CADWALADER

Credit Check

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In This Issue ...

This week we have a robust issue discussing recent guidance on using artificial intelligence, navigating regulations and more.

Mercedes Tunstall dives into the recent guidance from the Consumer Financial Protection Bureau that lays out what lenders using AI need to disclose when denying credit (spoiler alert: it is probably more, not less).

I discuss FDIC Chair Martin Gruenberg's speech this week on the financial stability risks posed by nonbank financial institutions compared to their insured bank counterparts.

We also highlight updates in the UK, including Policy Statement PS23/13 released by the UK's Financial Conduct Authority, the lowdown on the International Organisation of Securities Commissions consultation report and the European Commission's sustainability reporting standards.

What's on your mind? I'd love to hear. You can reach out to me here.

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

CFPB Issues Guidance on Credit Denials by Lenders Using Artificial Intelligence

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

On September 20th, the Consumer Financial Protection Bureau ("CFPB") published guidance – Consumer Financial Protection Circular, 2023-03 – regarding the list of reasons that must be provided when an applicant is denied credit, per the Equal Credit Opportunity Act, and its implementing Regulation, Regulation B. Accompanying Regulation B is an Appendix that contains a Sample Notification Form listing 23 denial reasons, as well as one open-ended denial reason, that could be used in an adverse action notice sent to the applicant regarding why they were denied credit. The CFPB's guidance states that while "[t]hese forms include a checklist of sample reasons for adverse action which 'creditors most commonly consider'", they have concluded that a creditor "may not rely solely on the unmodified checklist of reasons ... if the reasons provided on the sample forms do not reflect the principal reason(s) for the adverse action."

Practitioners should note the CFPB's use of "solely" in their conclusion. In the past, prudential regulator examiners have highlighted an institution's failure to use at least the checklist of reasons for their adverse action notices, even when some of the reasons do not apply, as being potentially non-compliant. With an unmodified list that extends to 23 denial reasons, many lenders have already had difficulty mapping each of these denial reasons to an aspect of their credit modeling (*i.e.*, the programming can become quite cumbersome with so many variables and denial reasons in play). Accordingly, as lenders have shifted their credit models to reflect new sources of data and more accurate ways of evaluating an applicant's credit risk, many have resorted to choosing a combination of denial reasons from the sample checklist that are the "closest, but nevertheless inaccurate, identifiable factors." Nevertheless, this guidance clearly indicates that the CFPB expects lenders to expand the list of denial reasons to include as many additional denial reasons that "relate to and accurately describe the factors actually considered or scored by a creditor." In other words, lenders will need to expand their list of denial reasons well past the 23 provided in the sample checklist, if applicable, but should be careful to continue to include at least those 23 denial reasons.

The CFPB's guidance also provides more targeted commentary on how lenders should expect to characterize denial reasons that result from the use of artificial intelligence (AI) solutions. As mentioned in guidance issued last year by the CFPB (which we covered in "No, Fancy Technology Does Not Excuse Compliance Obligations"), AI solutions often operate in a "black-box" that makes it difficult for humans to ascertain the exact reason for the results provided by the AI solution. At that time, the CFPB mandated the use of so-called "explainable AI", especially when it comes to denial reasons for adverse action notices. To wit, the instant circular provides the following example for how specific the denial reasons should be, especially when AI solutions are involved: "For instance, if a complex algorithm results in a denial of a credit application due to an applicant's chosen profession, a statement that the applicant had 'insufficient projected income' or 'income

insufficient for amount of credit requested' would likely fail to meet the creditor's legal obligations. Even if the creditor believed that the reason for the adverse action was broadly related to future income or earning potential, providing such a reason likely would not satisfy its duty to provide the specific reason(s) for adverse action."

FDIC Chair Speaks on Risks of Nonbank Financial Institutions Resolution of Large Regional Banks

By **Daniel Meade**
Partner | Financial Regulation

On Wednesday, Federal Deposit Insurance Corporation ("FDIC") Chair Martin Gruenberg gave remarks to the Exchequer Club of Washington on the financial stability risks of nonbank financial institutions.

Chair Gruenberg stated that nonbank financial institutions are critical financial intermediaries in the U.S. and global financial system, noting that in 2021, U.S. nonbank financial assets are estimated at approximately $20.5 trillion, compared to $23.7 trillion in assets held by U.S. insured depository institutions. Given this near parity with the banking system in terms of assets, Chair Gruenberg noted the ability of nonbank financial institutions can easily transmit risk into other parts of the financial system. He noted, however, that nonbank financial institutions often are not subject to the same prudential safety and soundness requirements that banks are subject to, and that poses risk that we should address.

Chair Gruenberg proffered that the Financial Stability Oversight Council ("FSOC") could be useful in addressing these risks, not only in its ability to designate systemically important nonbanks to be regulated by the Federal Reserve, but also through its ability to direct the Office of Financial Research to collect information from nonbanks to lend more transparency to their impact.

