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Cabinet News and Views

Informed analysis for the financial services industry

# Well, That's Novel

# August 10, 2023

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## In This Issue ...

Even though it's mid-August, it was a busy week for the Fed.

As my colleague Mercedes Tunstall writes, the Fed took aim at "novel activities conducted by supervised banking organizations," essentially cautioning banking organizations that the Fed would be closely watching all the hot-button areas, including crypto-asset related activities, banking services to fintechs and distributed ledger technology.

There was more. Mercedes notes that the Fed this week also focused on stablecoins, requiring that state member banks receive "supervisory nonobjection" from the Fed prior to "issuing, holding, or transacting in dollar tokens to facilitate payments." As Mercedes points out, the Fed's actions suggest that the Lummis-Gillibrand crypto bill is gaining traction – an interesting but perhaps somewhat unexpected development.

Moody's was also busy this week with credit ratings downgrades of some regional banks and putting some larger banks on watch. We have an article on the downgrades and the possible transactional implications the downgrades can bring. My colleagues Peter Malyshev, Stu Goldstein and Lary Stromfeld took the laboring oar on our brief article on the downgrades, but as you will see in the article, it truly was a team effort amongst our Capital Markets, Finance, and Financial Services practices to highlight what Moody's actions can mean going forward.

Be sure to also take a look at important updates from my UK colleagues Alix Prentice and Sukhvir Basran.

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

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## Regulatory and Transactional Implications of Recent Moody's Bank Ratings Downgrades

By **Peter Y. Malyshev**
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By **Stuart Goldstein**
Partner | Capital Markets

By **Lary Stromfeld**
Partner | Financial Regulation

Earlier this week, Moody's Investor Services downgraded the credit ratings of 10 regional banks and put 17 other banks under review or gave their rating a negative outlook. Notwithstanding the downgrades, most of the institutions remain investment grade under most definitions. Moody's action follows Fitch's downgrade of U.S. sovereign credit by one notch on August 1, 2023, and is likely to raise both transactional and regulatory implications for the affected banks as well as for their counterparties and customers.

Numerous contracts, such as the International Swaps and Derivatives Association ("ISDA") master agreements for derivatives (over the counter swaps, securities-based swaps and options) often include provisions referencing generally a credit "downgrade" or a failure to meet a specific credit rating as: (a) additional termination events; (b) events of default; or (c) grounds for insecurity. These events may trigger a closeout or requests for additional credit support. Given that these credit rating thresholds are subject to counterparties' individual negotiation, each transactional agreement, confirmation or a credit support document referencing a credit downgrade or a credit rating must be individually reviewed.

To the extent that the affected banks trade futures or options on futures through futures commission merchants ("FCM"), relevant FCM agreements and clearing arrangements must also be reviewed since they too may be impacted by a bank's downgrade or a negative change in credit ratings. Likewise, if Moody's action applies to the banks that are also registered as FCMs or swap dealers ("SD"), there could be an impact on their clearing arrangements with the derivatives clearing organizations ("DCOs") as well as on their SD capital and their SD risk management programs. Commodity Futures Trading Commission ("CFTC") regulations also specifically reference "credit risk" as a factor to consider for SDs in connection with design and implementation of risk-based margin models for uncleared swaps.

In the event that the affected banks act as third-party services providers (*e.g.*, as reporting counterparties or valuation agents), or as custodians or depositories, or as commodity trading advisors ("CTAs") or asset managers and commodity pool operators ("CPOs"), additional disclosures or amendments to standard disclosures may need to be made to the customers and to the National Futures Association ("NFA") if the downgrade may materially impact these entities' operations.

