner, California Department of Financial Protection & Innovation ("CADFPI").

The House Financial Services Committee held two hearing this week. On Tuesday, it had a hearing with the same four federal financial regulators as the Senate hearing noted above. On Wednesday, the House Financial Services had a two-part hearing that first brought former leaders of the failed banks similar to the Senate hearing, but this time including Michael Roffler, the former President and CEO of First Republic Bank. The second part of the House hearing had the same NYDFS and CADFPI leaders as the Senate hearing noted above.

The hearings including the former leaders of the failed banks may have made the most general news as this represented generally the first public appearances of the former bank executives, and the clips of the respective executives being raked over the proverbial coals tends to make for good TV or newspaper copy. Vice Chair Barr and Chair Gruenberg's testimony and appearances generally stuck close to the scripts of their respective post-mortem reports on the SVB and Signature failures. Vice Chair Barr's testimony also noted the FRB's release of its semiannual Supervision and Regulation Report, which stated that, notwithstanding the stress the system has experienced since March, “[t]he U.S. banking system is sound and resilient with strong capital and liquidity.” Chair Gruenberg’s testimony included some discussion of the recently released Comprehensive Overview of Deposit Insurance System, where the FDIC noted possible legislative options to update deposit insurance, including the recommended approach to have targeted, unlimited insurance for certain business transaction and payroll accounts.

The hearings included NCUA Chair and Acting Comptroller Hsu, even though the recent failures have not included any national banks or thrifts or federal credit unions. Acting Comptroller Hsu noted that the OCC is using the reviews done by the FDIC and FRB “to do a ‘look across’ and evaluate our own supervisory processes to identify any areas that may need adjustment.” He offered four preliminary observations to improve confidence in the banking system: (1) supervisors need support to act in a timely and effective manner; (2) regulations regarding the resilience and resolvability of large banks need to be strengthened; (3) deposit insurance coverage needs to be updated; and (4) the diversity (*i.e.*, having banks of all sizes) of the banking system must be preserved as the industry evolves. Acting Comptroller Hsu noted that this is consistent with a theme that has been highlighted during his tenure at the OCC – guarding against complacency. NCUA Chair Harper noted that “the overall performance of federally insured credit unions and the Share Insurance Fund has remained stable” despite the recent stresses, and noted that if Congress does amend deposit insurance coverage, that parity remain for the Share Insurance Fund.

The Q&A sessions during the various hearing showed that, while there might be some consensus that the root cause of the failures should be laid at the feet of former management, there are varying degrees of views among the members of the Committees for what blame lies with the supervisors and/or tailored regulatory relief that passed Congress in the last administration. What is clear is that the Federal banking agencies do seem to have some level of consensus that they have the flexibility to update both their supervisory approaches and applicable regulations without the need for new legislation, and that they will use that flexibility to implement changes on the supervisory front and propose changes on the regulatory front.

## Proposed Bicameral Legislation to Broaden FERC's Enforcement Jurisdiction over Trading Energy Commodities

By **Peter Y. Malyshev**
Partner | Financial Regulation

Earlier this month members of Congress jointly introduced the "Energy Consumer Protection Act of 2023," with the intention of expanding the Federal Energy Regulatory Commission's ("FERC") ability to address energy market trading violations under the Federal Power Act and Natural Gas Act. Under the proposed bicameral bill, Section 316A of the Federal Power Act and Section 22 of the Natural Gas Act would be amended to include new suspension penalties for violators, in addition to the existing monetary penalties that were already available to FERC. With this expanded civil penalty authority, the Commission would have the ability to permanently, or for such period of time as the Commission deems appropriate, prohibit any person from engaging in direct or indirect trading of natural gas, electric energy, electric energy products, or transmission services, subject to the jurisdiction of FERC.

