In This Issue ...

What started out as just another (albeit important) speech on the Fair Lending Act soon became another flashpoint on AI.

As my colleague Mercedes Tunstall and I note in this week's issue, AI-related comments from Federal Reserve Board Vice Chair Michael Barr this past Tuesday drew some headlines and furthered the discussion on AI – this time, with a focus on AI's impact on fair lending laws.

I guess we ought to stop being surprised. We can all expect to see AI come up in lots of financial regulatory conversations over the coming weeks, months and years.

Any thoughts on AI? You can reach me here.

Daniel Meade
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Vice Chair Barr Speaks on Fair Lending in Age of AI

By **Daniel Meade**
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By **Mercedes Kelley Tunstall**
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Michael Barr, the Federal Reserve Board's ("FRB") Vice Chair for Supervision, delivered remarks, titled "Furthering the Vision of the Fair Housing Act," to the National Fair Housing Alliance 2023 National Conference earlier this week.

Vice Chair Barr noted the importance of the Fair Housing Act and the Equal Credit Opportunity Act ("ECOA") "in making good on the promise of the Civil Rights Act, and of the vision of Dr. Martin Luther King, to build a fair and equal society." He also noted that "today we can recognize the progress made in fair housing while also acknowledging how much farther we have to go and recommitting ourselves to reaching that destination."

Vice Chair Barr went on to discuss the FRB's role (along with the other federal banking regulators) in supervision and enforcement related to fair lending. He also noted that the Community Reinvestment Act ("CRA") complements the fair lending laws to "address redlining and other systemic inequalities in access to credit, investment and banking services," and that the agencies are hard at work finalizing a final CRA rule after the agencies issued a proposed CRA rule last May.

The aspect of his remarks that may have garnered the most attention, however, was his comments about the importance of fair lending measures keeping up with technological change, such as artificial intelligence and machine learning ("AI"). Vice Chair Barr noted that "[w]hile these technologies have enormous potential, they also carry risks of violating fair lending laws and perpetuating the very disparities that they have the potential to address." These comments echo statements from the Consumer Financial Protection Bureau, Federal Trade Commission, the Equal Employment Opportunity Commission and the Department of Justice earlier this year wherein they further explained that AI can lead to discriminatory results due to a variety of factors. These factors may include datasets used for training AI that are unrepresentative, imbalanced or that incorporate historical bias; the lack of transparency that AI systems have regarding how or why the systems make decisions; and the use of third-party AI solutions that have not been properly tailored or designed to accommodate fair lending considerations.

Vice Chair Barr ended his speech by calling for the conference attendees "to remain ever vigilant against discrimination in credit transactions."

FTC and DOJ Jointly Issue Draft Merger Guidelines

By **Joel Mitnick**
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Proposing a radically different conception of government enforcement merger guidelines, the Federal Trade Commission and the Department of Justice jointly issued draft merger guidelines yesterday that would replace current Merger Guidelines, which were revised last in 2010. Stating that the "goal of this update is to better reflect how the agencies determine a merger's effect on competition in the modern economy," the structure of the draft merger guidelines replaces the step-by-step economically analytical approach to merger analysis with a manifesto of 13 doctrinaire statements that will instead guide the Agencies' analysis.

You can read our analysis here.

The UK and Europe Introduce New Securitisation Rules

By **Alix Prentice**
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By **Assia Damianova**
Special Counsel | Capital Markets

The UK and Europe have released a number of updated requirements for securitisations that, while not effecting material changes, are notable in their scope and number.

You can read our brief guide to these changes and their implementation schedules here.

The UK's Regulator Writes to Asset Managers about Liquidity Management

By **Alix Prentice**
Partner | Financial Regulation

Alongside work being done internationally on liquidity management by the Financial Stability Board and IOSCO, the UK's Financial Conduct Authority ("FCA") has written to the Chief Executives of authorised asset management firms with the key findings of a multi-firm review of liquidity management by Authorised Fund Managers ("AFMs").