Credit risk assessments also are important under various Securities and Exchange Commission ("SEC") rules and in the context of trading various SEC-regulated

instruments. For example, they are pertinent to the manner in which a securities broker-dealer computes its net capital under Rule 15c3-1, as well as to the manner in which a security-based swap dealer computes its net capital under Rule 18a-1 and an OTC derivatives dealer computes its capital under Rule 15c3-1f. Credit risk assessments also are a component of the ongoing monitoring process a security-based swap dealer must undertake under the margin rule applicable to those dealers (Rule 18a-3) and to a security-based swap dealer's ability to use a model-based approach to calculating initial margin. Determining whether an instrument involves "minimal credit risk" also is important to the ability of a money market fund to acquire that instrument. Further, as is the case with CFTC-regulated products, the margin provisions under certain brokerage or clearing agreements could be implicated by a downgrade.

Credit ratings downgrades may also impact certain lending or securitization transactions. For example, in many secured financing deals or securitization transactions, collateral accounts must be kept at a depositary that qualifies as an "Eligible Institution" and certain transaction parties, including trustees and certificate administrators, are required to maintain minimum rating requirements. The criteria to be "Eligible Institution" or to serve in those roles includes, among other things, a minimum short-term and/or long-term unsecured debt rating. To the extent that a bank's credit rating drops below a certain level, the borrower and other obligors may be required to move these accounts to another institution or to replace itself in that role.

As many of our readers will remember, section 939A of the Dodd-Frank Act removed reliance on credit ratings from most prudential bank regulations. Thus, these downgrades will not have any direct impact on the institutions' treatment by the federal bank regulators. However, the regulators will be watching very closely in their supervisory capacity if these downgrades lead to any liquidity or capital challenges to the institutions, and will likely point to last week's interagency update to their Guidance on Liquidity Risks and Contingency Planning.

*Special thanks to Maurine Bartlett, David Burkholder, Leah Edelboim, Dan Meade, Wes Misson and Bonnie Neuman for their contributions to this article.*

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## Fed Establishes Novel Activities Supervision Program

By Mercedes Kelley Tunstall
Partner | Financial Regulation

Earlier this week, the Federal Reserve issued a Supervision and Regulation Letter regarding the "Creation of Novel Activities Supervision Program" (SR 23-7). The letter informs all banking organizations subject to supervision by the Fed, including those with assets of $10B or less, that it has established an enhanced program to "monitor and examine novel activities conducted by supervised banking organizations" that will "work within existing supervisory portfolios and alongside existing supervisory teams."

Novel activities specifically mentioned by the Fed include hot-button issues such as "crypto-asset related activities" and the provision of banking services to fintechs, but also include "projects that use distributed ledger technology with the potential for significant impact on the financial system" as well as complex partnerships with non-banks that involve "technologies like application programming interfaces ("APIs") that provide automated access to the bank's infrastructure." However, the scope of novel activities now subject to enhanced supervision is not limited to these specific areas, but rather extends generally to "financial innovation supported by new technologies" that can "lead to rapid change in individual banks in the financial system and generate novel manifestations of risks that can materially impact the safety and soundness of banking organizations." Banking organizations whose novel activities will be subject to examination will be notified in writing.

Practically speaking, this announcement by the Fed puts all supervised banks on notice that they can and should expect to be questioned regarding activities that are considered novel. In particular, banking organizations that provide banking support to cryptocurrency companies of all kinds or that have significant involvement with innovative fintech products and services should expect imminent inquiries from the Fed, in addition to whatever inquiries may have been posed already by other prudential regulators. Even the biggest banks should take notice because while most have limited their involvement in crypto-asset related activities, many have more broadly engaged with fintechs and incorporated API-based third-party services into their everyday retail and commercial offerings. The best strategy to ensure an optimal outcome in these kinds of supervisory exams is to take all of the following steps: 1) identify all products, services and relationships that could be deemed to include "novel activities"; 2) review, update and correct all related risk assessments such that perceived risks are either validated or debunked through experience with the novel activity and appropriate controls have been clearly documented to address validated risks; 3) examine consumer complaints related to all novel activities, even if such consumer complaints are received by the fintech or cryptocurrency company and not the bank; and 4) create, review or update the banking organization's strategy and perspective regarding engagement in novel activities so that it can be presented cohesively to the Fed.