Furthermore, the language of the enforcement provisions of each Act, Section 314(d) of the Federal Power Act and Section 20(d) of the Natural Gas Act, would be amended as well to broaden the scope of FERC's enforcement capabilities by replacing the term "individual" with "person." Under corporate personhood, the use of the term "person" includes legal entities such as corporations and associations, in addition to individuals. As such, the existing enforcement provisions of each Act would be altered to reflect the same broad suspension penalties for violators that have been proposed for Section 316A and Section 22, respectively.

The proposed bill also adds Section 4B to the Natural Gas Act, which would prohibit persons from willfully and knowingly reporting false information to a federal agency, or private-sector price-reporting agency, concerning the transportation or sale of natural gas (subject to FERC jurisdiction). The new language of Section 4B mirrors the prohibition on filing false information that is already incorporated in Section 221 of the Federal Power Act. As such, the Energy Consumer Protection Act of 2023 seeks to punish the same type of violations in the natural gas trading sector as the Federal Power Act already penalizes for in electric energy trading.

The bill was proposed because members of Congress, particularly in the western United States, were concerned with rising energy costs after reaching record-high natural gas prices in California during the winter in 2022/23. Recent investigations by FERC into skyrocketing natural gas and energy prices in the wake of Winter Storm Uri in Texas (2021) also likely prompted the proposed legislation, as FERC found anomalies in the post-storm market that may have been caused by market manipulation in the region. It is also expected that accelerating climate change will cause greater severity of weather events and potentially destabilize U.S. energy commodity markets.

The purpose of the Energy Consumer Protection Act of 2023 is to expand the enforcement capabilities of FERC to include new suspension penalties for violators of the Federal Power Act and Natural Gas Act, particularly where these violations exacerbate the volatility in energy markets. With this addition to the existing Acts, FERC would have the ability to ban companies from trading in energy markets, whereas before they were only able to assign monetary penalties for corporations engaged in market manipulation or the reporting of false information to applicable agencies.

If enacted, these amendments will further test the bounds of FERC's and the Commodity Futures Trading Commission's ("CFTC") jurisdiction given that both power and natural gas qualify as "commodities" under the Commodity Exchange Act of 1936; as such, the CFTC has the non-exclusive jurisdiction to prosecute fraud and manipulation in trading commodities in the interstate commerce. As was shown several years ago in the Amaranth litigation (U.S. Commodity Futures Trading Commission v. Amaranth Advisors LLC, No. 07 Civ. 6682, (DC) May 21, 2008), sometimes FERC's and CFTC's jurisdiction may overlap as it relates to energy commodities.

*(The author wishes to thank summer associate William Lewis for his research and contributions to this news item.)*

## The UK's Financial Conduct Authority Consults on Changes to the Rules on Remuneration

By **Alix Prentice**
Partner | Financial Regulation

The UK's Financial Conduct Authority ("FCA") has published Consultation Paper CP23/11 on enhancing the proportionality of the application of rules on remuneration for smaller, dual-regulated firms in relation to the risks those firms pose to UK consumers and markets.

Dual-regulated firms comprise banks, building societies, larger investment firms and firms from overseas that carry on those activities from a UK establishment who are prudentially regulated by the Prudential Regulation Authority ("PRA") and regulated by the FCA for conduct of business. CP23/11 proposes to address how the remuneration rules affect smaller and less complex dual-regulated firms in a way that is proportionate to their size, internal organisation and the nature, scope and complexity of their activities by:

*1. Amending proportionality thresholds by increasing the total asset threshold and changing the additional criteria that firms with over £4 billion of total assets must meet*:

This amendment will mean that firms that either have average total assets equal to or below £4 billion on a three-year average, or have average total assets greater than £4 billion and equal to or below £20 billion and which meet other criteria, will be able to disapply certain remuneration rules on grounds of proportionality.

Those other criteria for firms with assets over £4 billion include:

- level of trading book business;
- size of foreign exchange positions relative to own funds;
- no commodities or commodity derivatives positions;
- no provision of clearing, settlement, custody or correspondent banking services outside their immediate group; and
- not an operator of a payment system.

