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Cabinet **News and Views**

Informed analysis for the financial services industry

What's the Risk?

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The NBA and NHL seasons came to an end earlier this week, but that didn't stop Acting Comptroller of the Currency Michael Hsu from using sports imagery to describe the work of federal regulators. Commenting on the release of the OCC's Semiannual Risk Perspective for Spring 2023, Acting Comptroller Hsu said that the banks and the UCC's examiners would be "on the balls of their feet" with regard to risk management.

Taking today's sports analogy a step further, a regulatory dream team – the OCC, FRB, FDIC, NCUA and CFPB – proposed Interagency Guidance on Reconsiderations of Value of Residential Real Estate Valuations that focuses on policies and procedures that financial institutions may want to incorporate to address and mitigate valuation discrimination risks. My colleague Mercedes Tunstall and I take a closer look in this week's issue.

Alix Prentice also provides some valuable insights into the European Banking Authority's final report on amendments to its guidelines on improving resolvability under the Bank Recovery and Resolution Directive.

What's on your mind? Happy to discuss. You can reach out to me here.

Daniel Meade
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OCC Issues Latest Semiannual Risk Perspective

By **Daniel Meade**
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The Office of the Comptroller of the Currency ("OCC") issued its Semiannual Risk Perspective for Spring 2023 ("SARP") yesterday. The OCC highlighted liquidity, operational, credit, and compliance risks, among the key risk themes in the report.

The OCC's stated highlights from the report include:

- Liquidity levels have been strengthened in response to the failures of several banks and to investment portfolio depreciation. Rising long-term rates caused significant depreciation in investment portfolios, focusing attention on banks' liquidity risk profiles.

- Credit risk remains moderate in aggregate, but signs of stress are increasing – for instance, in certain segments of commercial real estate. Overall, credit markets and loan portfolios remain resilient, and problem loan levels remain manageable. The persistent drag from high inflation and rising interest rates, however, is causing credit conditions to deteriorate.

- Operational risk is elevated. Cyber threats persist. Digitalization of banking products and services is expanding, especially as banks increase use of third parties. This expansion presents both opportunities and risks.

- Compliance risk is elevated. Banks continue to operate in a dynamic environment in which compliance management systems are challenged to keep pace with changing products, services, and delivery channel offerings developed in response to customer needs and preferences.

Acting Comptroller of the Currency Michael Hsu issued a statement to accompany the release of the SARP. In it, he noted: "[s]ince March, the OCC has been closely monitoring the conditions of the institutions we supervise. The federal banking system is sound, and deposits are safe. Notably, national banks and federal savings associations (banks) have strengthened their liquidity to cover potential deposit withdrawals." He also noted a familiar theme of guarding against complacency and said he "expects banks to 'be on the balls of their feet' with regards to risk management, just as our examiners are."

Agencies Issue Proposed Interagency Guidance on Real Estate Appraisal Reconsiderations of Value


By **Daniel Meade**
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By **Mercedes Kelley Tunstall**
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Last week, the Office of the Comptroller of the Currency ("OCC"), Federal Reserve Board ("FRB"), Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), and the Consumer Financial Protection Bureau ("CFPB") (collectively, "the Agencies") proposed Interagency Guidance on Reconsiderations of Value of Residential Real Estate Valuations ("the "Proposed Guidance").

The Proposed Guidance is intended to help financial institutions confidently request a reconsideration of value ("ROV") when there is reason to believe that an appraisal is deficient in some way, while also maintaining appraiser independence required by Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). ROVs are viewed by the federal banking regulators as a potentially important tool for financial institutions to address proficiencies in collateral valuations "due to prohibited discrimination" or other kinds or errors omissions, with the goal of helping "individuals, families, and neighborhoods [to build] wealth through homeownership [and] accessing accumulated equity" and to support the homebuying and refinancing process for all borrowers. To this end, the Proposed Guidance includes examples of policies and procedures that financial institutions may want to incorporate to address and mitigate valuation discrimination risks.

The comment period will close 60 days after publication in the *Federal Register*. The Agencies particularly request comment on the following four questions:

1. To what extent does the proposed guidance describe suitable considerations for a financial institution to take into account in assessing and potentially modifying its current policies and procedures for addressing ROVs?
    a. What, if any, additional examples of policies and procedures related to ROVs should be included in the guidance?
    b. Which, if any, of the policies and procedures described in the proposed guidance could present challenges?
2. What model forms, or model policies and procedures, if any, related to ROVs would be helpful for the agencies to recommend?
3. What other guidance may be helpful to financial institutions regarding the development of ROV processes?

4. To what extent, if any, does the proposed ROV guidance conflict, duplicate, or complement the existing Interagency Appraisal and Evaluation Guidelines or a financial institution’s policies and procedures to implement those Guidelines?

The European Banking Authority's Guidelines on Resolvability

By **Alix Prentice**
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The European Banking Authority ("EBA") has published its final report on amendments to its guidelines on improving resolvability under the Bank Recovery and Resolution Directive (*2014/59/EU*) (BRRD).