The FCA conducted the multi-firm review of 14 firms of different sizes in order to ensure that fund redemptions work in line with fund terms and how they are marketed so that investors are able to redeem them at an accurate price, ensuring fairness for both exiting and remaining investors. The specific requirements of liquidity management rules vary depending on the nature of the fund, but all firms are required to manage liquidity in a way that is appropriate for their offering. The FCA's review found a "wide disparity among firms in the quality of compliance with regulatory standards and depth of liquidity risk management expertise" with most firms falling short in some aspects. Chief among the findings were the following:

1. Insufficient weight attached to liquidity risk management in governance systems, with challenge and escalation being particular issues;
2. Variability in approaches to liquidity stress testing practices, with some methodologies being flawed and misleading – for example, through an exclusive focus on cash without consideration of selling a vertical slice;
3. A lack of governance and organisation arrangements to meet cumulative or market-side redemptions (as opposed to large one-off redemptions that were not a symptom of wider market issues);
4. A variation in the application of anti-dilution tools that could lead to difficulties in treating all customers fairly; and
5. A lack of internal challenge to valuations.

There are no current proposals to change the rules for asset managers, though this may change as international standards evolve. However, as a result of this review, the FCA does now expect firms to review and, if necessary, revise governance arrangements to oversee liquidity risk management improvements, working with service providers as necessary. The importance of diligent stress testing is also emphasised.

European Financial Regulators Define Greenwashing, Outline Risks and Propose Mitigation Approaches

By Duncan Grieve
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In progress reports to the European Commission ("EC") published on June 1, 2023, the European Banking Authority ("EBA"), European Insurance and Occupational Pensions Authority ("EIOPA") and European Securities and Markets Authority ("ESMA") have articulated a common, high-level definition of greenwashing and outlined greenwashing risks, impacts, proposed mitigation efforts and challenges for their respective industries ("the Progress Reports").

The Progress Reports are a culmination of a process commenced in May 2022 during which the EC had requested that the European supervisory authorities ("ESAs") provide input on greenwashing risks in the financial sector and the supervision of sustainable finance policies, including a common understanding regarding, and the most relevant types of, greenwashing; risks that greenwashing pose to entities, investors and consumers in various financial sectors; supervisory practices, experiences and capacities, including tools to monitor greenwashing; and issues related to the current legislative framework. As we reported previously, the ESAs, in turn, issued a Call for Evidence to stakeholders, including financial institutions, retail investors, consumer associations, non-governmental organizations and academia, seeking information on greenwashing, soliciting their greenwashing-related views, examples and data.

The ESAs have jointly agreed upon a cross-sector definition of greenwashing: "a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants." The Progress Reports also detail the individual findings of the ESAs related to their respective banking, insurance and pensions, and financial markets industries as to how greenwashing occurs, and its impact, supervisory challenges and regulatory implications.

EBA

The EBA's Progress Report primarily focuses on the banking sector, with some information on investment firms and more limited feedback from payment service providers. The report identifies that an increased public attention to climate change has led to banking entities being held more accountable for their environmental policies, climate impact and disclosures, and "a clear increase in the total number of potential cases of greenwashing across all sectors." The EBA observes that it is unclear whether the trend is driven primarily by companies engaging in more greenwashing or is attributable to increased scrutiny by stakeholders. Pledges about future environmental, social and governance performance are considered to be the most prone to greenwashing, followed by ESG strategies and objectives, and ESG labels and certificates. The report indicates

that member state competent authorities and stakeholders estimate that the highest risk related to greenwashing is reputational damage, followed by operational, strategic and business risks for banks and investment firms. Liquidity and funding risks are perceived to be low. Challenges to mitigating greenwashing include lack of adequate data and methodologies, and the absence of a fully developed sustainable finance regulatory framework.

EIOPA

According to EIOPA's Progress Report, greenwashing has a substantial impact on both consumers and insurers. Unsubstantiated sustainability claims can mislead consumers into buying insurance and pension products that are not aligned with their preferences. The impact on insurance providers includes increased public mistrust, as well as reputational and financial damage when instances of greenwashing are made public. The EIOPA report notes that greenwashing can occur to varying degrees across all stages of the insurance and pensions lifecycles.

The report also acknowledges that EIOPA and member state competent authorities recognize that addressing greenwashing in the marketplace requires integrating it into supervisory activities, but identifies supervisory challenges including limited expertise on sustainable finance requirements and lack of methodologies, data and tools to assess greenwashing in the insurance and pensions sectors.

ESMA

The ESMA's progress report focuses on four sectors – issuers, investment managers, benchmark providers and investment services providers – and identifies the specific areas in which each is most susceptible to greenwashing. Overall, the report concludes that market participants across the sustainable investment value chain face challenges in implementing the necessary governance processes and tools to support sustainability disclosures and transition efforts. These challenges include difficulty in producing and accessing relevant, high-quality sustainability data and keeping up with a fast-moving regulatory framework. To mitigate greenwashing risks, market participants must ensure that claims are substantiated, communication on sustainability is balanced and labelling schemes for financial products are well-designed and reliable.