*2. Removing malus and clawback requirements:*

Firms meeting the amended proportionality thresholds will be able to cease to operate malus and clawback, and will continue to be exempt from deferral, payments in instruments and discretionary pension arrangements requirements. Note that the outcome of a separate consultation on the removal of the bonus cap for all firms will be the subject of final rules to be published in Q3.

The amended remuneration rules and guidance on thresholds and malus and clawback will apply to the next performance year that begins on or after publication of the final FCA Policy Statement that results from CP23/11.

## ECB Releases Results of 2022 Eurosystem Balance Sheet Climate Risk Stress Test


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As part of the European Central Bank's ("ECB") 2021 action plan to incorporate climate change considerations into its monetary policy, the ECB conducted a climate risk stress test of the Eurosystem balance sheet in 2022. Those results are now available.

The purpose of the stress test was two-fold: first, to analyze the Eurosystem's financial risk profile with respect to climate change, and second, to enhance climate risk assessment capacity itself. The test addressed various Eurosystem portfolios including covered bonds, corporate bonds, asset-backed securities and collateralized credit operations. The results of the stress test indicate that both transitional and physical risk have a material impact on the Eurosystem balance sheet's risk profile.

**Stress Test Results**

The ECB's exercise tested five scenarios — three long-term scenarios developed by the Central Banks and Supervisors for Greening the Financial System ("NGFS") and two short-term scenarios developed by the ECB. The long-term scenarios projected macro-financial and climate variables over a 30-year period. Essentially, the scenarios adjust the extent to which climate change mitigation policies have been implemented and then assess the associated climate risk results. The "hot house world" scenario assumes climate policies are not enforced. The test indicates that this scenario presents severe physical risk but not transition risk. At the other end of the spectrum, the orderly transition scenario works off the assumption that the implementation of climate change policies is timely. In the middle is the disorderly transition scenario, which assumes climate change policies are delayed in implementation. The test indicates that this scenario presents severe transition risk but only limited physical risk.

In addition to the three long-term scenarios, the two short-term situations considered were a flood risk scenario over a one-year period (posing material physical risk) and a short-term disorderly transition scenario, which tested the potential impact of steep increases in carbon prices over a three-year period (posing material transition risk).

Overall, results from the climate risk stress test show that both transitional and physical risk have a material impact on the Eurosystem balance sheet's risk profile. In terms of long-term scenarios, the disorderly transition and hot house scenarios generate risk estimates 20-30% higher than the risk estimates under the orderly transition scenario. Analysis of the long-term scenarios suggests that corporate bonds are the main risk driver, while covered bonds, asset-backed securities and credit operations pose less total risk. Corporate bonds are the main risk driver under the short-term scenarios as well, although covered bonds also were a significant risk contributor in the flood risk scenario.

Across all five different scenarios, the transition risk for corporate bonds is concentrated in specific sectors, and the physical risk for corporate bonds is concentrated in certain areas geographically.

Taking the Temperature: As we have observed, financial institutions, including in the EU, are committing to considering climate shocks when stress-testing their own financial institutions. Similar stress-testing initiatives are underway with other major prudential regulators, including the Bank of England and the Federal Reserve. As part of the EU's attempts at implementing an orderly transition, the European Banking Authority's sustainable finance roadmap, released at the end of 2022, sets out a three-year plan that provides guidance on sustainable finance in the EU. The roadmap sets out the EBA's plan for the next three years to "integrate ESG risks considerations" into the banking framework and to "support the EU's efforts to achieve the transition to a more sustainable economy." Relatedly, the ECB recently published its first climate-related financial disclosures. The disclosures provide information on ECB portfolios, including detailing their carbon footprints and exposure to climate risks, and also discuss climate-linked governance and risk management. The disclosures are part of a Eurosystem-wide effort to increase transparency around the sustainability characteristics of European central bank portfolios.

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