## Federal Reserve Says Permission Required for State Banks to Be Involved in Stablecoin Issuance

By **Mercedes Kelley Tunstall**
Partner | Financial Regulation

The Federal Reserve issued a Supervision and Regulation letter earlier this week to all state member banks ("SMBs") regarding their involvement in activities involving stablecoins, taking an even more reticent position than the Office of the Comptroller of the Currency ("OCC") took regarding national banks and stablecoins in January 2021.

The letter, SR 23-8, specifically tells state member banks that they must receive "supervisory nonobjection" from the Fed prior to "issuing, holding, or transacting in dollar tokens to facilitate payments." This is the second time this year that the Fed has addressed SMBs specifically regarding cryptocurrency-related concerns. (The first time was, as we reported in January, when the Fed issued a new policy statement in response to inquiries regarding crypto-asset-related activities, stating that there is now a rebuttable presumption that SMBs may not engage in activities that are impermissible for national banks.) The nonobjection process described by the Fed in the letter requires the SMB, before engaging in any activity related to stablecoins, to "notify its lead supervisory point of contact ... of the bank's intention to engage" in the activity and then to await a notice of nonobjection before proceeding with the activity. The Fed explains that its supervisory staff will focus on the risks identified in its January policy statement to determine whether the SMB should receive a notice of nonobjection, specifically: 1) operational risks such as clarity of roles, responsibilities and liabilities of the parties involved in the activity; 2) cybersecurity risks such as those "associated with the network on which the dollar token is transacted, the use of smart contracts, and any use of open source code"; 3) liquidity risks that could be caused by substantial redemptions of dollar tokens that then leads to rapid outflows of deposits, as already experienced by those banks that were involved with cryptocurrency companies whose stablecoins failed; 4) illicit finance risks; and 5) consumer compliance risks.

The timing of this letter seems to signal that the federal banking regulators are paying close attention to the progress of the most recent Lummis-Gillibrand crypto bill (which we reported on two weeks ago), which includes an entire section devoted to the "responsible innovation of payments" and establishes that only depository institutions may issue stablecoins. As we mentioned, the Lummis-Gillibrand bill specifically states that stablecoins are not to be considered securities or commodities, and instead designates them as being in the province of the federal prudential banking regulators. To this end, the bill sets high standards for depository institutions, as it includes provisions requiring that any depository institutions issuing stablecoins must maintain "high-quality liquid assets ... equal to not less than 100 percent of the face amount of the liabilities of the institution on payment stablecoins issued by the institution" and detailing how such depository institutions should account for stablecoins on their call reports. While banks (and readers) might be tempted to conclude that stablecoins are not worth the risks, nevertheless, despite the regulatory and legislative focus on them, stablecoins

have the capacity to innovate, and may yet play an important role in innovating payments in many sectors.

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## UK Rules on Margin Requirements for Non-Centrally Cleared Derivatives

By **Alix Prentice**
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In Consultation Paper 13/23 (CP 13/23), the UK's Prudential Regulation Authority ("PRA") sets out its "Margin requirements for non-centrally cleared derivatives: Amendments to BTS 2016/2251."

- *Temporary exemptions from bilateral margining requirements:* The PRA and the UK's Financial Conduct Authority ("FCA") are extending the temporary exemptions for single-stock equity options and index options from UK bilateral margining requirements until 04 January 2026. The PRA and the FCA will use this extension to gather evidence to create a permanent regime for the UK outside the EU. As a reminder, requirements for the exchange of initial and variation margin for uncleared derivatives were introduced in the UK via the onshored Regulation (EU) 648/2012 on OTC derivatives, central counterparties, and trade repositories (UK European Market Infrastructure Regulation ("EMIR)). The PRA has primarily taken this decision in light of the maintenance of the exemption in a number of other jurisdictions.