Chair Gruenberg went on to note that "[i]t is worth keeping in mind that nonbank financial institutions are not banks" and that "one of the impediments to the FSOC's nonbank designation process has been the perception of its binary nature." He called for development of "a more tailored process that reduces undue financial system risk while applying prudential regulation and resolution planning requirements that are fit-for-purpose in the context of a particular nonbank financial institution's risks" rather than the binary all-on or all-off prudential regulation for designated firms.

Chair Gruenberg also noted that he has already heard some criticism of the Basel III Endgame proposal, and arguments that it would push more activities to the "more lightly regulated 'shadow banks' and cause greater risk to the system." He concluded that "[t]he obvious response to that is there should be appropriately strong capital requirements for those activities in the banks, complemented by greater transparency, stronger oversight and appropriate prudential requirements for nonbanks. That would be the most effective and balanced way to enhance the stability of the entire financial system."

FCA's Introduction of a Gateway for Firms to Approve Financial Promotions

By **Jack Andrew Kelly**
Special Counsel | Financial Regulation

On September 12, 2023, the UK's Financial Conduct Authority ("FCA") published Policy Statement PS23/13 (the "Policy Statement") setting out its final position on the introduction of a new gateway for firms that approve financial promotions. This Policy Statement and final position follows from the FCA's Consultation Paper CP22/27 published in December 2022.

This initiative aims to bolster consumer protection and strengthen oversight and accountability in the UK financial promotion approval process and acknowledges the importance of maintaining high standards in financial promotions to protect consumers.

Financial Promotions

In the UK, financial promotions are regulated under section 21 of the Financial Services and Markets Act 2000 ("FSMA"), which, in the course of business, restricts a person from communicating an invitation or inducing to engage in an investment activity (that is, make or issue a financial promotion) unless:

- (i) that person is authorised by the FCA or the Prudential Regulation Authority in accordance with the FSMA;
- (ii) the content of the communication has been approved by an authorised person in accordance with the FCA rules; or
- (iii) the communication is covered by an exemption.

Before an authorised person approves a financial promotion either for itself or for communication by an unauthorised person, it must confirm that the financial promotion complies with the FCA's financial promotion rules and ensure that the financial promotion is fair, clear and not misleading. However, there is currently no requirement for a copy of the financial promotion to be submitted to the FCA.

The Gateway for Approval

The Policy Statement and corresponding amendments to section 21 of the FSMA introduces significant changes to the current process in which authorised persons approve financial promotions in the UK for communication by an unauthorised person by creating an online approval gateway operated by the FCA. This move comes in response to concerns about the quality and accuracy of advertisements related to financial products and services.

Once the new gateway comes into effect, all authorised persons that want to continue to approve financial promotions for unauthorised persons will need to apply to the FCA for permission to do so (subject to certain exemptions). They will

also be required to undergo rigorous screening checks to ensure their suitability for the role. This includes evaluating their competence and ability to carry out their duties effectively.

It will not affect authorised persons that only approve their own financial promotions for communication by an unauthorised person, the financial promotions of their appointed representatives for the regulated activities they have accepted responsibility for, or the financial promotions of unauthorised persons within their corporate group.

Firms need to consider whether there is a need for them to apply to continue to approve financial promotions for unauthorised persons.

Timing

While the new legislation will not come fully into force until February 7, 2024, the FCA intends for firms to be able to submit applications for permission to approve financial promotions through the new gateway from November 6, 2023.

Firms that have not applied to the gateway by February 6, 2024 will no longer be able to approve financial promotions (subject to exemptions).

Firms that apply to the gateway during the initial application period (*i.e.*, from November 6, 2023 to February 6, 2024) will be able to continue approving financial promotions for unauthorised persons while the FCA determines their application.

Firms that do not apply to the gateway during the initial application period that want to approve financial promotions in the future must apply to the FCA for permission to approve using a variation of permission form. However, they will not be able to approve financial promotions until the FCA has determined their application as successful.

(The author wishes to thank paralegal Queenie Je for her important contributions to this news item.)

IOSCO Consults on Good Practices for Leveraged Loans and CLOs

By Alix Prentice
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The International Organisation of Securities Commissions, or IOSCO, has published a Consultation Report on good practices for consideration in relation to leveraged loans and CLOs.

Background

Against a backdrop of low default rates, Leveraged Loan ("LL") and Collateralised Loan Obligation ("CLO") markets have evolved significantly since the Great Financial Crisis, both in terms of growth and in terms of borrower and investor base. This growth and a shift in market participants from banks to non-banks has led IOSCO to focus on what it sees as a rise in covenant-lite LLs using 'overly optimistic' EBITDA adjustments in increasingly complex documentation that potentially works to the detriment of LL investors. After extensive engagement with market participants, credit rating agencies and other professionals on the impact of fewer and looser covenants on investor protection, the adequacy of current transparency standards in the LL and CLO markets and other conduct issues, IOSCO is setting out 12 proposed good practices grouped into five themes spanning the intermediation chain from LL origination to sale of CLOs.