The report introduces new guidelines giving a common framework for testing resolvability by:

1. Introducing a requirement for self-assessment by resolution entities of their resolvability, benchmarked against the EBA's Resolvability and Transferability Guidelines (published in January and September 2022, respectively) and relevant rules. The Resolvability and Transferability Guidelines set out a number of key capabilities that EU institutions must be able to demonstrate at all times. The self-assessment report will require: confirmation on the level to which these capabilities are met and how that is achieved; a demonstration of understanding of the resolution strategy and its execution; a description of how each capability is met (or why it is not relevant); how the capabilities relate to recovery planning and business as usual; and how internal assurance on resolvability is achieved.
2. Requiring regulators to develop multi-annual testing programmes over three years for each resolution entity that would examine the adequacy of those entities' resolution plans. These plans will leverage the self-assessment reports and are aimed at giving authorities assurance that institutions have the right capabilities to meet their resolvability objectives. They will also incorporate "horizontal testing" identified by authorities acting in tandem.
3. Introducing a "master playbook" for the most complex institutions such as G-SIIs and others that pose a systemic risk. These playbooks will demonstrate the operational capacity of relevant institutions to enact their resolution strategies and how the various aspects supporting that – governance, access to financial markets infrastructure, funding and liquidity, operational continuity and communication – work together effectively. The playbooks are intended to be a guide for senior management to enable them to manage and coordinate resolution actions firm-wide.

The guidelines will apply from 1 January 2024, and institutions are expected to submit their first self-assessment report by 31 December 2024, the first master playbook by 31 December 2025, with relevant authorities setting out testing programmes by 31 December 2025.

WBA Releases First Financial System Benchmark

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In May 2023, the World Benchmarking Alliance (WBA) released a report on the first edition of its Financial System Benchmark, which assesses financial institutions' progress toward climate change goals. The WBA is a non-profit organization which aims to develop a variety of benchmarks to assess and rank "the world's most influential companies" on their contribution to meeting the United Nations' Sustainable Development Goals ("SDGs"). The benchmark, which WBA launched at COP27 in November 2022, assesses and ranks the 400 "most influential" or "keystone" financial institutions worldwide — those "with disproportionate influence on the structure and function of the systems within which they operate" — on their contribution to global sustainability transition goals, such as the SDGs and the Paris Agreement. The financial institutions assessed include banks, asset owners such as pension funds, development finance institutions ("DFIs"), sovereign wealth funds, asset managers, including alternative investor entities such as private equity, venture capital and hedge funds, and insurance companies.

The institutions were assessed across three areas:

1. Governance and strategy (40% of the total score), using five indicators: impact management and strategy, senior leadership accountability and remuneration, gender equality and diversity, engagement policy, and public policy engagement;
2. Respecting planetary boundaries (30% of the total score), using nine environment- and climate-related indicators, five on alignment with the Paris Agreement (financed emissions, financed emissions targets, engagement aligned with a 1.5° C trajectory, climate solutions and approach to fossil fuel sectors) and four on nature and biodiversity (nature and biodiversity-related impacts, protection and restoration of nature and biodiversity through finance, protection and restoration of nature and biodiversity through engagement, and nature- and biodiversity-related solutions); and
3. Adhering to societal conventions (30% of the total score), using 18 indicators related to human rights.

The report highlighted seven key takeaways:

1. The entire financial system scores poorly on governance and climate. Although there are "no notable overall outliers," some financial institutions have made progress in certain areas and can stand as examples for others.
2. The entire system is lagging on the approach to fossil fuels, a "contentious issue" that requires "stronger multi-stakeholder collaboration" and more transparency.

3. Financial institutions that have "gender-balanced boards" outperform those that do not across all climate-related indicators.
4. Financial institutions that tie executive compensation to sustainability also outperform across all climate indicators.
5. Stronger regulations result in greater transparency, which in turn leads to better performance across climate indicators.
6. Asset owners that are regarded as "important influencers" lack transparency and score poorly on climate-related indicators.
7. Despite often being at the forefront of financing climate solutions, private equity and venture capital are typically outside the scope of "mainstream regulations," lack transparency and score poorly on climate indicators.

The WBA report offers specific recommendations for stakeholders, including regulators, standards organizations, activists and financial institutions themselves, as well as five overarching calls to action:

1. Board responsibility and top-down leadership for climate and sustainability actions are essential.
2. Gender-balanced boards and leadership go beyond equity considerations by positively impacting climate-related and sustainability decision-making.
3. Financial institutions must recognize their influence and commit to positively changing the financial system from within.
4. Wide-ranging transparency in climate disclosures is critical to financial system transformation, in particular around climate-change solutions.
5. Given WBA's assessment that no institutions had "an adequate approach to phasing out all fossil fuels," collaboration among all stakeholders is necessary to tackle this complex issue.

Taking the Temperature: The financial services industry remains at the center of numerous climate-related issues and challenges, including concerning emissions financing, financial system stability and regulatory capital requirements, as well as having to navigate "anti-ESG" forces in the U.S. While banks increasingly are voluntarily establishing emissions financing reduction targets and strategies, as are some insurers, at least some financial institutions have been subject to litigation and shareholder activity about their absolute climate commitments or the adequacy of plans to meet articulated targets.

Meanwhile, regulators remain concerned about whether financial institutions are adequately assessing and disclosing climate-related risk, and about overall financial system stability. Recent examples include studies on these issues conducted by the Bank of England and the European Central Bank; guidelines issued by Canada's Office of the Superintendent of Financial Institutions on climate risk management applicable to insurers and financial institutions; and guidance from the New York Department of Financial Services for New York domestic insurers on managing the financial risks from climate change.

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