- *Model pre-approval:* The FCA and PRA have elected not to amend the FCA's current supervisory framework for the bilateral initial margin models by requiring formal pre-approval. This is due to the fact that international standards for initial margin models have developed sufficiently, and pre-approval is just one element of model supervision in a UK regime that already sets out detailed and prescriptive modelling requirements.

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## Next Steps in the Proposed Replacement of the UK Securitisation Regulation

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

This Clients & Friends Memo discusses the FCA proposals for revisions to firm-facing securitisation rules, including clarifications of due diligence and risk retention obligations. Also discussed is a preview of an upcoming consultation on the definitions of public and private securitisations.

You may access the Memo here.

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## Basel Committee Issues Guidance on Core Principles for Effective Banking Supervision

By **Sukhvir Basran**
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In April 2022, the Basel Committee on Banking Supervision (the Basel Committee) began a review of “the core principles for effective banking supervision” (Core Principles or CP). Last month, the Basel Committee published a Consultative Document on the Core Principles following its review.

The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Its 45 members comprise central banks and bank supervisors from 28 jurisdictions. The Core Principles are an important component of the Basel Committee’s global standards, aimed at ensuring sound prudential regulation and supervision of banks worldwide and are intended to remain a “living” standard, evolving over time in response to global financial developments, emerging risks, and changes in the regulatory landscape. The current review and update includes a consideration of supervisory and regulatory developments since the last substantive update in 2012.

The current review has been informed by several themes, including climate-related financial risks and risk-management practices. The Consultative Document makes clear that climate-related financial risks can affect the safety and soundness of banks while also affecting the financial stability of banking systems as a whole.

To address these “new” risks, targeted changes have been introduced to the Core Principles to specifically address climate-related financial risks and promote a principles-based approach to supervisory practices and risk management. Proposed revisions to the Core Principles include the following:

- amendments to CP8 *Supervisory approach* and CP10 *Supervisory reporting*: supervisors would be required to consider climate-related financial risks as part of their supervisory methodologies and processes, and banks would be required to provide information to enable regulators to assess climate-related financial risks;

- adjustments to CP15 *Risk management process*: banks would be required to adopt comprehensive risk management policies and processes for climate-related financial risks that take into account the impact of different and varying time horizons, and implement appropriate risk management measures;

- adjustments to CP26 *Internal control and audit*: this would require the consideration of climate-related financial risks as part of a bank’s internal control framework;

- amendments to CP14 *Corporate governance*: these amendments give greater emphasis to corporate culture and values and emphasize diversity

and inclusion on bank boards;

- amendments to CP15 *Risk management process*: proposes the introduction of the concept of business-model sustainability, with the key components of business-model sustainability set out in CP8 *Supervisory approach*; and
- revisions to CP25 *Operational risk and operational resilience*: these reflect the importance of resilience to operational risk-related events (including pandemics and natural disasters) and include an emphasis on risk-related interconnections and interdependencies.

The Basel Committee is seeking the views of stakeholders on the revised Core Principles, and comments should be submitted by October 6, 2023.

**Final Thoughts**

The Basel Committee's Consultative Document proposes certain key adjustments that have been informed by climate-related financial risks. The proposal recognizes the need for different, more comprehensive risk-management policies and processes that take into account that climate-related financial risk may materialize and/or have impacts over varying time horizons, potentially beyond current capital planning. While supervisors have long emphasized the potential impact of climate-related risk on the financial stability of the banking system, the Consultative Document recommends that targeted, specific amendments and adjustments be implemented to address climate-related financial risks. We have previously reported on Basel III Pillar 3 requirements, which have as a key objective enhancing a focus on ESG-related risks within the bank prudential regulatory framework. In particular, Pillar 3 requires a variety of ESG-related disclosures, including qualitative and quantitative information on transition and physical risks, exposure to at-risk sectors and green lending. More recently, we also have discussed a European Central Bank assessment from April finding that banks, on the whole, are unprepared to comply with the European Banking Authority's ("EBA") imminent Implementing Technical Standards (ITS) on Basel III Pillar 3 ESG risks.

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

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