IOSCO Good Practices

Theme A – origination and refinancing based on a sound business premise:

- Measure 1 – debt repayment capacity test: this should be underpinned by sound business and financial risk assumptions and borrowers should be able to demonstrate sufficient debt repayment capacity (the ability to repay 100% of senior debt or 50% of total debt over the medium term).
- Measure 2 – dividend recaps: dividend recapitalisations should be considered by reference to remaining equity support, degree of leverage and debt repayment capacity and the use of incremental debt should be limited.
- Measure 3 – enterprise values ("EV"): EV's should be based on 'well-constructed' financial models with disclosure of key assumptions and independent review and validation.

Theme B – EBITDA and Loan documentation transparency:

- Measure 4 – EBITDA complexity and transparency: EBITDA definitions should not be unnecessarily complex and adjustments should be made on a reasonable and justified basis.
- Measure 5 – transparency on covenants' limitations: clear, concise and effective documentation on covenants' with full disclosure of key terms that could materially impact a borrower's credit risk.

Theme C – strengthening alignment of interest from loan origination to end investors:

- Measure 6 – transparency and fairness during underwriting and syndication: sufficient, clear information to allow well-informed investment decisions.

- Measure 7 – alignment of interest between underwriting entities and investors: whether through risk retention or other means. Underwriting entities and LL investors are "encouraged to obtain independent and impartial legal advice which represents their interests".

Theme D – addressing interests of different market participants throughout the intermediation chain:

- Measure 8 – reducing restrictions on transferability of loans: broad transferability and transparency of any restrictions are encouraged.

- Measure 9 – managing conflicts of interest where PE sponsors also act as lenders: conflicts management and disclosure are key here.

- Measure 10 – managing conflicts of interest in management of CLOs: the use of indentures and the provision of sufficient opportunity to do due diligence on valuation methodologies and results are emphasised alongside the identification and management of conflicts.

Theme E – disclosure of information on an ongoing basis:

- Measure 11 – disclosure in CLOs: regular provision of all materially relevant information on valuation, credit quality and performance of the CLO portfolio should be made according to local regulatory requirements.

- Measure 12 – disclosure on underlying loans: this should be timely, up to date and include any events that may invalidate affect any assumptions or impacts.

Final Thoughts

The draft of IOSCO good practices is intended for the "consideration of market participants" and are not standards or recommendations. Responses to the consultation and the questions it raises are due by 15 December 2023.

Investor Groups Raise Concerns Over European Sustainability Reporting Standards

By **Sukhvir Basran**
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By **Simon Walsh**
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On July 31, 2023, the European Commission adopted the long-anticipated European Sustainability Reporting Standards ("ESRS") for use by all companies subject to the Corporate Sustainability Reporting Directive ("CSRD"). The version of the ESRS published by the Commission in June 2023 made a number of significant changes to the first draft prepared by EFRAG in November 2022.

The European Sustainable Investment Forum ("Eurosif"), the Principles for Responsible Investment ("PRI"), the Institutional Investors Group on Climate Change ("IIGCC"), the European Fund and Asset Management Association ("EFAMA"), the United Nations Environment Programme Finance Initiative ("UNEP FI"), as well as 92 investors and other financial market participants expressed concerns about these changes in a joint statement published on July 7, 2023, in which they urged the Commission to reflect the integrity and ambition of the first set of ESRS as set out in EFRAG's final proposals of November 2022. Despite this, the final ESRS do not reflect the recommendations of various investor groups and remains largely unchanged from June 2023.

The Commission has emphasized that the standards adopted seek to address the regulatory burden on reporting companies while enabling companies to demonstrate their ESG credentials and access sustainable finance. The ISSB has also highlighted that collaboration between the Commission, EFRAG and the ISSB has resulted in a high degree of alignment among standards, which reduces complexity and duplication for reporting companies. Further assistance will be provided to companies through the publication of non-binding technical guidance by EFRAG.

The joint statement's signatories, however, point out that making disclosure requirements subject to a materiality assessment (as opposed to outright mandating disclosure in certain areas) has led to a misalignment between what companies are obligated to report under ESRS and the reporting obligations of market participants and investors under EU sustainability reporting frameworks. This threatens to adversely affect the ability of investors to access comparable data and information and therefore inform decisions and ultimately mobilize sustainable capital and investment. In addition, according to the joint statement, it is also likely to affect their ability to accurately comply with sustainability-related reporting and disclosure requirements, including under EU's Sustainable Finance Disclosure Regulation and Basel Pillar 3, potentially increasing greenwashing risk: "In light of the EU's climate objectives and investors' own climate commitments, reporting on GHG emissions, transition plans and climate targets should always be considered material and hence mandatory. This would ensure that investors can

access information from their holdings to support the alignment of their portfolios with net-zero and the Paris Agreement targets." Other market participants have also criticized the decision to make some biodiversity and social indicators voluntary.

The ESRS are subject to a two-month scrutiny period (extendable by a further two months) and are intended to apply from January 1, 2024 (for fiscal years beginning on or after that date).

Final Thoughts

We have frequently emphasized the importance of aligning reporting and disclosure frameworks to enable investors to compare sustainability credentials and make fully informed investment decisions. Greater collaboration among international standard setters also enhances interoperability and avoids duplication, as we have discussed here, here, and here.

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