The ESAs anticipate issuing their final reports in May 2024.

Conclusion

The lack of an accepted definition of greenwashing has been an ongoing concern for regulators and industry. The ESAs' consensus on a high-level understanding of greenwashing likely will help promote consistent efforts to address greenwashing in the financial industry across the European Union, but is by no means the last word on how greenwashing is defined. We have previously reported on definitions put forth by other groups, including the UN High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities, which proposed a broad greenwashing definition. As we noted in March, the EC proposed the Green Claims Directive to combat greenwashing and misleading environmental claims. The proposal must be approved by the European Parliament and the Council, but currently there is no date set for entry into force.

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

Report Makes Recommendations for Financial Institutions to Advance Climate-Action Initiatives

By **Jason M. Halper**
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In a report published in June 2023, the Columbia Center on Sustainable Investment ("CCSI") claims that many financial institutions' climate strategies are not currently aligned with global climate goals under the Paris Agreement. The report, titled "Finance For Zero: Redefining Financial-Sector Action to Achieve Global Climate Goals," also states that the financial sector's climate commitments are sometimes overstated or misrepresented due to a reliance on misaligned targets or metrics.

The report focuses on three types of financial institutions: asset owners, asset managers, and banks. The report highlights that these financial institutions, along with other market participants like insurance companies and rating agencies, have important roles in achieving climate goals. The CCSI acknowledges that the absence of a clear public policy framework presents challenges to the sector but makes several key recommendations:

Clear, Transparent Communications

The report emphasizes that financial institutions should "be clear and unambiguous about their climate commitments, and use robust and relevant targets, metrics, and methodologies that are aligned with their goals." For example, the report states that the Glasgow Financial Alliance for Net Zero stated that "over $130 trillion of private capital is committed to transforming the economy for net zero" but that this figure does not reflect new capital allocated to climate goals but rather "is the sum of assets under management or controlled by the member financial institutions." The report calls on financial institutions to release clear communications regarding climate-related pledges, particularly "whether their goal is to contribute to climate action or to mitigate risk and how business strategies will be aligned to achieve those goals."

Stop Anti-Climate-Action Lobbying

The CCSI urges financial institutions to cease anti-climate-action lobbying and focus on "how new finance is being directed and whether new finance is contributing to and not undermining a rapid and just transition." The report highlighted that an assessment of the lobbying positions of 80 financial institutions showed that, "both directly and through industry associations, many [financial institutions] are more 'obstructive' than 'supportive' of climate policy."

Adopt Strong Climate-Related Governance

The report recommends that financial institutions employ strong corporate governance embedding climate commitments at both board level as well as in day-to-day management. “Having in place clear internal oversight structures and mandates, incentives, and monitoring and review processes is necessary to ensure climate commitments are taken seriously by all the internal stakeholders who need to prioritize meeting them,” the report noted.

Contribute to Filling Gaps in Metrics and Methodologies

The CCSI highlights that current practices for calculating carbon emissions are inconsistent and in many cases lead to underreporting. Under the frameworks based on the GHG Protocol (the most widely used greenhouse gas accounting standards), companies are “not required to disclose how they calculated their emissions estimates,” such as the “type of research they did to rigorously prepare for their disclosures.” Different scenarios are used by companies using the science-based targets (“SBTs”) benchmarks, which leads to more inconsistency. CCSI highlighted that “there should be more alignment and consensus among [financial institutions] on what scenarios to use (in particular, when it comes to carbon budget and probability).”

Conclusion

The CCSI report identifies that to stay on track for the Paris Agreement’s 1.5°C goal, there is a need for a significant increase in non-fossil fuel investments. The report echoes the concerns of certain climate-focused investor groups, which have been taking increasingly interventionist steps to scrutinize and influence the transition approaches of major financial institutions. In February, a group of investors representing over $1.5 trillion AUM urged five major European banks to stop financing new oil and gas fields by the end of this year. In March this year, a French bank was sued over its fossil fuel financing strategies. A report published by the London School of Economics’ Grantham Institute on trends in climate litigation identified actions focused on the financial sector as one of the key categories of emerging “strategic” litigation.

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